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ARTICLES

PARTNERSHIP REORGANIZATIONS: A NEW TAX FRONTIER

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THE history of taxation of partnerships has been largely the history of the conflict between fundamental theories as to the very nature of a partnership. The two theories are as well known to general commercial lawyers as to tax specialists; and, indeed, perhaps better known to the former. One is the "entity" theory, holding that the partnership is a jural entity having much the same relationship to the partners as a corporation does to its shareholders. This was the civil law notion, and was brought into our jurisprudence through application of the law merchant.[1] The "aggregate" theory, on the other hand, disregards the partnership itself as anything more than a shorthand way of denoting a whole series of special relationships between a group of individuals associated together in a business venture.[2] This is the common law approach, and it largely dominated both legislative and judicial thinking prior to 1954. In that year Congress compromised the dispute.

It can safely be said that Subchapter K of the Internal Revenue Code of 1954, dealing with taxation of partnerships, has put the two conflicting theories themselves into partnership. The "aggregate" theory clearly dominates the rules dealing with taxation of partnership income.[3] On the other hand, the "entity" theory was chosen as the polestar for taxation of a partner's disposition of his interest in the firm.[4]

If a partnership is an entity for purposes of sale, exchange or disposition, it is immediately necessary that there be rules dealing with the reorganization question. It is well settled policy with regard to corporations that those readjustments in the form of a business which do not materially affect its continuity, and the continuity of interest of the shareholders therein, should give rise to no

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[1] For complete discussion of historical materials see LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS, §§ 1.3, 1.4.

[2] *Ibid.*, § 1.4.

[3] INT. REV. CODE OF 1954, §§ 701, 702; Regs. §§ 1.702-1, 1.702-2; SEN. REP. NO. 1622, 83d Cong., 2d Sess. 376 ff. (1954).

[4] INT. REV. CODE OF 1954, § 741; Regs. § 1.741.1.

tax consequences.[5] This rule is equally beneficial to taxpayer and government, since it operates not only to defer taxation of "paper" gain but as well to defer allowance of "paper" loss. The 1954 Code gives nodding recognition to the applicability of this policy as regards partnerships. Section 708 embodies rules which may fairly be described as embryonic prototypes of a system of partnership reorganization principles. The rules, however, are so sketchy as to portend unintended and unrealistic tax consequences; and a brief legislative history, which does little more than recite the statutory language, shows a lack of congressional grasp of the implications of the reorganization problem.[6]

Similarly, the Advisory Group on Subchapter K, reporting to the House Ways and Means Committee, gave no attention to any major problem in the reorganization area. The committee recommended only two minor changes, neither going to the heart of the policy problems underlying partnership readjustment.[7] The legal writers have also ignored this area of tax law.

A complete technical analysis of the operation of section 708 and its relationship to the other parts of Subchapter K would be inappropriate here. This article will treat certain major problems, both operational and in terms of fiscal policy, which are raised by section 708.

All "reorganizations" fall into three basic classifications: first, a mere adjustment of continuing interests in a single business; second, a consolidation of two or more separate businesses; and third, the split-up of an existing business into two or more separate units. Section 708 in fact recognizes and deals with each of these types of reorganization.

ADJUSTMENT WITHIN A SINGLE FIRM

From the standpoint of continuity in reorganization, the significant partnership concept is that of "termination." When a partnership terminates, tax consequences ensue to partner and firm alike. Partners may realize taxable gain or sustain taxable loss;[8] the assets of the firm may change basis;[9] the taxable year of the firm is automatically ended,[10] and partners may as a result thereof suffer bunching of income.[11] Hence, a statutory provision which excludes "termination" on the happening of a certain event in effect recognizes that the event does not interrupt continuity of the enterprise.

[5] See, *e.g.*, Regs. § 1.368-1(b).
[6] See SEN. REP. No. 1622, 83d Cong., 2d Sess. 388 (1954); H. R. CONF. REP. No. 2543, 83d Cong., 2d Sess. 61 (1954).
[7] *Revised Report on Partners and Partnerships*, 20 (U. S. Gov't. Printing Office, 1957).
[8] INT. REV. CODE OF 1954, § 731; Regs. § 1.708-1(b)(1)(iv).
[9] INT. REV. CODE OF 1954, § 732(b), (c).
[10] Regs. § 1.708-1(b)(1)(iii).
[11] INT. REV. CODE OF 1954, § 706(a). This would result, of course, only if the partner and the firm have differing taxable years (see, *e.g.*, Anne Jacobs, 7 T.C. 1481 (1946)), a situation now generally forbidden. INT. REV. CODE OF 1954, § 706(b).

