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Recent and Prospective Developments in Taxation of Partnerships

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*Stephen A. Bauman***

The authors here analyze those provisions of the Revenue Act of 1962 pertaining to the taxation of partners and partnerships. They further discuss recent decisions and revenue rulings in this field as well as expected and proposed future legislation.

Subchapter K of the Internal Revenue Code of 1954[1] and the Regulations[2] promulgated pursuant to it introduced substantial and radical changes into the codified tax laws applicable to partners and partnerships. The developments in this area, however, from that time until now have been relatively few in number and conservative in nature. Whether it be that the partnership area is one which, because of its complexity or otherwise, causes more tax planning and consultation before transactions are consummated, whether it be that the provisions of the Code have not had time to be applied prospectively in published rulings or retrospectively in litigation following audits, or whether it be simply that the partnership is an infrequently used or seldomly audited entity, the amount of authority is sparse. The activity in the area in terms of recent developments is meager.

The Revenue Act of 1962 contains a few provisions which affect the partnership area, and through it, affect the individual partners. Two of these are areas of general application—the investment credit and the

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1. Unless otherwise indicated, all references herein are to the Internal Revenue Code of 1954.
2. T.D. 6175, 1956-1 CUM. BULL. 211.

potential recapture of depreciation. One pertains strictly to taxation of partnerships but is of insignificant importance—the continuation of the partnership taxable year for a surviving partner in a two-man partnership under the 1939 Code where one partner dies.

The recent developments in this area aside from the Revenue Act of 1962 cover a multitude of partnership and partner areas, questions, and problems. Many technical aspects of partnership reporting are involved. Some procedural areas are clarified, including certain elections available to partners and partnerships. Many substantive matters are included.

As thorough as was subchapter K and the Regulations (which were the result of excellent cooperation between the Treasury Department and the American Law Institute and the organized bar associations), many changes yet remain to be made before the codified, decisional, and governmental policy coverage of the law in this area is complete. All concerned recognized this and to some extent attempted to fill part of the void—H.R. 9662 as introduced in 1960 made a sweeping reform of the organization of subchapter K, along with a great many substantive alterations. H.R. 9662 died when not enacted. Some day its equivalent will be enacted, undoubtedly in the next session or two of Congress. Other legislation will follow. Court decisions will come down, and governmental policy will be expressed. The constantly changing nature of the law in general, and the tax laws in specific, will cause new legislation, new decisions, new policies.

This article will attempt to set forth the provisions of the Revenue Act of 1962 insofar as they affect the taxation of partners and partnerships, the recent developments in this area in brief detail and wide exposure, and the significant aspects of expected future legislation, including an analysis of certain parts of H.R. 9662.

REVENUE ACT OF 1962

The provisions of the Revenue Act of 1962 affecting the taxation of partners and partnerships for the most part do so only because partners are taxpayers, and the partnership is an income reporting entity. One of these provisions, however, does affect only partners and partnerships, although it is of extremely limited application. The provisions affecting all taxpayers in general will be discussed both insofar as they are new law, and also as they affect partners and partnerships.

I. INVESTMENT CREDIT

Sections 38, 46, 47, and 48, as added by section 2 of the Revenue Act of 1962, give a credit against tax equal to a percentage of the

investment in certain productive facilities. The credit is seven per cent of qualified investment in new, and to the extent of $50,000, in used depreciable personal property. The credit is subtracted from the tax liability and offsets it dollar for dollar up to the first $25,000 of tax and in an amount equal to one-fourth of the tax over $25,000. The amount of credit not usable because of the limitation in a current year may be carried back to the three preceding years (but not before 1962) and carried over to the succeeding five years. If the carry-over expires unused, a deduction is allowed to compensate for the over-reduction in basis. The credit reduces the basis of the assets and thus limits total depreciation allowances. If certain dispositions of property qualifying for the investment credit are made, the tax for the year of disposition is increased by the amount that the credit or carry-over would have been decreased had the original credit been computed in the period of actual use instead of estimated use. If the credit is adjusted under the recapture rule, an upward adjustment of basis is made.

Where a partnership purchases qualified property, the limit on the credit is figured separately for each partner so that each may take a credit against his own individual tax up to $25,000 on a dollar for dollar basis, and for one-fourth of the amount over $25,000, on his proportionate part of the partnership's purchase of property qualifying for the investment credit. The $50,000 limit on the acquisition of used property in any one year which may qualify for the investment credit applies at both the partnership and partner level.[3]

Several problem areas arise, however, to which the Code fails to pay attention, and the answers to which may require patience until the Regulations have been issued or until the courts interpret the statute, the Regulations, or both. First is the question of what happens upon the transfer by a sole proprietor of qualifying property, with respect to which the proprietor has claimed the investment credit, to a partnership in exchange for an interest in the partnership. Will the credit and its potential recapture be transferred to the partnership, or will the transfer be a premature disposition by the sole proprietor calling for a restoration of the credit as an addition to the tax liability for that year? If the latter, will the sole proprietor be allowed a deduction for the unused portion, including any restoration? It would seem that, consistent with expressed congressional intent not to tax individuals on contributions to partnerships under section 721, no early disposition should occur, but rather that there should be a carry-over of the credit and the potential recapture to the partnership. Consistency also would indicate that this should be an item available for allocation to the

3. INT. REV. CODE OF 1954, § 48(c)(2)(D) as added by § 2(b) of the Revenue Act of 1962.

contributing partner under section 704, so that any credit, or potential recapture, or both, could be allocated to the contributing partner. The Senate Finance Committee Report,[4] however, indicates that a premature disposition occurs upon a transfer of qualifying property to a partnership.

What about the situation where the partnership acquires qualifying property and claims the investment credit and the profit and loss ratio or the interests in capital of the partnership thereafter change, or partners are added or leave the partnership for one reason or another? Upon a premature disposition, in what ratios do the partners report the resulting increase in tax? Does the partnership profit and loss ratio as of the date of acquisition of the property determine the persons required to report the increase and the percentages allocated to each, or does each year stand on its own so that an individual may be required to report part of the increase in a year in which he becomes a partner or thereafter even though he was not a partner at the time the property was acquired? The Senate Finance Committee Report[5] indicates that the sale by any partner of his interest in the partnership is a cessation of use of section 38 property.

What about a sale of a partnership interest, withdrawal from the partnership, the death of a partner, or other means by which a partner's interest in the partnership terminates? The Committee Reports also provide that an individual transferring property to a partnership as a contribution will no longer be entitled to the credit; the contribution of property constitutes a mere change in form of operating the trade or business. The Committee Reports also provide that if the aggregate cost of used property which qualifies for the investment credit purchased by the partnership during a taxable year exceeds $50,000, the partnership, under Regulations to be prescribed, is to select the properties, the cost of which is to be taken into account by the partners. Each partner will then combine his share of the cost of the used property to which he may be entitled. This combined amount may not exceed $50,000. If the amount does exceed $50,000, the taxpayer will then select the properties to which the applicable percentages are to be applied in computing his qualified investment and resulting credit.

