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CONTRIBUTIONS OF PROPERTY TO A PARTNERSHIP: A PRIMER (AND BEYOND)

INTRODUCTION

No gain or loss is recognized by a partnership or by any of its partners when property[1] is contributed to the partnership in exchange for an interest in the partnership.[2] This nonrecognition rule is complemented by rules giving the contributing partner a substituted basis for his partnership interest received in the exchange and the partnership a carryover basis for the contributed property.[3] If the contributed property is subject to a mortgage, or if the partnership assumes a liability of the partner in the exchange, the nonrecognition rule nevertheless applies, even if the sum of the liabilities transferred exceeds the aggregate adjusted basis of the assets transferred. The sum of the liabilities transferred to the partnership which are allocable to other partners, however, is treated as a distribution of money to the transferor partner, and this constructive distribution of money reduces (but not below zero) the transferor partner's basis for his partnership interest.[4] If the amount of the constructive distribution of money to the transferor partner exceeds his basis for his partnership interest, then he recognizes gain in the amount of the excess. This gain is treated as gain from the sale or exchange of his partnership interest, generally capital gain.[5]

The policy reason for not treating a contribution of property to a partnership in exchange for a partnership interest as a taxable event is that there has been a mere change in the form of ownership and the transferor has not profited on the theoretical gain or closed out a losing venture.[6] The transferor's relationship to the transferred property does not materially change: the assets formerly owned directly are owned indirectly through his partnership interest.[7] This continuity of ownership is reflected in the Internal Revenue Code, which

1. See text accompanying notes 56-66 *infra* for a discussion of the meaning of the term property. This article does not consider the tax treatment of the receipt of a partnership interest in exchange for services. For a discussion of this topic, see Cowen, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 TAX L. REV. 161 (1972); Lane, Sol Diamond: *The Tax Court Upsets the Service Partner*, 46 So. CAL. L. REV. 239 (1973).

2. I.R.C. §721(a).

3. I.R.C. §§722, 723.

4. I.R.C. §§752(b), 733.

5. I.R.C. §§731(a), 741.

6. *See, e.g.*, Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.) (no gain or loss recognized if properly transferred to a corporation controlled by the transferor), *cert. denied*, 310 U.S. 650 (1940). *See also* Helvering v. Walbridge, 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934); Edward B. Archbald, 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

7. *See* Edward B. Archbald, 27 B.T.A. 837, 844 (1933), *aff'd*, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

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generally preserves the tax characteristics of the contributed property. The policy is sound, and its theoretical underpinnings are unquestionably correct.[8]

This article discusses the rules regarding contributions of property to a partnership. It begins with a historical review of the subject. This is followed by a discussion of the operative statutory provisions and some of the uncertainties in the present statutory scheme.

HISTORY

Nonrecognition

Prior to the adoption of the 1954 Code there was no explicit statutory statement that a contribution of property to a partnership in exchange for a partnership interest was not a taxable event. There was, however, implicit statutory authority. Section 113(a)(13) of the Revenue Act of 1934 provided that a partnership obtained a carryover basis for property contributed by a partner.[9] This obviously subsumed that the contributing partner recognized no gain or loss on the contribution. Even prior to the 1934 enactment, the courts had little difficulty finding that a contribution of property to a partnership in exchange for a partnership interest was not a taxable event.[10]

The leading pre-1934 case holding that a contribution of property to a partnership in exchange for a partnership interest is not a taxable event is *Edward B. Archbald.*[11] In *Archbald* the taxpayers were members of a partnership organized in 1928 to buy, sell, and invest in securities. Each partner contributed securities to the partnership in exchange for his partnership interest. The Commissioner contended that each partner recognized income on the contribution of the securities to the partnership. The Board of Tax Appeals rejected the Commissioner's contention and held that the partners had realized no gain or loss on the contribution of the securities to the partnership.[12]

8. See text accompanying notes 90-131 *infra* for a discussion of the policy of §721(a) with respect to contributions where the contributor receives boot as well as a partnership interest in the exchange.