As a general matter, changes of interest resulting from transactions between the firm as such and one or more of its members do not lead to a "termination;" *i.e.*, such changes do not affect the continuity of the firm and its tax attributes. This is implicit in the statute and is made clear by the Regulations, which provide that neither the admission and contribution of property by a new partner, nor the liquidation of an existing partner's interest, effects a termination.[12]

There can be little criticism of these rules. Neither an entry nor a withdrawal constitutes any real change in the nature of the remaining partner's interest; it remains in solution, and the gain or loss (if any) is unrealized. The clear analogy is to the case where a corporation liquidates the interest of one shareholder, thereby increasing the proportionate interest of the others. The economic change is entirely potential, and there is no warrant for a change in the partners' tax climate.[13]

When we turn to the question of the sale of a partnership interest, the treatment of partnerships diverges sharply from that afforded corporations. Section 708 provides that if fifty per cent or more of the total interest in partnership capital and profits is sold within a twelve month period the firm terminates.[14] The Regulations make it clear that it is immaterial whether the transfer of the requisite fifty per cent interest be accomplished through a single sale or through a series of sales within the twelve month period.[15] It is equally immaterial whether the sales be related or unrelated, whether the interests sold belonged to one partner or several, and whether the selling partner or partners have even disposed of their entire interest in the firm.[16] Upon the date when the fifty per cent mark is passed the firm must end. As will be seen this rule is at once inadequate to its purpose, arbitrary in its operation and unwise from a policy standpoint.

Both the inadequacy and the arbitrariness result in large part from the fact that while a sale of fifty per cent or more of the partnership interests imposes tax consequences, a change in ownership resulting from liquidation of the same interests, accompanied by the entry of new members through contribution, would preserve the firm's continuity. There seems to be no reason in policy why this difference should exist, and there certainly is no provision of Subchapter K which

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[12] Regs. § 1.708-1(b)(1) (ii).

[13] *E.g.*, Holsey v. C.I.R., 258 F. 2d 865 (3d Cir. 1958).

[14] INT. REV. CODE OF 1954, § 708(b)(1)(B). The phrase "50 per cent or more of the total interest in capital and profits" requires the percentage of each type of interest sold to be separately calculated. A sale of 50% interest in capital, and a 49% interest in profits, does not result in termination. Regs. § 1.708-1(b)(1)(ii).

[15] Regs. § 1.708-1(b)(1)(iii)(b).

[16] *Cf.* Regs. § 1.708-1(b)(1)(ii).

would expressly prohibit taxpayers from choosing either a sale or liquidation-*cum*-contribution as might best suit their interests. [17]

If, in fact, the parties had been so ill-advised as to negotiate a sale between a partner and an outsider and then at the last minute merely switch the form, it might be possible to treat the case as a sale in fact. But there are many situations in which no such construction can be imposed upon the parties. For example, suppose that the original partnership agreement prohibited sale of any interest, so that liquidation, and contribution by a new partner, is the only means available under state law to effect a transfer of ownership. Although the Regulations obliquely suggest that no such circuitous arrangement for sale will be recognized as anything but a sale,[18] there must remain serious doubt as to the Commissioner's power to prevent the parties from successfully choosing their own form, and, therefore, their own tax consequences.

It must also be noted that Subchapter K holds out added bait, in addition to non-termination, to cast the deal as a liquidation, rather than a sale. If there is a sale at a time when the firm holds "unrealized receivables" or "substantially appreciated inventory" (as broadly defined in the "collapsible partnership" provisions of section 751),[19] the selling partner will pay an ordinary income tax on the gain attributable to these items; yet ordinarily no one, and in rare cases only the purchaser, will derive the normal tax benefit of a step-up in basis on such assets.[20] On the other hand, if the firm pays out the retiring partner in cash as a liquidating dividend, the firm will obtain a stepped up basis for the retiring partner's proportionate interest in inventory assets (but not unrealized receivables), which basis will operate for the benefit of all remaining partners.[21] The retiring partner, of course, will generally be unable to avoid ordinary income tax on his *pro rata* share of unrealized receivables and inventory appreciation.