II. Ordinary Income upon Certain Disposition of Depreciable Property

Section 1245, as added by section 13 of the Revenue Act of 1962 provides that gain on certain dispositions of depreciable property will constitute ordinary income to the extent of depreciation deduc-

4. S. Rep. No. 1881, 84th Cong., 2d Sess. (1962).
5. *Ibid.*

tions taken on the property after December 31, 1961, where the dispositions of this type property occur in taxable years beginning after 1962.

Contribution of such property to a partnership by a partner has no immediate tax consequences, but the partnership carries over the individual partner's potential realization of ordinary income.[6] A partner will have ordinary income to the extent of his share of the section 1245 gain attributable to any of the partnership's assets when he sells his interest in the partnership. Again, consistency would indicate the propriety of allocating all or any part of the potential recapture to the individual partner contributing the property in which it is imbedded, under section 704. If his interest is partially or completely liquidated, he will realize income if he does not get his pro rata share of section 1245 property; the converse is also true in that the other partners will realize income if the partner whose interest is being liquidated receives more than his share of section 1245 property. The Revenue Act of 1962 accomplishes this by adding a sentence to section 751(c) which, for purposes of sections 731, 736, and 741 defines unrealized receivables to include section 1245 property to the extent of the amount which could be treated as gain if such property had been sold by the partnership at its fair market value at the time of the transaction described in sections 751, 741, 736, or 731.

III. Continuation of a Partnership Year for Surviving Partner in a Two-Man Partnership Where One Dies

The Revenue Act of 1962 amends section 188 of the Internal Revenue Code of 1939 by adding a new subsection (b). This provides that if the surviving partner so elects within one year after the date of enactment of the Revenue Act of 1962, the death of one of the partners of a partnership consisting of two members shall not result in the termination of the partnership or in the closing of the taxable year of the partnership with respect to the surviving partner prior to the time the partnership year would have closed if neither partner had died or disposed of his interest. The amendment applies only with respect to taxable years of a partnership beginning after December 31, 1946, to which the 1939 Code applies (*i.e.*, taxable years beginning before January 1, 1955).

Under the 1954 Code in this situation the partnership year does not close before the deceased partner's interest is liquidated or disposed of, or the partnership year closes at its normal end, whichever occurs first.

6. Int. Rev. Code of 1954, § 1245(b)(3), as added by § 13(a) of the Revenue Act of 1962.

Under the amendment to the 1939 Code, where the survivor and the partnership have different taxable years, the effect is to prevent a bunching of income in the survivor's return in the year of the other's death. It would seem, however, that the section may not prevent bunching in the succeeding year, unless the survivor continues the business in partnership either with the deceased's successor or another. The section is elective as to the survivor. No relief is given to the estate of the deceased partner.

It appears that the provision is of limited application, and perhaps even of the special-favor legislation type.

OTHER RECENT DEVELOPMENTS

Aside from the Revenue Act of 1962, the recent developments in the area of taxation of partnerships and partners touch a great many areas, some important, some minor, some with broad application and implication, others with only slight relevance to the everyday operation and conduct of the partnership business. This article will attempt to set forth a brief summary of what the law in a particular area is or has been, and how it has been affected, changed, altered, or modified by the recent development.

I. Elections: Form of Organization

The Code and the Regulations create a series of elections available to partners and partnerships which enable the partners to achieve a certain degree or amount of equity and equitable results among or between themselves.

One of these elections provides that if all the members of an unincorporated organization so elect, the organization can be excluded from the operation of the partnership tax provisions, if it is availed of

> for investment purposes only and not for the active conduct of a business, or for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.[7]

The Regulations[8] as originally issued provided that the election is made by the filing of a properly executed partnership return, together with a statement containing the names and addresses of all the members, a statement that the organization qualifies for the election and a statement that the organization elects to be excluded from the operation of the partnership tax provisions. These

7. Int. Rev. Code of 1954, § 761(a).
8. Treas. Reg. § 1.761-1(a)(2)(iv)(a) (1956).

regulations have been changed[9] so that in order to so elect, the statement must be that all of the members of the organization elect to be so treated rather than that the organization so elects. The Treasury Department then ruled that the statement that all the members have elected to have the organization excluded from the operation of the partnership tax provisions will not be disputed.[10] The amended Regulations discussed above[11] provide that the election is not effective if any member of the organization notifies the Commissioner that he wishes the partnership provisions to be applicable. The Treasury Department here ruled[12] that if the organization's election has been filed prior to time of receipt of the notice, the organization may file a regular partnership return as an amendment to the original return, and in doing so may then properly exercise any elections which were available to it as a partnership in the event it had filed a timely original return. The Treasury Department also ruled[13] that the election, which, so long as the organization qualifies for such treatment, cannot be revoked except with the consent of the Commissioner, is not affected by a sale of a member's interest.

An organization may desire to be excluded from the operation of some partnership provisions but want others to apply. The Treasury Department has ruled[14] that approval will not be granted for exclusion from section 706(b), which would eliminate the requirement of the business purpose for adoption of a partnership taxable year different from that of all the principal partners. Another Treasury Department ruling provided that approval likewise will not be granted for exclusion from the provisions of section 704(d), which would eliminate the limitation restricting the deduction of a partner's distributive share of partnership loss to the adjusted basis of his interest in the partnership.[15]

Another Treasury Department ruling held that an operating company that is required to file returns for many ventures with the same membership may file a single Form 1099 for each individual, listing the organizations in which he is a member, and a Form 1096 for each organization.[16]

A partnership arrangement is often similar to the relationship of debtor and creditor. However, the Fourth Circuit Court of Appeals

9. T.D. 6198, 1956-2 Cum. Bull. 461.
10. Rev. Rul. 56-500, 1956-2 Cum. Bull. 464.
11. See note 8 *supra.*
12. See note 10 *supra.*
13. *Ibid.*
14. Rev. Rul. 57-215, 1957-1 Cum. Bull. 208.
15. Rev. Rul. 58-456, 1958-2 Cum. Bull. 376.
16. Rev. Rul. 58-132, 1958-1 Cum. Bull. 257.

held[17] that a partnership existed where, after loaning money to an inventor over a period of years, an attorney entered into a written agreement with the inventor whereby he agreed to advance expenses for purposes of experiments, and the parties were to share the profits from the venture. The agreement was upheld as valid and not a sham, even though its expressed purpose was to give the attorney a deduction for part of the expenses to be incurred for future research and experiments. The Fourth Circuit Court of Appeals denied the taxpayer's deduction for the same expenses represented by advances made by him to the inventor prior to the date the written agreement was executed, on the ground that the inventor, rather than the attorney, made the experimental expenditures. The parties admitted that the primary purpose of the written agreement was to record the tenor of the mutual understanding of the parties for purposes of section 174(a)(1) of the 1954 Code. The Tax Court had found that the taxpayer's advances were loans throughout the years in question, but the court of appeals, though recognizing the reason for execution of the agreement as tax-founded, held that the written agreement was not a sham and that the parties intended to be bound by it. The court said:

> In this instance, the decision of the parties to the agreement to define their relationship so as to take advantage of the benefits of the statute was in harmony with the purpose of the enactment to encourage expenditure for research and experimentation.[18]

II. ASPECTS OF THE PARTNER'S INCOME

Under the 1939 Code, two courts of appeals have held[19] that a partner's share of partnership capital gains and losses must be used to offset the capital gains and losses of the individual. The Tax Court has now also accepted this rule.[20] Similarly a recent Treasury Department ruling held that nonbusiness income or loss of the partnership is reflected at the individual partner level before the net operating loss provisions are applied at the partner level.[21]

The Treasury Department has ruled that dividends received by the partnership are treated as having been received by the partners on the date they are received by the partnership.[22]

17. Cleveland v. Commissioner, 297 F.2d 169 (4th Cir. 1961), *reversing in part* 34 T.C. 517 (1960).
18. *Id.* at 173.
19. Commissioner v. Ammann, 228 F.2d 417 (5th Cir. 1955), *reversing* 22 T.C. 1106 (1954); Commissioner v. Paley, 232 F.2d 915 (9th Cir. 1956), *reversing* 22 T.C. 1236 (1954).
20. Mae E. Townend, 27 T.C. 99 (1956).
21. Rev. Rul. 56-233, 1956-1 CUM. BULL. 51.
22. *Ibid.*

The Tax Court has held[23] that excessive rent paid by a corporation to a partnership composed of its stockholders which was disallowed as a deduction to the corporation nevertheless kept its same classification as a corporate distribution at the individual partner level, despite the fact that this results in a capital gains tax for the earnings and profits, instead of it being taxed as rental income. The constructive dividend exceeded both the corporation's current earnings and profits and its accumulated earnings and profits. The taxpayer's principal argument was that the income which the partnership and the partners reported as rent changed its character to dividends by reason of the Tax Court's validating the Commissioner's determination that the amount was not deductible as rent. The Tax Court accepted this theory.

The Tax Court has held[24] that where a partnership agreement contemplates that travel and entertainment expenses necessary to the conduct of the partnership business will be paid for by one partner without reimbursement from the partnership, that partner is entitled to deduct the amount on his individual return. By the agreement of the partners, one of them was required to pay these expenses out of his own funds, and the court found this entitled him to deduct them from his gross income. Although the evidence did not disclose the exact terms of the agreement, the partner in question testified, without being contradicted, that in making payment of the unreimbursed expenses, he had followed a partnership practice which had become routine. The taxpayer further testified, without contradiction, that such practice had arisen through his own acquiescence in the other partners' position that the taxpayer must bear such partnership expenses because the partnership agreement provided he was to receive an allowance of five per cent of sales to cover them. The court found that such an arrangement was tantamount to an agreement between the partners that the taxpayer should bear the unreimbursed expenses out of his personal funds. The court held that he was entitled to deduct them from his individual gross income to the extent they were actually paid by him and were ordinary and necessary expenses of the partnership.

The Treasury Department has ruled[25] that a city income tax on net profits, which is not deductible by a sole proprietor in determining his adjusted gross income, is deductible by the partnership in determining its taxable income, and that the partnership's deduction does not prevent any individual partner from utilizing the standard deduc-

23. Fairmount Park Raceway, Inc., 21 CCH Tax Ct. Mem. 52 (1962).

24. Frederick S. Klein, 25 T.C. 1045 (1956); *cf.* Robert S. Wallendal, 31 T.C. 1249 (1959).

25. Rev. Rul. 58-25, 1958-1 CUM. BULL. 95.

tion on his own individual return. Where one partner was entitled to all of the partnership income, the Tenth Circuit Court of Appeals held[26] that the deduction of real estate taxes by the partnership, where the partnership owned the real estate did not preclude any individual partner from using the standard deduction if the partnership's existence had not ceased.

III. Allocations: Modifications: Fraud or Dispute: Capital Adjustments: Assignments

A. General

Under the 1939 Code, there was no statutory sanction for partners allocating items of income or deduction in other than the partnership profit and loss ratio. However, the Treasury Department has ruled[27] that under the 1939 Code partners properly could allocate items of income and loss in ratios other than the profit and loss ratio contained in the partnership agreement, conditioning the ruling so as to prevent allocations which were for tax avoidance purposes. The ruling took cognizance of the allocation provided for by the 1954 Code insofar as the partnership agreement provides for disproportionate sharing by the partners of any item of partnership income, gain, loss, deduction, or credit.[28] It also took note that this provision was substantially in accord with existing practice. The ruling, therefore, allowed such allocation, and held that in such event, only one partnership existed for federal income tax purposes.

Any changes or modifications made to the partnership agreement are effective for tax purposes for any given taxable year of the partnership if made prior to or at the time prescribed by law for the filing of the partnership return for that taxable year. Such changes or modifications must be agreed to by all the partners or adopted in the manner provided for by the partnership agreement.[29] A case decided under the 1939 Code held[30] that such a retroactive allocation shonld be given effect, where the partnership agreement called for division of the income at the end of the year on a mutually agreeable basis, irrespective of the individual partner's percentage interests. The Tax Court found no reason for disregarding the allocation arrived at by the partners, and likewise found no assignment of income by one part-

26. Miller v. Commissioner, 285 F.2d 843 (10th Cir. 1961), *reversing* 32 T.C. 954 (1959).
27. Rev. Rul. 57-138, 1957-1, Cum. Bull. 543, revoking Rev. Rul. 56-134, 1956-1 Cum. Bull. 649.
28. Int. Rev. Code of 1954, § 704(b).
29. Int. Rev. Code of 1954, § 761(c).
30. Hyman P. Minkoff, 15 CCH Tax Ct. Mem. 1404 (1956).

ner to a related partner. However, the Tax Court, affirmed by the Third Circuit Court of Appeals, held[31] that a partner cannot properly deduct a state tax he paid on the income of the partnership after the partnership had terminated where he gratuitously waived his right of contribution from the remaining partners. The Tax Court disallowed the deduction on three grounds. One, the taxes involved were not those of the partner, but those of the partnership, and as such could not be deducted by a partner. Two, they were not the ordinary or necessary expenses of a business being conducted by the partner. Three, they were not uncompensated losses sustained by the partner in a profit transaction.

B. Effect of Fraud or Dispute

Normally, where the partnership has received income, it is taxable to the individual partners in accordance with the profit and loss ratios. No deferment of the taxation of the income to the individual partners is proper where only a dispute between the partners has arisen.[32] The Tax Court's rationale is that the principles of scienter and actual receipt have no application to the issue of whether or not partners are to be charged with their distributive shares of partuership profits, even if one or more partners are on the cash basis. Where, however, one partuer disputed the existence of liability on his part for any partnership loss in excess of his capital account, the Second Circuit Court of Appeals held[33] that the other partners properly deducted that share in the year of dispute where their claim against him had no value.