9. Revenue Act of 1934, Pub. L. No. 216, §113(a)(13), 48 Stat. 708, provided: "If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any of the paragraphs (1) to (12), inclusive, of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased by the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made." *See* H.R. REP. No. 704, 73d Cong., 2d Sess. 18 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 18-19 (1934). The statutory requirement that the basis be adjusted to take account of gain or loss recognized by the transferor was included because it was not established that transfers of property to a partnership in exchange for a partnership interest were not taxable events, there being no statutory non-recognition rule.

10. Helvering v. Walbridge, 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934); Flannery v. United States, 25 F. Supp. 677 (D.C. Md. 1938), *aff'd*, 106 F.2d 315 (4th Cir. 1939); Edward B. Archbald, 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934). *See also* United States v. Spaid, 28 F. Supp. 670 (D.C. Md. 1938), *aff'd*, 106 F.2d 315 (4th Cir. 1939); Solicitor's Opinion 42, 1920-3 C.B. 61; Tax Board Ruling 34, 1919-1 C.B. 46; I.T. 2010, III-1 C.B. 46 (1924).

11. 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

12. The Board stated: "That the contribution of individual property to a newly or-

The ratio decidendi of the Board's holding came from a line of cases that descended from *Eisner v. Macomber*,[13] which held that only realized gains are cognizable by the taxing statutes, and *Weiss v. Stearn*,[14] which held that exchanges are taxable only if the transferor received something really different from that which he already had.[15] Whether the Board in *Archbald* was correct in its premise that the exchanges were not events of realization because direct ownership of property does not materially differ from indirect ownership through ownership of the partnership interest, however, is debatable.

In *Archbald* the Board noted that a transfer of property to a corporation in exchange for stock is an event of realization, but it distinguished a partner's interest in a partnership and a shareholder's interest in a corporation: "Unlike corporate shares received in exchange for the subscription price in property, the new partnership interest may not be separately disposed of without destroying the partnership. . . . To this extent the partnership and the partner are identical, and a corporation and its shareholders are not."[16] True, common law courts typically viewed a partnership as an aggregate of partners not having a separate legal existence, and an assignment of a partner's interest in a partnership would dissolve the partnership.[17] But under current law, a partnership is viewed for many purposes as an entity, and an assignment of a partner's interest in a partnership does not of itself dissolve the partnership.[18] Under the current view a partnership and its partners are not identical, as stated by the Board in *Archbald*, and the exchange of property for a partnership interest must be viewed as an event of realization. Indeed, the Supreme Court has discerned an event of realization in far less compelling circumstances.[19]

Though the exchange of property for a partnership interest must be viewed as an event of realization, under section 721(a) of the Code the realized gains and losses will not be recognized. But section 721(a) was not enacted until 1954,

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ganized partnership operates to shift its title from the individual and to change the nature of his interest is clear. . . . But it does not follow that such change is itself the realization of gain or loss. . . . On the contrary, the investment is now more fettered than before, as it is bound with others in the joint enterprise. Although a transformation in title has occurred, *there has been no exchange of property for other and different property*, but only a further venturing of the old investment in a new project with the hope of added income in the future." 27 B.T.A. at 844 (emphasis added).

13. 252 U.S. 189 (1920).

14. 265 U.S. 242 (1924).

15. *See* Reg. §1.1001-1(a). For a recent discussion of the realization requirement, see Kaney, *Federal Income Taxation of Exchanges in Partition of Commonly Owned Property: Realization vs. Realism*, 8 FLA. ST. U.L. REV. 629 (1980).

16. 27 B.T.A. at 844.

17. *See, e.g.*, Aboussie v. Aboussie, 270 S.W.2d 636 (Tex. Civ. App. 1954). In *Aboussie* the court stated: "A partnership is not a legal entity. The law recognizes no personality in a partnership other than that of the partners who compose it." *Id.* at 639.

18. UNIFORM PARTNERSHIP ACT §27. *See generally* Crane, *The Uniform Partnership Act — A Criticism*, 28 HARV. L. REV. 762 (1915); Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?*, 16 VAND. L. REV. 377 (1963).