The Advisory Group have noticed this problem in a limited way. They propose that any sale of a partnership interest between the partners is to be treated as a liquidation for the purposes of section 708, provided only that the purchasing partner or partners have been members of the firm for at least a year.[22] As the Advisory Group state, the disparity of treatment between liquidation on the one hand and sale to the remaining partners on the other places too much

[17] Thus, if partner A of firm ABC, owning a 50% interest, sold to D, the firm would terminate. But if the firm liquidated A's interest, and D concurrently joined the partnership by making a capital contribution, there would be no termination.

[18] *Cf.* Regs. § 1.731-1(c)(3).

[19] INT. REV. CODE OF 1954, § 751 (c), (d).

[20] This benefit will be afforded to the purchaser only if (1) an election is made by the firm under INT. REV. CODE OF 1954, §§ 743 and 754, or (2) there is a distribution of property other than money to the purchaser. See INT. REV. CODE OF 1954, § 732(d).

[21] INT. REV. CODE OF 1954, §§ 736(b)(2)(A), 751(b)(2)(B); Regs. §§1.736-1(a)(2), 1.751-1(b)(4)(ii).

[22] *Op. Cit. supra,* note 7.

emphasis on form. As noted above, the opportunities for formal manipulation are also present in the case of an intended sale to an outsider. It would, therefore, appear that both sales and liquidations should be treated the same in all cases. It appears to the author that the "liquidation" rule should be extended, and that sale of a substantial partnership interest should not generally result in termination of the firm.

There are excellent reasons why the sale of a substantial interest in the firm should not work a termination. These reasons arise from the operation of the gain, loss and basis provisions of Subchapter K.

The Regulations under section 708 very sensibly provide that, when the firm is deemed terminated by sale or exchange of interests, a constructive liquidation distribution takes place, followed by a recontribution to the firm by the remaining partners and the purchaser.[23] The implications of such a constructive liquidation, however, seem undesirable. Gain will be recognized to the distributee partners to the extent that money distributed exceeds their bases for their interests.[24] Hence, there is a possibility of recognition of gain to the continuing partners, even though they have received no actual gain, even though the business in fact continues as before, and even though under state law they may be prohibited from making any actual withdrawal of money from the firm.

Secondly, upon liquidation, the firm's assets may acquire a new basis, and in any event there may be serious complexity in computing basis for the "new" firm. When assets are distributed in kind upon liquidation, inventory items and unrealized receivables retain, in the hands of the distributee, the same basis as in the hands of the firm; but all other property obtains a basis consisting in the aggregate of the remaining basis of the partners for their interest.[25] Thus, if assets are constructively distributed at a time when the aggregate basis to the members for their interests falls short of the firm's aggregate basis, there will be an unwarrantable decrease in basis to the new firm. Similarly, if aggregate basis of the members for their interests exceed the firm's aggregate basis for properties, there will be an unwarrantable increase in basis to the new firm. The result is undesirable in either case, since the business continues as before and there is no justification to increase or decrease depreciation, gain or loss on capital assets, or other tax items.

And even where there is no change in aggregate basis, but different partners have different bases, unnecessary administrative complexity is introduced. Pre-

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[23] Regs. § 1.708-1(b)(1)(iv).

[24] INT. REV. CODE OF 1954, § 731(a)(1). It should be noted that, here as elsewhere in Subchapter K, a reduction of the partner's share of partnership debts is treated as a distribution of money to him. INT. REV. CODE OF 1954, § 752(b).

[25] INT. REV. CODE OF 1954, § 732(b), (c).

sumably, on the constructive distribution in liquidation under section 708, each asset is distributed to all partners, as tenants in common. Hence, the basis for each asset will depend upon an analysis of the basis, in the hands of each partner, of his fractional share of the asset. In a firm which owns a large number of depreciable assets, and has a large number of partners, the paperwork would discourage even the most resolute accountant. And, reconstitution of basis through such an analysis will introduce fractional differences which could actually result in changing basis of the various assets in the hands of the new firm, even though their aggregate basis remains the same.