A similar situation is where one partner fraudulently conceals or shifts income. The Tax Court indicated[34] that the determination to be made in such a case is whether the partnership or the individual received the income. If the partuership receives it, the Tax Court held[35] that, even so, the cheated partner must include his share of income under the partnership agreement and the profit and loss ratio contained therein. If the partnership engages in illegal business activities, and a partner appropriates income to himself without the other partners finding out about it, the Tax Court held[36] that the embezzling partner is taxed on the amount in its entirety and that the

31. Daniel W. Farnsworth, 29 T.C. 1131 (1958), *aff'd*, 270 F.2d 660, (3d Cir. 1959), *cert. denicd*, 362 U.S. 902 (1960).
32. United States v. Baker, 233 F.2d 195 (10th Cir. 1956); Beck Chem. Equip. Corp., 27 T.C. 840 (1957).
33. Kugel v. Ryan, 289 F.2d 329 (2d Cir. 1961).
34. See Commissioner v. Smith, 285 F.2d 91, Daniel S. W. Kelly, 23 T.C. 682 (1959).
35. Jack Starr, 17 CCH Tax Ct. Mem. 253 (1958), *aff'd on this issue*, 267 F.2d 148 (7th Cir. 1959).
36. George Woods, 17 CCH Tax Ct. Mem. 698 (1958).

other partners are not taxed on any part of it, where under local law the other partners had no right to recover any part of the embezzled amounts. The Tax Court based its decision on the fact that none of the other partners received any of the funds and they were without legal recourse to recover the amounts.

C. Capital Account Adjustment

The Tax Court held[37] that a partner who was performing services on behalf of the partnership realized ordinary income when, as a result, he became entitled to a portion of the capital interest of the partnership from an investing partner who performed no such services for the partnership. The Tax Court based its decision on the rationale of a case[38] which held that a reallocation of capital to which partners become entitled because of the accumulations of partnership earnings is taxable income at the time they become entitled to it. Since the partnership agreement provided for the working partners to receive the increase in their capital account only when the partnership was liquidated, the Tax Court held that they were not taxable on it until that time. The Tax Court viewed the case as identical in tax consequences as if the other partners had paid the partners performing services the fair market value of the partnership interest transferred, under an agreement where the working partners were obligated to use the money to increase their investment in the partnership. The Tax Court felt that under those facts there could be no question but that the amount would be taxable to the working partners. The Tenth Circuit Court of Appeals, however, found[39] that the agreement vested the increase in the capital account at the time of the investing partner's contribution, and held that the working partners had no taxable income at the time of liquidation. The Tenth Circuit failed to indicate whether there were any tax consequences at the time of contribution.

In a case arising under the 1939 Code, one partner performed services and another invested capital. The Ninth Circuit Court of Appeals held[40] that the partner performing services realized capital gain on amounts received by him in liquidation of the partnership representing payment for his right under an executory contract to acquire a capital interest in the partnership from the other partner. The Ninth Circuit was not influenced by the fact that the liquidation took place before the partner performing services acquired any vested right to his interest in the partnership. The court based its decision on his contractnal right to receive an interest in the partnership at such

37. Leonard A. Farris, 22 T.C. 104 (1954).
38. Harry W. Lehman, 19 T.C. 659 (1953).
39. Farris v. Commissioner, 222 F.2d 320 (10th Cir. 1955).
40. Dorman v. United States, 296 F.2d 27 (9th Cir. 1961).

time as his share of the profits would have paid for his interest. The court felt that this right was a capital asset.

D. Assigning Partnership Income

The Supreme Court held[41] many years ago that although a partner assigned his share of partnership income to a third party, he was taxable on it. The Tax Court held,[42] distinguishing the Supreme Court decision, that where a partner assigns part of his partnership interest to a third party, and not just a share of partnership income, the third party is taxable on the income of that part, whether or not distributed to him, just as if he were a partner to that extent. The court ruled against the contention that the assignee was only taxable on actnal receipts to the extent they exceeded the adjusted basis for his interest in the partnership. The Tax Court based its decision on the action, conduct, and testimony of the parties to the basic partnership agreement, all of which, according to the Tax Court, clearly established the intention of the parties to make the third party a partner within the meaning of the Code.

IV. Adoption of Taxable Year

A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners, or the same as the taxable year to which all of its principal partners are concurrently changing, without the prior approval of the Commissioner.[43] The Treasury Department has ruled[44] that the short taxable period of any partner resulting from the change by such a partner of his taxable year to conform with the taxable year of the partnership must be cut off at the last day of the first taxable year of the partnership, whether or not such taxable year is a year of twelve full calendar months.

The Regulations[45] indicate that one acceptable business purpose for a newly formed partnership adopting a taxable year other than that of all of its principal partners is the intention of the partnership to make its tax year coincide with its natural business year, *i.e.*, the annual accounting period of time that encompasses all related income and expenses. However, the Treasury Department has ruled[46] that a partnership may not adopt a different taxable year from that of its partners where the reasons are merely to show a full year's operations in the first accounting period and to make it convenient for the partners to complete their federal income tax return.

41. Burnet v. Leininger, 285 U.S. 136 (1933).
42. Edith W. Adams, 20 CCH Tax Ct. Mem. 150 (1961).
43. Treas. Reg. § 1.706-1(b)(1) (ii) (1956).
44. Rev. Rul. 60-268, 1960-2 Cum. Bull. 206.
45. Treas. Reg. § 1.706-1(b)(4)(ii) (1956).
46. Rev. Rul. 60-182, 1960-1 Cum. Bull. 264.

V. SALARY: LOSSES: PARTNER-PARTNERSHIP TRANSACTIONS

Transactions between a partner and the partnership are considered as occurring between the partnership and an independent third party.[47] A Tax Court decision under the 1939 Code followed[48] this rule in recognizing as valid a loan by a partner to a partnership. On the other hand, the Tax Court held[49] that where a disabled partner received payments twice each month from his accounting partnership, the amounts should be treated as distributions of the profit rather than nontaxable remuneration, there being no evidence that he would have received any payments had there been no profits.

Salary paid to a partner is deductible by the partnership and reportable by the partner at the close of the partnership taxable year.[50] This assures that the tax results to all partners, both those receiving salary and those not receiving salary, will be proper in the event salary causes an operating deficit to the partnership. Thus, if the net income of the *XYZ* partnership is $3,000 before *X* receives a salary of $9,000, the partnership has an after-salary deficit of $6,000. If *X*, *Y*, and *Z* share profits and losses equally, *Y* and *Z* would each be allocated $2,000 as their distributive share of the partnership loss. *X*'s salary of $9,000 would be reduced by his $2,000 distributive share of the partnership loss, and he would have a net taxable income from the two transactions of $7,000.[51]

Generally, guaranteed salary is given the same treatment received by distributive shares of partnership income. It is not usually treated as remuneration for services rendered. The Treasury Department has ruled[52] that amounts paid by a partnership to a member who is absent from his partnership work due to an accident or sickness, do not constitute wages or payments in lieu of wages for a period during which an employee is absent from work and that such amounts may not be excluded from the partner's gross income under section 105(d) of the Code. The basis for the ruling was that a partner is not an employee of the partnership for purposes of section 105(d) even though he may be under section 707(c) for purposes of payments to him for services rendered.