19. In Marr v. United States, 268 U.S. 536 (1925), the Court discerned an event of realization when the General Motors Company shifted its state of incorporation from New Jersey to Delaware and slightly altered its capital structure.

and the entity theory of partnerships had its genesis long before 1954.[20] There are, however, no reported pre-1954 cases holding that a contribution of property to a partnership in exchange for a partnership interest is a taxable event. In fact, prior to *Archbald* the Commissioner had stated that a contribution of property to a partnership in exchange for a partnership interest was not a taxable event.[21] The Commissioner's change of position in *Archbald* resulted from the Board's refusal to accept the Commissioner's method of determining the partnership's gain on the sale of contributed property. In effect, the Board in *Archbald* held that the partnership obtained a stepped-up, or cost, basis for the contributed property. The Commissioner had argued that if the partnership obtained a stepped-up basis for the contributed property, the contribution of property to a partnership must be a taxable event.

Basis

Archbald was decided before the enactment of the carryover basis rule of section 113(a)(13) of the Revenue Act of 1934. Prior to 1934, there was no explicit statutory statement that a partnership obtained a carryover basis for property contributed by a partner in exchange for a partnership interest. In fact, the Commissioner did not contend in *Archbald* that the partnership obtained a carryover basis for the contributed securities. Instead, the Commissioner, relying on General Counsel Memorandum 10092,[22] applied the credited value approach to determining the partnership's and the contributing partners' gain on the sale of the contributed securities.

Under the credited value approach, each asset contributed to a partnership has a credited value equal to the amount by which the contributing partner's capital account is increased by the contribution, usually the value of the property. When the partnership sells the contributed property, it reports as income or loss only the difference between the selling price and the credited value. In addition, the contributing partner is treated as party to the sale, and he is treated as though *he* realizes the difference between his basis for the property and the credited value.

The Board in *Archbald* rejected the credited value approach for two reasons. First, the Board objected to treating the contributing partner as party to the sale by the partnership, which in effect disregarded the partnership.[23] Second, the Board held that the contributing partner had not realized his precontribution appreciation upon the sale of the property by the partnership.[24] Other courts[25] had similar objections to the approach, and the Service later abandoned it.[26]

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20. *See* Jensen, *supra* note 18.

21. Solicitor's Opinion 42, 1920-3 C.B. 61. *See also* General Counsel Memorandum 10092, XI-1 C.B. 114 (1932).

22. XI-1 C.B. 114 (1932).

23. 27 B.T.A. at 841.

24. 27 B.T.A. at 843.

25. *E.g.*, Helvering v. Walbridge, 70 F.2d 685 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934); Flannery v. United States, 25 F. Supp. 677 (D.C. Md. 1938), *aff'd*, 106 F.2d 315 (4th Cir. 1939);

The combined effect of the non-realization and cost basis rules of *Archbald* made contributions of appreciated property to partnerships a device for tax avoidance, not mere tax deferral. In fact, prior to the enactment of carryover basis in 1934, partnerships were often used as a device for avoiding tax on the sale of appreciated property, primarily securities.[27]

In 1934, Congress adopted the carryover basis rule now found in section 723.[28] The House Report to section 113(a)(13) indicates that Congress was concerned about tax avoidance:

> The committee also proposes two important changes in connection with the basis provisions, for the purpose of making it entirely certain that there can be no use of the partnership as a medium of tax avoidance in cases of sales of property which has appreciated in value. The result of the provision of section 113(a)(13) is that if property is purchased by a partnership the basis of such property to the partnership shall be its cost; but if the property is paid in by a partner then the basis to the partnership shall be the cost or other basis to the partner. The committee believes that this provision simply makes specific the correct interpretation of the general provisions of present law.[29]

Crawford v. United States, 24 A.F.T.R. 1137 (W.D. Pa. 1939); Cyrus S. Eaton, 37 B.T.A. 715 (1938); Carroll E. Donner, 32 B.T.A. 364 (1935).

26. Though General Counsel Memorandum 10092 was not revoked until 1950 (1950-1 C.B. 58), it was made obsolete in 1934 by the passage of §113(a)(13) of the Revenue Act of 1934, which provided for a carryover basis for property contributed by a partner to a partnership. The complexity of the credited value approach no doubt contributed to its demise. It is worth noting that the American Law Institute recently came close to recommending the adoption of the credited value approach, but rejected it because of its complexity. A.L.I. FED. INCOME TAX PROJECT DRAFT No. 3 (1979).