It is true, of course, that the present operation of section 708 serves to bring about a measure of simple justice for the purchasing partner which, as a practical matter, is not otherwise available. Unless the firm enters into the highly uncertain and virtually irrevocable election to adjust basis, provided by sections 743 and 754, the transferee will not be allowed any tax benefit for the fact that his purchase price valued firm assets at fair market value, rather than at adjusted basis in the hands of the firm. However, the constructive liquidation provisions of the section 708 Regulations give him this benefit through application of the basis adjustment provisions of section 732(d).[26] Yet obviously, the proper remedy for this situation is to rewrite the optional adjustment sections, as proposed by the Advisory Group, rather than to continue the present termination rule of section 708.

Finally, present law permits limited opportunities for the manufacture of capital losses which, while dubious, are at the least not expressly foreclosed. In the case of a liquidation, where no assets are distributed other than money, inventory property, and unrealized receivables, loss is recognized to the extent that the money and the basis to the firm of the other property fall short of the partner's basis for his interest.[27] Thus, where non-inventory property is of limited importance, it would seem possible for the firm to sell such property *pro rata* to its continuing partners at a low price prior to sale of interests to outsiders, so as to create the potential for loss on the constructive distribution. Subsequently, of course, the partners will recontribute the property, and business will go on as usual.

It is true that the foregoing device is subject to attack as a sham, but the point is not whether such a device, either in its raw form or suitably attired in sheep's clothing, would succeed or fail. The point is that a rule which involves the potentiality for loss development of this character is suspect. Obviously,

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[26] This would vary the limitation on basis of receivables and inventory in his hands, giving them a new basis equal to fair market value. It is clear that INT. REV. CODE OF 1954, § 732(d) is applicable to such a constructive distribution. See Regs. § 1.708-1(b)(1)(iv).

[27] INT. REV. CODE OF 1954, § 731(a) (2).

application of the continuity of interest rule which obtains when a partner's interest is liquidated will forestall anything of this nature.

PARTNERSHIP CONSOLIDATION

The provisions of section 708 dealing with partnership consolidation are deceptively simple. The statute briefly provides that in the case of merger or consolidation the resulting firm will be treated as a continuation of any previous partnership whose partners own an interest greater than fifty per cent in capital and profits of the successor.[28] The Regulations, foreseeing the possible merger of brother-sister partnerships, placed a gloss on these provisions which, though not justified by anything in statutory language, is unfortunately in accordance with the underlying Congressional intent. The Regulations provide that in such case, where, by application of the "fifty per cent rule," the successor could be considered a continuation of more than one of the merging or consolidating partnerships, the successor will be considered the continuation of only that partnership which contributed the greatest dollar value of assets to the merger.[29] But the Commissioner reserves to himself the right to "permit otherwise." [30]

There are a number of insistent questions raised by this statutory scheme. The first is a liminal problem of definition. What transactions will qualify as a merger or consolidation? The complexities of this question may be shown by a few elementary examples.

Firm A has five partners and conducts two distinct businesses. Firm B is considerably smaller and conducts yet a third business.

(1) Four of the five members of Firm A desire to retire. The remaining partner pays them out in cash by way of liquidation. Shortly thereafter he becomes a partner in Firm B, contributing both of the previous businesses of Firm A and receiving a fifty-one per cent interest in capital and profits of Firm B. If this is a merger then A is the continuing partnership, and B is deemed liquidated. On the other hand, if this is not a merger then B is the continuing partnership and A is deemed liquidated.

(2) The five members of Firm A desire to split up. All of the assets are sold and three of the partners receive a liquidating distribution consisting of cash. The remaining partners then join forces with Firm B, obtaining a fifty-one per cent interest therein. Is this a merger?

(3) The five members of Firm A decide to split up. Three of the partners receive a liquidation distribution consisting of all business assets and continue

[28] INT. REV. CODE OF 1954, § 708(b) (2) (A).
[29] Regs. § 1.708-1(b)(2)(i).
[30] *Ibid.*

to operate both businesses as a new firm. The two remaining partners, who retain an interest only in cash and securities, then join Firm B, obtaining a fifty-one per cent interest therein. Is this a merger?

(4) The five members of Firm A decide to split up. The three retiring members sell their interests to the remaining two who thereupon join Firm B, taking a fifty-one per cent interest. Is this a merger of the original Firm A, or should it be treated as a termination of Firm A by sale, followed by mere entry of new members into Firm B as a continuing firm?