A. LOSS ON PARTNERSHIP—PARTNER SALES

The general rule of application here is that gain or loss on a sale of property by the partner to the partnership, or vice versa, is

47. INT. REV. CODE OF 1954, § 707(a).
48. George A. Butler, 36 T.C. 1097 (1961).
49. Estate of Thomas J. O'Brien, 21 CCH Tax Ct. Mem. 944 (1962).
50. INT. REV. CODE OF 1954, §§ 707(c), 706(a).
51. See Rev. Rul. 56-675, 1956-2 CUM. BULL. 459.
52. Rev. Rul. 56-326, 1956-2 CUM. BULL. 100.

deductible in its entirety.[53] Two exceptions to this rule are designed to prevent tax avoidance. First, where a majority partner buys from or sells to the partnership, or one partnership sells to another partnership with the same majority interests, the loss is disallowed.[54]

A majority partner is one owning more than 50 per cent interest in partnership profits or capital. The constructive rules of ownership of section 267(c) are used to determine whether a person is a majority partner. For example, if a partnership is composed of three equal partners, *X*, *Y*, and a trust for the benefit of *X*'s wife, *X* is deemed to own, by the application of the constructive rules of ownership, more than a 50 per cent interest in the partnership. Any loss on a sale between him and the partnership would be disallowed. However, if *X*'s wife sold to, or bought from, the partnership, only two-thirds of the loss, attributable to the interests owned by *X* and the trust, would be disallowed.[55]

Second, where a controlling partner buys or sells to the partnership depreciable property and/or land used in a trade or business, or a controlled partnership sells any such property to another controlled partnership, the gain is taxable as ordinary income. A controlling partner is one that owns, directly or indirectly, more than an 80 per cent interest in the capital or profits of a partnership. Controlled partnerships are those in which the same persons, either directly or indirectly, own more than 80 per cent interest in the capital or profits of each.[56]

Again the constructive ownership rules of section 267(c) are applicable.[57] The Tax Court held[58] that where four brothers sold a patent owned by them to their partnership, the income was taxable as ordinary income pursuant to the above rules. The basis for the Tax Court's holding was that both before and after the transfer, the partners had the same economic interest in the patent, taking into account the attributive rules of ownership under section 267(c).

VI. Sales and Leases by a Partner to the Partnership

Very often one or more of the partners, rather than either contributing certain property to the partnership or selling it to the partnership, will retain title to it and lease it to the partnership. The Treasury Department has ruled[59] that even if local partnership law

53. Int. Rev. Code of 1954, § 707(a).
54. Int. Rev. Code of 1954, § 707(b)(1).
55. Treas. Reg. § 1.707-1(b)(3) (1956), as amended by T.D. 6312 (1958).
56. Int. Rev. Code of 1954, § 707(b)(2).
57. Int. Rev. Code of 1954, § 707(b)(3).
58. George D. Soffron, 35 T.C. 787 (1961).
59. Rev. Rul. 55-39, 1955-1 Cum. Bull. 403. See Treas. Reg. § 1.704-1(c)(1) (1956).

operates in such a way as to subject property a partner has leased to the partnership to claims against the partnership, the lessor-lessee relationship will be recognized for tax purposes. The situation covered in the ruling was one where the lending partner owned the entire economic interest in the leased property.

In the situation where two equal partners, who were also equal owners of the stock of two corporations, decided to discontinue their business ties, and to carry out the plan contributed all their stock to the partnership, each receiving all the stock of one corporation in liquidation of the partnership, the Treasury Department ruled[60] that a taxable exchange of stock resulted.

VII. Basis Problems

Any increase in a partner's share of the liabilities of a partnership, or in his individual liabilities because of his assumption of partnership liabilities, is treated as a contribution of money by him to the partnership.[61] It therefore increases his basis for his partnership interest.[62] The Tax Court has applied[63] the provisions dealing with basis of a partnership interest upon death of a partner and the effect of assumption of partnership liabilities upon distribution of partnership assets in liquidation of the partnership.

A partner's distributive share of partnership loss, including capital loss, is allowed only to the extent of the adjusted basis of his interest at the end of the partnership year in which the loss occurred.[64] The Treasury Department has ruled[65] that for purposes of calculating the allowable loss for a partner in a particular year, the basis of the partnership interest should reflect his portion of the partnership's current liabilities even where the partnership is on the cash basis of accounting and consequently has not reflected the liabilities on its books.

VIII. Distribution by the Partnership: Payments to a Retired or Deceased Partner

The 1954 Code provides that a partner does not recognize gain on distributions of money by the partnership except to the extent it exceeds his adjusted basis for his partnership interest just prior to the distribution.[66] Thus, a partner is allowed to completely recover his basis. On the other hand the Treasury Department has ruled[67] that

60. Rev. Rul. 57-200, 1957-1 Cum. Bull. 205.
61. Int. Rev. Code of 1954, § 752(a).
62. Int. Rev. Code of 1954, § 722.
63. M. Pauline Casey, 38 T.C. No. 41 (June 21, 1962).
64. Int. Rev. Code of 1954, § 731(a).
65. Rev. Rul. 60-345, 1960-2 Cum. Bull. 211.
66. Int. Rev. Code of 1954, § 731(a).
67. Rev. Rul. 56-5, 1956-2 Cum. Bull. 630.

under the 1939 Code, where only a portion of a partner's interest is liquidated, capital gain or loss resulted in an amount equal to the difference between the amount received and the adjusted basis of the proportionate part of the partnership interest that is liquidated.

Where one partner in a two-man partnership retired, the Tax Court held[68] that the substance of the transaction, rather than being a distribution by the partnership in retirement of the partner, under section 736, was the sale of a partnership interest by one partner to the other.

The valuation which the partners set for good will in an arm's length agreement, whether a fixed amount or ascertainable by use of a formula, is generally given effect for tax purposes.[69] The Tax Court held[70] that this necessitates a specific recital in the partnership agreement spelling out the fact that the particular amount or formula is for good will. Even if the general tenor of the agreement is such as to indicate some payment for good will, that will not suffice—the formula or amount must be directly specified to be for good will.

IX. Estate Tax Aspects of Income After Death

The United States Supreme Court, in *Bull v. United States*,[71] held that the decedent's gross estate for federal estate tax purposes did not include the present value of the right of the estate to participate in the future profits of the partnership for a period after death. The record in the case as it came before the Supreme Court was unusual and contained certain peculiarities; the facts in the case were also unusual. A factor that appears to have been of major consequence in the decision was that under the partnership agreement the amounts received did not represent payment for the deceased partner's interest in partnership capital. As a result of all these factors, the *Bull* decision may be limited to its facts. Later decisions, in fact, have held[72] that the *Bull* case does not preclude the inclusion in the gross estate of the present value of the right of the estate to participate in the future profits of the partnership earned after the death of the deceased partner.[73]

68. Leo Melnik, 20 CCH Tax Ct. Mem. 74 (1961).
69. Treas. Reg. § 1.736-1(b)(3) (1956).
70. V. Zay Smith, 37 T.C. No. 102 (March 6, 1962).
71. 295 U.S. 247 (1935).
72. United States v. Ellis, 264 F.2d 325 (2d Cir. 1959), *affirming* 154 F. Supp. 32 (S.D.N.Y. 1957); Riegelman v. Commissioner, 253 F.2d 315 (2d Cir. 1958), *affirming* 27 T.C. 833 (1957); McClennen v. Commissioner, 131 F.2d 165 (1st Cir. 1942); Alan M. Lincoln, 1 CCH Tax Ct. Mem. 326 (1942); Rev. Rul. 55-123, 1955-1 Cum. Bull. 433.
73. See Willis, Partnership Taxation 397-99 (1957); Bauman, *Income in Respect of a Deceased Partner*, 15th U.S.C. Tax Inst. (1962).