27. This is illustrated in Chisholm v. Commissioner, 70 F.2d 14 (2d Cir. 1935), *rev'g* 29 B.T.A. 1334 (1934), *cert. denied*, 296 U.S. 641 (1935). *See also* Crawford v. United States, 24 A.F.T.R. 1137 (W.D. Pa. 1939). In *Chisholm* the taxpayer and four others owned all the stock of an engineering company. On September 26, 1928, they gave an unrelated person an option to purchase their stock. On October 22, 1928, the shareholders organized a partnership and contributed their stock to it in exchange for partnership interests, a non-taxable event. Two days later the holder of the option exercised the option, paying cash to the partnership for the stock. The partnership, claiming a stepped-up, or cost, basis for the stock, reported no gain. The partners also reported no gain. The Commission contended that the transfer of the stock to the partnership followed by the sale of the stock was not bona fide. The Board of Tax Appeals agreed with the Commissioner, but the second circuit reversed. Writing for the court, Judge Learned Hand stated that the issue was whether the transaction was what it appeared to be, i.e., a transfer of stock to the partnership followed by a sale of the stock by the partnership. Distinguishing Gregory v. Helvering, 293 U.S. 465 (1935), Judge Hand held that the partners were not taxable on the pre-contribution appreciation in the value of the stock. It is of special interest to note that Judge Hand also wrote the circuit court opinion in *Gregory* which was affirmed by the Supreme Court. In *Gregory*, the Supreme Court stated that, to come within the corporate reorganization provisions, there must be a business purpose for the transaction, "[t]o hold otherwise would be to exalt artifice above reality and deprive the statutory provision in question of all serious purpose." 293 U.S. at 468. *See* R. PAUL, STUDIES IN FEDERAL TAXATION (1937).

28. Revenue Act of 1934, Pub. L. No. 216, §113(a)(13), 48 Stat. 708 (1934).

29. H.R. REP. No. 704, 73d Cong., 2d Sess. 18 (1934). *See also* S. Rep. No. 558, 73d Cong., 2d Sess. 18-19 (1934).

The final sentence of the House Report may be misleading. The legislative history of section 113(a)(13) reveals an interesting colloquy between a representative of the Secretary of the Treasury and several members of the Senate Finance Committee. When asked whether section 113(a)(13) was consistent with existing law, the Secretary's representative replied in the affirmative.[30] So at least the members of the Senate Finance Committee apparently did not know section 113(a)(13) was inconsistent with the prevailing view. Thus it is unclear whether Congress intended to overrule *Archbald* or intended to make statutory the prevailing common law view but was simply ignorant of that view.

THE STATUTORY PROVISIONS

A contribution of property to a partnership in exchange for a partnership interest is never of itself a taxable event. Section 721(a) provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."[31] The nonrecognition rule applies to contributions of property to a partnership at the time of the formation of the partnership and to contributions made at subsequent times.[32] Nonrecognition is not conditioned on the contribution being solely in exchange for a partnership interest,[33] nor is it conditioned on the contributing partner being in control of the partnership.[34] Section 721(a), however, is not a rule of forgiveness. Rather it is a rule of deferral. Deferral is accomplished by sections 722 and 723, which give the contributing partner a substituted basis for his partnership interest[35] and the

30. *Revenue Act of 1934: Hearings on H.R. 7835 Before the Committee on Finance*, 73d Cong., 2d Sess. 77-78 (March 8, 1934).

31. The transfer of property to a partnership in exchange for a partnership interest is a sale or other disposition of the property causing the transferor to realize gain or loss equal to the difference between the basis to the transferor of the property transferred and the value of the partnership interest received in the exchange. I.R.C. §1001(a). Absent §721(a), the entire amount of realized gain or loss would be recognized. I.R.C. §1001(c). *But see* Edward B. Archbald, 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d 720 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934).

32. Reg. §1.721-1(a). *See* H.R. REP. No. 1337, 83d Cong., 2d Sess. 68, A227 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 94, 388 (1954).