(5) Should it make a difference in any of the foregoing examples if the plan for entry of personnel from Firm A into Firm B predates or postdates the plan for readjustment in Firm A? [31]

The issues are, of course, impossible of any clear resolution under the present provisions of Subchapter K.

It is well enough to use the simple word "merger" in connection with the tax consequences of a corporate reorganization, since there is a whole body of state law defining the term "merger" as applied to corporations; but the idea of a "merger" of partnerships is a common law anomoly. Under state law the consolidation of two firms would be treated as the dissolution of both and the formation of a third partnership.[32] Hence, in attempting to transfer tax concepts in reorganization from the corporation to the partnership field, Congress should have more clearly defined the types of partnership consolidations and rearrangements which should, and which should not, be entitled to reorganization treatment.

Some of the questions requiring decision are suggested by the foregoing examples. Does a merger or consolidation require a plan, and if so, when and by whom must the plan be adopted? Should a merger be permitted in the case where only one partner of a predecessor firm is a member of the combined organization? Is it necessary that the merged firm continue all or a substantial part of the business of each predecessor? Can you have a merger where the actual business of one of the predecessors is continued by others? Should you have reorganization tax consequences where the "continuing" members, as in examples 2 and 3, have in fact transmuted their interest in the former business into cash and have embarked that cash on a new business?

It is possible to answer some of these questions by mechanical application of the rules of Subchapter K (*e. g.*, by applying both the partnership division

[31] In this connection, consider the rule that a partnership terminates if no part of its business, operations or financial ventures continues to be carried on by any partner in the partnership form. INT. REV. CODE OF 1954, § 708(b)(1).

[32] 40 AM. JUR. *Partnership* § 242(1942).

rules and the partnership merger rules simultaneously) or by resolving the total transaction into a series of transactions, each of which has its own consequences under Subchapter K. (*E. g.*, treating the split up as a simple liquidation insofar as the partners entering the merger are concerned.) But the questions here discussed go to the heart of tax policy, because they arise out of transactions which frequently will occur as an integrated whole. Congress should examine the policy implications of the integrated transaction and should give us an answer that is responsive to the total situation, rather than an answer which can be constructed by artificial examination of the parts.

The next question raised by the merger provisions of section 708 is one of determining the implications of "continuation" of the previous partnership. The only implication pointed out by the Regulations—and as we shall see the one implication which dominated congressional thinking—is that the new firm shall use the taxable year of the predecessor whose existence is deemed to continue.[33] The other implications, however, come readily to mind. Naturally, the bases of properties received from the continuing predecessor remain unchanged. Presumably, its method of accounting and all of its elections with regard to accounting carryover. Presumably also, the bases of the partners for their interests remain the same with appropriate adjustments. We suppose that they may also carry forward, against profits of the new firm, losses of the old which have been held in abeyance by reason of section 704(d).

We come finally to the question of why the continuity of interest principle has been so narrowly applied to partnership mergers. Here a continuity of interest of at least fifty per cent is required, but only the persons owning that continuing interest enjoy the benefits or bear the burdens of continuity. And, in a case where two brother-sister partnerships qualify as continuing firms after consolidation, the partners can enjoy the benefits or bear the burdens of continuity as to only one of the predecessors.

This is in sharp contradistinction to the situation under Subchapter C. There, of course, continuity of ownership interest is prerequisite to a reorganization. Yet once it is found, all parties to the reorganization enjoy tax free status and all bring forward most of their critical tax attributes. If, for example, General Motors and Chrysler should merge, it is undoubted that the basis of the properties received from both by the combined corporation would carry over, that the operating losses of both would continue to be available[34] and that all shareholders would exchange their stock tax free and without a change in basis.[35] Yet if General Motors and Chrysler were partnerships, this would all

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[33] Regs. § 708-1(b)(2)(i).
[34] *Cf.* INT. REV. CODE OF 1954, § 381.
[35] INT. REV. CODE OF 1954, §§ 354, 358.

change. Assuming that all "partners" in both firms remained as partners in the consolidated firm, the former General Motors "partners" would undoubtedly own more than a fifty per cent interest in the new enterprise. Consequently, Chrysler would be deemed to have terminated. As a result, a "partner" in Chrysler would have suffered a constructive distribution with possible recognition of gain. The basis of Chrysler's assets would be subject to change, if the aggregate basis of the "partners" either exceeded or fell short of aggregate firm basis for the properties; and there would be the same administrative difficulties in determining the new basis of Chrysler's assets as has been discussed above in connection with termination of a partnership through sale. Finally, past loss experience of Chrysler would be wiped out.