The Senate Finance Committee Report covering section 753 contains a roundabout reference to payments under section 736(a) made to the successor in interest of a deceased partner which might be thought to raise the problem again:

> Section 753 thus covers payments in the nature of mutual insurance as well as payments attributable to the decedent's interest in the unrealized receivables of the partnership. While a successor in interest of a decedent partner will be required to include in gross income amounts received from the partnership which are attributable to the value of the decedent's interest in unrealized fees or mutual insurance, the recipient will at the same time receive a deduction *for the estate tax paid with respect to the inclusion of such rights to income in the decedent's estate.* (Emphasis added.)[74]

The matter is also made confusing by the fact that section 753 applies only in the case of payments with respect to decedents dying after December 31, 1954. With reference to the effective date of section 753, the Conference Committee Report states:

> The paragraph restricts the application of Section 753 to decedents dying after December 31, 1954, and leaves unchanged the treatment of payments made with respect to prior decedents. *No inference is intended as to the inclusion of the value of the right to such payments in the gross estate of the decedents dying prior to January 1, 1955.* (Emphasis added.)[75]

One might feel that the Committee Reports could be interpreted to mean that there will be a new effort by the Treasury Department to require the inclusion in the gross estate of the right of the estate to participate in the future profits of the partnership earned after the death of the deceased partner. Notwithstanding the *Bull* decision, which is undoubtedly limited to its facts, it is likely that a court would be persuaded that the right to such payments is an asset of the estate.[76]

One problem that does exist, however, is the valuation of the right to payments unascertainable in amount because they are based on future income, especially where they are uncertain and difficult to predict.

The Tax Court in the recent case of *Arthur H. Hull,*[77] in fixing the value to be included in the gross estate of the right of a deceased partner's estate to receive a share in the net income of the partnership for several years after his death, took into consideration the reduction of payments under a compromise agreement entered into on the date

74. S. REP. No. 1622, 83d Cong., 2d Sess. 405 (1954).

75. H.R. REP. No. 2543, 83d Cong., 2d Sess. 66 (1954).

76. For a complete discussion of this problem, see WILLIS, PARTNERSHIP TAXATION 397-99 (1957).

77. 38 T.C. No. 54 (July 27, 1962).

of the decedent's death by all the partners except the decedent.[78] In addition, even though the alternate valuation date was used, discount of the right was permitted to the date of death rather than to the alternate valuation date elected by the executors. The court also held that the actual partnership income for the year of death, rather than for the year after death, should be used in estimating future partnership income.

It now appears, therefore, that the present value of the right of the estate of the deceased partner to receive part of the post-death partnership income is an asset of the decedent's estate and includible therein. However, one court which declined to follow the rationale of the *Bull* decision, the Second Circuit Court of Appeals, has indicated[79] that only partnership income in respect of a deceased partner qualifies for such treatment. The Second Circuit held that interest paid to the decedent's successor on payments for the deceased partner's share of partnership assets over a period of time was not an asset of his estate. The court held that this interest was not income in respect of the deceased partner, since it was attributable to his capital that was retained in the partnership after his death. The Second Circuit also gave the same treatment, *viz.*, not includible in the deceased partner's estate, to the amounts received by the estate for its claimed share of after-death profits of the partnership. The court's theory here was that the amount paid for this aspect resulted from a settlement of the estate's claim, was based on the time lag the estate encountered in receiving payment from the partnership, and was not payable under the partnership agreement but was part of a negotiated settlement following death.

X. Sale or Exchange of Partnership Interest

The Treasury Department has ruled[80] that where a partner sells only a part of his partnership interest rather than all of it, he nevertheless realizes capital gain to the extent it is not applicable to substantially appreciated inventory or unrealized receivables. The Treasury Department, in an earlier ruling,[81] had held that if there is a deficit in the capital account of the selling partner, which the partnership forgives in connection with the sale, the selling partner real-

78. The *Hull* case involved a situation where the estate's right to receive a share of the net income of the partnership after the death of the decedent was given to the estate, under the agreement, in exchange for the estate giving up its right to an accounting and to a distribution of the decedent's share of partnership assets and income items as of the date of death. The case therefore is not a specific overruling of the *Bull* case.

79. Mandel v. Sturr, 266 F.2d 321 (2d Cir. 1959).

80. Rev. Rul. 59-109, 1959-1 Cum. Bull. 168.

81. Rev. Rul. 57-318, 1957-2 Cum. Bull. 362.

izes gain in the amount of the forgiveness. The selling partner in such a case would have a basis for his partnership interest of zero. The amount forgiven would be added to the amount received from the buyer to determine the total gain.

In a case arising under the 1939 Code, the Tax Court indicated[82] that a partner could sell his partnership interest in a particular partnership asset. The court found that the partner recognized a loss in an amount equal to the portion of the partnership, and the Tax Court applied the capital loss limitation on the theory that the property was a capital asset of the partnership.

PROSPECTIVE LEGISLATION—A REVIEW OF H. R. 9662 (86TH CONGRESS)

H.R. 9662 contained many provisions relative to subchapter K. They were lengthy and as elaborate as those contained in the 1954 Code. The principal simplification was in the rearrangement of the sections, putting the simple rules for normal transactions at the outset and then listing the alternative rules and provisions for less frequent transactions. Although the bill died when not enacted by the 86th Congress, it is anticipated that legislation of this sort will be enacted sometime in the near future.[83] This article will attempt to set forth a brief resume of some of the significant substantive changes contained in the bill and expected to be a part of any major revision of the partner and partnership areas in the future.[84]

I. LEVEL FOR DETERMINING CHARACTER OF INCOME

The conduit principal established by section 702(b) of the present law, which provides that the character of certain items is to be determined as if they were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership, would be made to apply to all items, not just those contained in the 1954 codification. In reality this effect has already been obtained by the Regulations, which under existing authority provide that the character of all items of income, gain, loss, deduction, or credit which have tax significance carry over into the hands of the separate partners.[85] In addition, the character of items

82. Carl Hensley, 31 T.C. 341 (1958).

83. All references to sections of H.R. 9662 are to S. REP. No. 1616, 86th Cong., 2d Sess. (1960), which contained a bill favorably reported by the Senate Finance Committee to the Senate.