33. For a discussion of the tax consequences of the receipt of boot in a §721(a) exchange, see text accompanying notes 90-131 *infra*.

34. *Compare* I.R.C. §721(a) *with* I.R.C. §351(a).

35. I.R.C. §722 provides: "The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized to the contributing partner at such time." A partner's basis for his partnership interest is prescribed in §705(a). The starting point under §705(a) is §722. I.R.C. §705(a) provides:

> (a) The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests) —
>
> (1) increased by the sum of his distributive share for the taxable year and prior taxable years of —
>
> (A) taxable income of the partnership as determined under section 703(a),
>
> (B) income of the partnership exempt from tax under this title, and

partnership a carryover basis for the contributed property.[36]

To illustrate, assume *A* contributes property with a value of $10 and a basis of $4 to partnership *Y* in exchange for a 20 percent interest in the partnership. Neither *A* nor the partnership recognizes gain on the transfer.[37] *A*'s basis for his partnership interest is $4,[38] and the partnership's basis for the contributed property is $4.[39] When the partnership sells the property, it recognizes[40] the pre-contribution appreciation, as well as any post-contribution appreciation or depreciation, and *A* will report his distributive share of partnership gain or loss.[41]

The policy behind this statutory scheme, deferral of recognition of gain and preservation of the tax characteristics of the contributed property, is reflected elsewhere in the Code. Under sections 1245(b)(3) and 1250(d)(3), depreciation is not recaptured upon a contribution of depreciable property to a partnership in an exchange in which gain is not recognized. Nor is such an exchange of a section 453 installment obligation a disposition.[42] Nor typically is such an exchange of section 38 investment credit property a disposition.[43] Further, the partnership's holding period for the contributed property includes the contributor's holding period,[44] and the partner's holding period for his partnership

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(C) the excess of the deductions for depletion over the basis of the property subject to depletion;

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and the sum of his distributive share for the taxable year and prior taxable years of —

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and

(3) decreased (but not below zero), by the amount of the partner's deduction for depletion under section 611 with respect to oil and gas wells.

36. I.R.C. §723 provides: "The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized to the contributing partner at such time." If property which has not been used in a trade or business is contributed to a partnership for use in a trade or business, then the partnership's basis for determining its allowance for depreciation is the lesser of its value on the date of contribution or the contributing partner's basis for the property. Lawrence Y.S. Au., 40 T.C. 264 (1963), *aff'd per curiam*, 330 F.2d 1008 (9th Cir. 1964). *See* Reg. §1.167(g)-1. In such cases, it is uncertain whether the contributing partner's basis for his partnership interest also is equal to the lesser of the two amounts. Since the limitation prescribed in Reg. §1.167(g)-1 is made solely for purposes of determining the allowance for depreciation, arguably the contributing partner's basis for his partnership interest should be unaffected by the limitation. *But see* I.R.C. §732(b).

37. I.R.C. §721(a).

38. I.R.C. §722.

39. I.R.C. §723.

40. *See* I.R.C. §703(a).

41. A partner's distributive share of partnership income or loss generally is determined by the partnership agreement. I.R.C. §704(a). See text accompanying notes 138-151 *infra* for a discussion of partnership allocations.

42. Reg. §1.453-9(c)(2).

43. I.R.C. §47(b); Reg. §1.47-3(f)(b), Example (5). See text accompanying notes 87-89 *infra* for a discussion of I.R.C. §47(b).

44. I.R.C. §1223(2).

interest received in the exchange includes his holding period for the contributed property provided the property is either a capital or section 1231 asset.[45]

The policy of preservation of the tax characteristics of the contributed property, however, does not invariably apply. The partnership is not the original user of the contributed property, and thus the accelerated depreciation rates of sections 167(c)(2) and 167(j)(4) are unavailable.[46] Also, the partnership is a separate entity that must elect its own taxable year[47] and method of accounting.[48] But in most instances, the policy of continuity will apply.