There seems no justification for such a striking difference in tax results between two transactions with essentially the same economic impact; but there appears to be an explanation for the difference. The explanation is to be found in history.

The genesis of corporate reorganization legislation was the problem of taxing the shareholder on the exchange of stocks in a merger or consolidation.[36] Aside from basis, the operating problems for the corporations received attention of the Congress at a later date, and it was not until the enactment of section 381 of the 1954 Code that full legislative attention was given to the operating consequences of a merger or other reorganization.

On the other hand, the specific problem which apparently evoked section 708 of the 1954 Code was an operating problem, rather than one of recognition of gain on exchange. In the years immediately preceding 1954 the courts were grappling with the issue of the tax consequences of dissolution of a partnership under state law, and particularly the effect of such dissolution on the taxable year of the firm.[37] As a consequence, most of the problems implicit in terminating or continuing a partnership were apparently not considered, and the provisions of section 708 are manifestly directed to, and responsive to, only this one problem.

Congressional preoccupation with the taxable year question explains some of the seeming inconsistencies in section 708. It explains, principally, why the Regulations are correct in asserting that only one of two or more consolidating partnerships can be treated as the survivor. It is obvious that if more than one firm is deemed to have survived there will be an embarrassing choice of taxable year where the firms have different accounting periods. And if we probe beneath

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[36] *E.g.*, Marr v. United States, 268 U.S. 536 (1925).

[37] *E.g.*, Samuel Mnookin, 12 T.C. 744 (1949), *aff'd* 184 F. 2d 89 (8th Cir. 1950), N.A. 1949-2 C.B. 4, withdrawn and acq. 1953-2 C.B. 5. The Commissioner, in 1953, adopted the principle now contained in INT. REV. CODE OF 1954, § 706(c)(1), R.R. 144, 1953-2 C.B. 212.

the surface there may also be other conflicts of tax attributes, principally accounting methods and accounting elections. These choices can be, and were, neatly side-stepped by deciding that only one firm may survive. In the simple case of a merger between a "big" firm and a "small" one, section 708 is undoubtedly adequate to solve this one particular problem in accordance with the realities.

Yet here is a rule which, as pointed out above, may operate to produce unjustified tax upon the partners notwithstanding that their interests continue in solution, and may also work to permit unjustified tax advantages such as a step-up in basis. Perhaps the better solution would be to treat all the merging partnerships as continuing to the extent that their members retain a substantial continuity of interest in the successor and perhaps as well only where there is a substantial continuity of the business as such. In the case of conflicting tax attributes, however, those of the partnership making the largest contribution of assets to the new firm would prevail. Conflict of tax attributes is certainly a problem, but it scarcely affords any reason to abandon the commendable effort to avoid taxable events in the case of a mere modification of the business structure.

DIVISIVE REORGANIZATION

The divisive reorganization provisions of section 708 start out down the right road. It is generally provided that, in the case of the division of a partnership, all resulting partnerships shall be considered a continuation of the common "ancestor" firm. But this broad rule is quickly, and unfortunately, qualified by a proviso: it is made applicable only to those successor firms whose members in the aggregate owned more than fifty per cent interest in capital and profits of the original partnership.[38] Any other resulting firm will be considered as a new partnership. The Regulations provide further that any partner of the original firm who does not become a member of a firm which is deemed a continuation thereof shall be treated as though his interest were liquidated.[39]

The statute clearly provides, and the Regulations recognize, that more than one firm can qualify as a continuation of the common "ancestor" in the case of a division.[40] This presents no difficulty or embarrassment, inasmuch as there is no problem of conflicting tax attributes, such as occurs upon consolidation of partnerships. There was, then, nothing to impede Congress or the Commissioner in following generally accepted reorganization principles, as found in the corporate area. It may only be noted that this easy acceptance of multiple continuity highlights the probable source of the contrary rule in the case of partnership mergers.