84. Parts of this section of the article are based on the paper delivered to the 20th Annual New York University Institute on Federal Taxation by Arthur B. Willis entitled *Old and New Frontiers in Partnerships: A Review and a Look Ahead*, N.Y.U. 20TH INST. ON FED. TAX 699.

85. TREAS. REG. §§ 1.702-1(b), 1.702-2 (1956).

of income, gain, loss, deduction, or credit would be determined on a partner by partner basis depending upon the activities of each partner. However, due regard would be given to any business, financial operation, or venture in which the partnership is engaged since the partnership is carrying on this activity for the partner. As a result, the sale of property by a partnership which is not a real estate dealer might result in ordinary income to one partner who is a real estate dealer and capital gain to the other partners who are not real estate dealers in their separate capacities. It would, of course, also be necessary to take into account the activities of all partnerships where an individual is a partner in more than one partnership in determining the character of these various activities for the partner. This rule is designed to prevent tax avoidance since dealers could otherwise avoid ordinary income tax by combining in partnerships with non-dealer partners.

II. Limitations in Computing Taxable Income

Section 702(d) would make it clear that wherever a limitation is imposed upon the includibility or deductibility of an item, each partner is entitled to his full share up to the statutory limit and that the partnership is to be disregarded for this purpose. This proposed amendment was intended to clarify and not to change present law, according to the Committee Reports. However, the Committee Reports also make it clear that the use of the word limitation does not include the restrictions on the choice of depreciation methods under section 167.

III. Termination of Partnership on Sale to Another Partner of an Interest of 50 Per Cent or More

Section 708(b)(1)(B) of the present law provides that a partnership is terminated if within a twelve-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits. Proposed section 708(b)(1)(B) would provide that a partnership is not to be terminated by the sale of an interest (regardless of the percentage interest sold) to partners who have been members of the partnership for at least twelve months prior to the sale. This equates the sitnation with the one where a partner's interest is liquidated by making distributions to him of 50 per cent or more of the partnership assets, where no termination occurs.

IV. Transfers of Interest in a Partnership

Section 741 would contain a new subsection providing that pro rata sales of interest in a partnership to existing partners (or sales which are substantially pro rata) are to be treated as coming under section

736 which under the revisions would be renumbered section 776. This would provide uniformity of treatment for these payments in accordance with the treatment given liquidating distributions made by the partnership. This would cause the amounts received and classified as capital payments not to be taxable to the recipient (or deductible by the payors) unless there is a capital gain or loss realized. The exception would be for payments for substantially appreciated income assets which are taxable to the recipient and deductible to the payors. This latter category includes unrealized receivables.

The change would prevent taxpayers using buy-and-sell agreements effective as of the date of a partner's retirement or death, and which provide for the purchase of the partnership interest by the remaining partners, from treating the entire amount received as a capital transaction except to the extent substantially appreciated inventory or unrealized receivables are involved.

The proposed amendment would solve the problem under consideration, but it might be said to be unfair. It assumes the partners are aware that, where there is a ratable purchase by the other partners, the partnership agreement should contain provisions similar to those that would be included if the agreement specifically provided for the liquidation of a partner's interest by distributions from the continuing partnership. It also assumes that the partnership agreement deliberately contained or omitted a provision for payment of a retiring or deceased partner's interest in partnership good will. A specific dollar allocation would be less likely for any interest in good will in the case of the usual cross-purchase agreement than in the case of the liquidation of a partner's interest.

New problems are raised by the proposed section 741(b) of H.R. 9662. The timing of reporting gain on sale of a partnership interest is different than the timing of reporting gain on liquidation of a partnership interest.

Further, under another proposed provision of H.R. 9662,[86] there would be separate elections as to adjustment of basis upon a sale of a partnership interest and upon liquidation of a partnership interest. An election by the continuing partnership to adjust basis predicated on the purchase by the remaining partners of the interest of the retiring or deceased partner would not be effective if, under the proposed section 741(b) of H.R. 9662, the transaction were treated as a liquidation of a partnership interest. Thus, if the election were made under the wrong theory, the privilege of adjusting the basis of its property might be lost to the continuing partnership.

If proposed section 741(b) becomes law, all partnership agreements providing for the purchase of the interest of a retiring or deceased

86. H.R. 9662, 86th Cong., 2d Sess. § 780 (1960).

partner should be reviewed. If the interest is to be purchased ratably by the other partners, the agreement should be revised to reflect the new concept that, for income tax purposes, the interest will be considered as liquidated by distributions from the partnership.

V. Collapsible Partnership Transactions

Section 751 assets presently include unrealized receivables and inventory items both of which are intricately defined. The definition of section 751 assets would be changed so that the term would mean assets which, if held by an individual, would result in ordinary income upon their sale.

In addition, the income treated as ordinary income would be reduced by a loss which is referred to as a section 751(b) loss. This is defined as any net loss which would occur as a result of the application of section 1231 with respect to partnership property which in effect the partner is selling. This may occur either because he is in effect selling such property when he sells his partnership interest, or when, in a distribution, a distributee partner gives up an interest in such property or the partners remaining in the partnership after the distribution give up an interest in such property.

In determining whether the sale or exchange of an interest or a distribution of property will result in ordinary income, the character of the property is determined at the time of sale or exchange or distribution and as if the property were sold directly by the person relinquishing the interest in the property. Again due regard is given to any business, financial operation, or venture in which the partnership is engaged. The character of the property is determined as if all of it had been sold to one person in one transaction.

The substantial appreciation test is applied uniformly to all section 751 assets in the aggregate. Thus, ordinary income would be realized in the case of unrealized receivables only when their value, together with the appreciation in inventory, represents a substantial element in the sale or distribution transaction.

The fair market value of the partnership property, other than money, with which the value of the section 751 assets is compared, would be reduced for any liabilities of the partnership. This would prevent the reducing of the section 751 assets below the specified percentage of all assets by borrowing funds and purchasing additional non-section 751 assets, or by an existing high ratio of borrowing to total assets.

The percentage requirements on section 751 also would be raised. The fair market value would exceed 125 per cent rather than 120 per cent of the adjusted basis of the assets and the fair market value must exceed 15 per cent rather than 10 per cent of the fair market

value of all partnership property, in order for the assets to be treated as substantially appreciated and as resulting in ordinary income. Further, there would be no ordinary income under section 751 unless appreciation in the section 751 assets exceeds $1,000. This $1,000 de minimis rule is applied on an aggregate basis with respect to all of these assets considered as sold or exchanged, by any partner, or by the partnership, as the case may be, in all transactions in the twelve-month period immediately before and also in the twelve-month period immediately after the transaction in question.

Further, assets contributed to or otherwise acquired by the partnership within the twelve-month period immediately prior to the sale or exchange or distribution involved were not taken into account in applying the percentage tests unless there was a bona fide business purpose for the contribution of the property to the partnership or for the acquisition of the property by the partnership. This provision prevents the avoidance of the percentage tests by the contribution of property in order to bring about the situation where the unrealized depreciation and the ordinary income assets are not above the specified percentage and/or that the fair market value of the section 751 assets does not exceed the specified percentage of partnership property (other than money and reduced by the liabilities of the partnership).