SOME LIMITATIONS

Transfers to a Partnership "Investment Company"

In 1976 Congress created an exception to the nonrecognition rule of section 721(a) to preclude the use of a partnership organization to obtain tax-free diversification of an investor's portfolio.[49] Section 721(b) provides that the nonrecognition rule of section 721(a) shall not apply to a partnership that would be treated as an investment company if the partnership were a corporation.[50] If the partnership is an investment company, the contributing partner must recognize gain which he realizes on the exchange; the exception to the nonrecognition rule of section 721(a) applies only to realized gains, not losses.[51]

The investment company, or swap-fund, typically involved the transfer of appreciated securities by numerous unrelated individuals, who usually were solicited by a promoter, to a newly organized corporation or partnership. The transferor thereby converted his investment in a single enterprise into another

45. I.R.C. §1223(1). If the contributing partner contributes both capital or §1231 assets and other property it is unclear whether the partner's holding period for his partnership interest is fragmented. If so, this poses conceptual difficulties because a partnership interest generally is treated as a single asset, even if the partner makes contributions to the partnership at different times. *See, e.g.*, I.R.C. §731(a). *But cf.* Harry M. Runkle, 39 B.T.A. 458 (1939) (holding period for corporate stock is fragmented). A contribution of a negligible amount of capital or §1231 assets made solely for the purpose of tacking the contributor's holding period, however, may be ignored under tax avoidance or form/substance principles.

46. *See* Reg. §1.167(c)-1(a)(6). The authors of a leading partnership tax treatise make an argument that the accelerated depreciation rates are available with respect to partnership property subject to I.R.C. §704(c)(3). 1 W. McKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, at ¶10.09[3] (1977). See text accompanying note 151 *infra* for a discussion of I.R.C. §704(c)(3).

47. *See* I.R.C. §441(b); I.R.C. §706(b)(1); Reg. §1.442-1(b)(2). Under §706(b)(1) a partnership may not adopt a taxable year other than that of all its principal partners (defined in §706(b)(3)) unless the partnership obtains the consent of the Commissioner. *See also* Rev. Rul. 60-182, 1960-1 C.B. 264; Rev. Proc. 72-51, 1972-2 C.B. 832.

48. *See* I.R.C. §446; Reg. §1.446-1(c)(1); Reg. §1.446-1(e)(1). Any election affecting the computation of partnership income generally must be made by the partnership, not the partners. I.R.C. §703(b).

49. Pub. L. No. 94-455, §2131(b), (f), 90 Stat. 1924-25. *See* S. REP. No. 938, 94th Cong., 2d Sess., pt. 2, 43 (1976); H.R. REP. No. 94-1049, 94th Cong., 2d Sess. (1976).

50. I.R.C. §721(b) provides: "Subsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated."

51. H.R. REP. No. 94-1049, 94th Cong., 2d Sess. 10 (1976).

and different enterprise (the swap-fund) with a diversified portfolio. By application of section 351(a), regarding contributions of property to corporations, or section 721(a), regarding contributions of property to partnerships, any gain realized on the transfer of the securities to the corporate or partnership swap-fund would not be recognized. Accordingly, if the nonrecognition rules of section 351(a) and 721(a) applied, the transferor would be permitted to cash in his investment, but without the necessity of having to recognize gain on the transfer. In 1966, Congress decided that transfers to a corporate swap-fund should not go untaxed, so it enacted the predecessor to section 351(d), which exempts transfers to a corporate investment company from the nonrecognition rule of section 351(a). But Congress failed at that time to enact a similar exception to section 721 for transfers to a partnership swap-fund, and in 1975 the Internal Revenue Service issued a private letter ruling holding that a swap-fund could be formed tax-free as a publicly syndicated limited partnership.[52] This ruling prompted Congress in 1976 to enact section 721(b), which exempts transfers of property to a partnership investment company[53] from the nonrecognition rule of section 721(a).[54]

Section 721(b) generally applies to transfers made after February 17, 1976, but certain transfers to partnerships made after that date are excepted if before March 27, 1976 the partnership filed a request for a private ruling from the Internal Revenue Service or filed a registration statement with the Securities Exchange Commission.[55]

Defining "Property"

The nonrecognition rule of section 721(a) is limited to contributions of property to a partnership in exchange for a partnership interest. The term property is not defined, nor do the regulations under section 721(a) offer much guidance, except to provide that property includes installment obligations but does not include services.[56] But the absence of an authoritative definition of the