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[38] INT. REV. CODE OF 1954, § 708(b)(2)(B).
[39] Regs. § 1.708-1(b)(2)(ii).

Yet notwithstanding this feature, the divisive reorganization provisions remain essentially unsatisfactory. Again, there seems to be no reason why the fifty per cent rule should be imposed. Assume a corporation with five shareholders, each owning a twenty per cent interest. The corporation conducts two businesses. The parties decide to separate their interests, and to this end one of the businesses is transferred to a newly formed subsidiary. The stock of this new corporation is then distributed to two of the five shareholders, in exchange for all of their stock in the original company. There is no tax consequence of any kind. The provisions of section 355 operate here in recognition of the fact that a spin-off of this nature has essential reorganization characteristics.[41] As a consequence, there is neither gain nor loss recognized,[42] nor any material change in the tax attributes of the severed businesses.[43] This is as it should be.

But assume instead that there was no corporation, and that the five parties in interest were members of a partnership. The tax consequences change radically. The business which, after reorganization, is owned by the three "majority" partners will be treated as a continuing entity. The two "minority" partners, who take the "spin-off" business, however, will be treated as though they had liquidated their interests and started in business anew. As noted above, if they sustain either gain or loss it will be recognized, the basis of properties used in the "spin-off" business may change, loss carry-overs may be terminated. And, if disproportionate distributions are made, either of "inventory" items or of "other property," even the three members of the "continuing" firm may be affected. Depending upon which type of property is distributed to the retiring members in excess of their *pro rata* interest therein, the "continuing" firm may either sustain ordinary income by virtue of a constructive "sale" of inventory,[44] or may obtain a step-up in basis on inventory as the result of a constructive "purchase" thereof.[45]

Obviously, there is no warrant for any such divergency in treatment between business readjustments which differ only as to legal form. And the corporate rule would seem by far the better one.

Policy considerations aside, section 708(b) (2) (B) has serious operational problems as well. Definitional difficulties are not too great, since it is much

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[40] *Ibid.*

[41] Regs. § 1.355-3.

[42] INT. REV. CODE OF 1954, § 355(a)(1), (2).

[43] See, as to basis, INT. REV. CODE OF 1954, § 362(a); as to carry-over of earnings and profits, Regs. § 1.312-10.

[44] See Regs. § 1.751-1(b)(2)(3).

[45] The same effect would, of course, occur with respect to unrealized receivables, but for the special rules of INT. REV. CODE OF 1954, § 736, dealing with "payments" to a retiring partner. "Payments" may be thought to include property other than money; and there is no express warrant to exclude § 736 as a factor in a liquidation under Regs. § 1.708-1(b)(2)(ii).

easier to define the concept of a partnership "division" than of a partnership "merger." Consider, however, the problem inherent in the following situation. The firm of ABCD conducts a retail appliance business and also performs service work for customers. At some point along the line C and D, the "minority" partners, decide to take over the service business while also retaining an interest in the sales business. Accordingly, it is agreed that they will reduce their interests in the sales business to, respectively, five per cent each and will take over the assets of the service business, including its good will. What are the reorganization consequences?

This case is not expressly covered by the Regulations which deal only with the case where the minority partners withdraw entirely from the "continuing" partnership. In all probability the case would be treated as one of a distribution to the "minority" partners in a non-liquidation transaction. The result will be a carry-over of basis on the distributed assets, limited only by the basis of the distributee for his interest.[46] Unless money in excess of basis is distributed no gain would be recognized,[47] but if there is a disproportionate distribution of assets of any kind ordinary income may result either to partner or firm under section 751.

Suppose, however, that the parties have proceeded without benefit of counsel, and have entered into an agreement whereby the "majority" partners undertake to "sell" to the minority partners all of the former's interest in the service assets, in exchange for a portion of the interest of the "minority" members in the old firm. It would be quite possible to construe this transaction as involving a primary distribution of the service assets to the *majority* partners. Then the "purchase" of these assets by the minority, in exchange for a part of their interest in the old firm, would probably result in a recognition of gain to them.[48] And, under section 751, even if there were an overall loss on the "sale" of a part of their original partnership interests, the minority would suffer ordinary income on the portion of the gross proceeds attributable to their share of unrealized appreciation of partnership receivables and inventory.[49] Obviously, this difference in forms should not produce any difference in tax results; and the Commissioner might well consider indicating by Regulation that all transactions having the effect of a divisive reorganization, in whole or part, shall be treated as such.