VI. Transfer of a Capital Interest in a Partnership for Services

There is no statutory provision dealing with the transfer of a capital interest in a partnership as compensation for services. The problem is covered in the Regulations at section 1.721-(b), which provides that the amount of ordinary income to the service partner is the fair market value of the capital interest transferred. However, the Regulations imply that the amount includible in the income of the service partner does not include unrealized appreciation in value of partnership property. The Regulations also provide that the time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest.[87] This gives little help in making the determination.

Proposed section 770 of H.R. 9662 draws a distinction depending upon whether the capital interest transferred was subject to restrictions or limitations at the date of transfer. In the absence of restrictions and limitations on transferability, the income to the service partner would be the fair market value of the interest he acquired reduced by his proportionate interest in the unrealized appreciation in section 751 assets (*i.e.*, assets which would produce ordinary income upon a

87. Treas. Reg. § 1.721-1(b)(1) (1956).

sale by the partnership).[88] Where restrictions or limitations on transferability are present, the income to the service partner would be the lesser of:

(1) The fair market value of the services, or

(2) The fair market value of the interest at the date transferred, had there been no restrictions or limitations on transferability at that date, reduced by the service partner's proportionate interest at that date in the unrealized appreciation in section 751 assets.[89]

VII. Closing of Taxable Year upon Death of a Partner

The Treasury Department ruled[90] that a change in membership of a partnership resulting from, among other factors, the death of a partner does not, in itself, effect a termination of the partnership for federal income tax purposes. The ruling stated that ordinarily where the business of the partnership, or a substantial portion thereof, is continued, the partnership will be regarded as continuing for income tax purposes.

Section 706(c)(1) provides that the taxable year of a partnership does not close on the death of a partner except in the cases of (1) termination of the partnership and (2) the sale by a partner of his entire interest in the partnership. In the event of the continuation of the deceased partner's interest, with the successor in interest of the deceased partner substituted as a member of the firm, there is no closing of the partnership year with respect to the deceased partner as of the date of death.[91] The partnership taxable year continues until its normal close. Absent a provision in the partnership agreement for the purchase or liquidation of the interest of a deceased partner, and if after the death of a partner the interest of the deceased partner is either purchased or retired by liquidating distributions, the partnership taxable year continues with respect to the deceased partner until the date of the purchase of that interest or until the termination of his interest by distributions in liquidation.[92]

The continuation of the taxable year of the partnership for income tax purposes may work to the detriment of the deceased partner's interest. This is true where, for example, both the partnership and the deceased partner have reported for income tax purposes on the basis of the calendar year, and the principal or sole source of income of

88. H.R. 9662, 86th Cong., 2d Sess. §§ 770(c)(1)(A), 770(c)(2).

89. H.R. 9662, 86th Cong., 2d Sess. §§ 770(c)(1)(B), (c)(2).

90. Rev. Rul. 144, 1953-2 Cum. Bull. 212.

91. Treas. Reg. §§ 1.706-1(c)(2)(i), 1.706-1(c)(3)(i) (1956).

92. Note 89 *supra*. Of course, the taxable year would close at the regular date for all partners if that date occurred before the purchase of the interest or the termination by liquidating distribution of the interest of the deceased partner.

the decedent partner was his distributive share of partnership income.

The share of partnership income, if includible in the final return of the deceased partner, could be offset by allowable deductions arising during the calendar year up to the date of his death and by personal exemptions. In addition, there would be available the income tax saving from the filing of a joint return with his surviving spouse. These tax advantages are lost if the partnership year does not close with respect to the deceased partner as of the date of his death.

Proposed section 764 of H.R. 9662 would provide that the taxable year of the partnership does close with respect to a deceased partner as of the date of his death unless the executor or other successor in interest of the deceased partner files an election not to have the taxable year so close. Proposed section 764 adopts the substance of the Advisory Group recommendation in this area. This is a highly desirable change in the provisions of the law.

VIII. Deduction of Income Payments under Section 736 by Successor to the Partnership Existing at the Date of a Partner's Retirement or Death

Where the partnership agreement provides for the retirement of the interest of a deceased partner by distributions by the partnership in liquidation of the interest of that partner, a problem may arise because of changes in the business organization following the date of death, and before the full liquidation of the interest of the deceased partner. If the partnership is terminated for one reason or another, due to the technicalities of the Code,[93] and payments to the retiring or deceased partner continue to be made by the successor of the terminated partnership, the question arises as to the deductibility of the payments made by the successor. Such payments clearly would be deductible under section 736(a) if made by the same partnership which was in existence at the date of the retirement or death.

Section 736 of the 1954 Code does not specifically cover deductibility of income payments under section 736(a) which are made by a successor to the partnership which existed at the time of the partner's retirement or death. It would appear that there is no assurance of deductibility of such payments made by a successor organization. The deductibility would appear to depend on the application of general income tax concepts, which raise serious doubts as to the deductibility.

The Advisory Group recommended that income payments to a retiring or deceased partner should be deductible when made by any successor organization, with appropriate safeguards to prevent a double benefit by way of deductibility of such payments, as well as by an

93. Int. Rev. Code of 1954, § 708(b).

adjustment to basis of assets resulting from assumption by the successor organization of the liability for such payments.[94]

Proposed section 776(c)(3) of H.R. 9662 would permit the deduction of income payments to a retiring or deceased partner after termination of the partnership, but only under extremely restricted conditions. Proposed section 776(c)(3) would require that for payments to be deductible, the person making them must (1) be an individual, (2) be a partner in the partnership immediately before the retirement or death, (3) be under a binding legal obligation to make such payments, or (4) be operating a trade or business as a sole proprietor.

The proposed section 776(c)(3) fails to provide for deductibility of payments by a successor corporation, a successor partnership, or the executor of the estate of a decedent who previously was a partner in a two-man partnership and was obligated under the partnership agreement to make income payments to a former partner who retired or died at an earlier date.

Other possibilities of changed conditions exist which may technically create a new partnership for income tax purposes in the case of the partnership. This is more true of the partnership than of most other forms of business organization. It would be highly desirable to include in the law a specific provision recognizing the deductibility of income payments made to a retired or deceased partner, even though such payments are made by an entity that is not technically the same partnership that was in existence at the date of the retirement or death.

CONCLUSION

The courts, the legislature, and the Government, for one reason or another, have been moving slowly in making significant changes in the tax laws affecting partners and partnerships. Perhaps this means that the results have been worth waiting for. Perhaps it means that the area is misunderstood, seldom used, or susceptible of planning. In any event, more changes will and must come—the enactment of the provisions of H.R. 9662 will be one of the first. Continued cooperation by Congress, Government, the courts, the taxpayers, and their representatives is dictated. Only in this way can logical and fair results be reached.

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94. ADVISORY GROUP ON SUBCHAPTER K, REVISED REPORT ON PARTNERS AND PARTNERSHIPS 28-34 (1957).