The provisions of section 708(b)(2)(B) are not without possibilities for improper manipulation. Suppose, for example, that firm ABCD, engaged in

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[46] INT. REV. CODE OF 1954, § 732(a)(2).
[47] INT. REV. CODE OF 1954, § 731(a)(1).
[48] *I.e.*, if the fair market value of the "service" assets exceeds the basis of the partnership interest surrendered in exchange therefor.
[49] See Regs. § 1.751-1(a)(1)(2); 1.751-1(g), *Example* 1.

both sales and service businesses, has heavy losses. It is then possible for "minority" partners to form a new partnership with family members of the "majority" partners, and purchase from the prior firm the necessary assets for conduct of the service business, paying for same out of future profit. The gains sustained by the old firm will be wiped out by the losses, the assets so transferred will have a stepped up basis, and (since "majority" partners will participate in the new firm through their families) there will be no significant changes in overall economic interest. This method of avoidance could perhaps be defeated by judicial decision. But the express Code provision that the "minority" successor shall be a new firm plays into the hands of persons attempting any such transaction.

There are even more blatant possibilities. Suppose that a partnership consists of two husbands and their wives, each family owning a fifty per cent interest. Assuming that there are current partnership losses, it is possible for the two families to step-up basis on assets, including receivables (if on a cash receipts accounting method), and as well to create capital losses for family use.

What would be done, quite simply, would be to distribute all of the firm's assets in liquidation, taking care that receivables and money alone go to the wives, the husbands accepting the other property. The results would be as follows:

(1) If the distribution to the wives, consisting of money and the *basis* of receivables, falls short of their bases for their interests, then losses will be recognized.[50] These would be capital loss.[51] Inasmuch as the receivables in a cash method firm would have a zero basis, there are many cases in which this artificial capital loss could be created.

(2) The distribution of receivables and inventory items would, to the extent it was disproportionate, be treated as a sale of such assets by the firm to the wives. Hence, basis is stepped up, and the gain recognized to the firm can be wiped out by loss carry-overs. By the same token, basis is stepped up on the wives' share of "other property," at the cost of a capital gains tax.

(3) The disproportionate distribution of depreciable and capital assets to the husbands would result in a converse step-up in basis of the remaining one-half of the assets.

The business would then be reorganized into two firms, each one perhaps composed of one husband and the other man's wife. Under section 708(b)(2)(B), the Commissioner would be virtually obliged to recognize both of these

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[50] INT. REV. CODE OF 1954, § 731(a)(2).
[51] *Ibid.*

firms as new entities, since the partners of each would have owned an aggregate interest in the predecessor which *did not exceed* fifty per cent. Under the Regulations, the liquidation tax consequences above described would be mandatory.

The courts might prevent this scheme from ever becoming effective, by applying the "business purpose" test or otherwise. But, then again, they might not. It can readily be seen that the potential for these unseemly manipulations arises solely from the "fifty per cent rule" embodied in the statute. A broadening of the continuity of interest concept in partnership reorganizations would clearly and unquestionably remove such possibilities.

Conclusion

The criticisms here tendered are not unfriendly in purpose. Section 708 is a pioneer effort, and, like other innovations, requires to be refined in the crucible of extended discussion. One conclusion emerges fairly clearly, however, even from a cursory review. Continuity of interest should, in every case, dictate nonrecognition in partnership transactions having as their net effect the mere readjustment of existing business relationships. For the good of the Revenue as well as in fairness to the taxpayer, the statutory standards of continuity should be broadened and made flexible.

Responsible observers have noted a disturbing upsurge in gimmickry among tax men. In part, this is the result of thorough digestion of the many new provisions which were contained in the 1954 Code. Subchapter K is in many ways the darkling wood of the Code, but after five years there are undoubtedly many practicing tax men who now have a thorough grasp of its intricacies. We can expect that, within a short period, the unremitting quest for tax-saving devices will lead to exploitation of the potentialities of section 708. It would, therefore, behoove Congress to deal shortly with the problems of that section, attempting to write a gimmick-proof program more fully effectuating economically sound reorganization principles.