52. S. REP. No. 938, 94th Cong., 2d Sess., pt. 2, 43 (1976).

53. The term investment company is not defined by statute, but Reg. §1.351-1(c)(1) provides that a transfer will be deemed a transfer to an investment company if: (1) the transfer results, directly or indirectly, in a diversification of the transferor's interests and (2) the transfer is to . . . (c) a corporation [partnership] more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities, or interests is regulated investment companies or real estate investment trusts. H.R. REP. No. 94-1049, 94th Cong., 2d Sess. 10 (1976) states that Reg. §1.351-1(c)(1) is applied in determining whether a partnership is an investment company.

54. I.R.C. §721(b). The determination of whether a partnership is an investment company ordinarily is to be made immediately after the transfer of property under the same plan or as part of the same transaction. H.R. REP. No. 94-1049, 94th Cong., 2d Sess. 10 (1976). Also, the exception to the non-recognition rule applies whether the property is transferred to a partnership investment company already in operation or one which is newly formed. *Id.* at 11, 14. A Senate amendment would have excepted certain family partnerships from the investment company exception, but the amendment was dropped as part of the conference agreement, so the exception applies to all such partnerships, whether limited or general, public or private. *Id.* at 11.

55. S. REP. No. 938, 94th Cong., 2d Sess. 44-45 (1976).

56. Reg. §1.721-1(a).

term property should present few difficulties because in most cases the transferred assets clearly will be property. Difficulties arise, however, if the transfer is a disguised device for compensating the transferor for services or the transferor attempts to convert an ordinary income right into capital gain.

In the typical case of a contribution of a going business to a partnership, the transferred assets will include money, accounts receivable, goodwill, and trade secrets or know-how. This will create few difficulties. Money clearly is property,[57] and so are accounts receivable.[58] Likewise, the term property should encompass the goodwill and know-how of a going business transferred to a partnership.[59] If the transferor's personal efforts created the know-how, however, the issue of disguised compensation for services may arise. In *United States v. Frazell*[60] the taxpayer agreed to perform certain geological tests in designated areas to determine whether there was potential for oil and gas exploration. In return for his services, Frazell was to receive a salary and expenses plus an interest in any properties acquired for exploration, but only after the other investors recovered their costs and expenses. At about the time the other investors had recovered their costs and expenses, the properties that had been acquired for exploration were transferred to a newly formed corporation. Frazell received 13 percent of the corporation's stock. The court held the interest in the venture received by Frazell attributable to his services was taxable to him, but the portion of his interest that could be attributed to geological maps created by his personal efforts was not taxable because they were property. The court remanded the case to the district court to determine the value of the maps. The court's opinion is unclear as to whether Frazell received an interest in the venture at the outset or just prior to the transfer to the newly formed corporation. Importantly, however, the court established that assets created by the personal efforts of the transferor can be property for purposes of section 721(a).[61]

The property created by the taxpayer in *Frazell* is to be distinguished from bare income rights. So-called carved out income rights, such as oil payments and lease payments, arguably are not property, an argument which closely parallels assignment of income principles.[62] Analogous to carved out lease payments, the regulations[63] make a distinction between a contribution of property and a contribution of the right to use property, suggesting that the right to use property is not encompassed by section 721(a). For example, if *A* owns land

57. *See* I.R.C. §722. *Cf.* George M. Holstein, 23 T.C. 923 (1955) (money is property for purposes of §351(a)). *Accord*, Rev. Rul. 69-357, 1969-1 C.B. 101.

58. *See* Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974) (accounts receivable are property for purposes of §351(a)).

59. *See* Rev. Rul. 64-56, 1964-1 C.B. 133 (transfer of industrial know-how to a corporation qualifies for non-recognition under §351(a) under certain conditions).

60. 335 F.2d 487 (5th Cir. 1964).

61. *See also* Stafford v. United States, 435 F. Supp. 1036 (M.D. Ga. 1977), *rev'd on other grounds*, 611 F.2d 990 (5th Cir. 1980).

62. *See* Eustice, *Contract Rights, Capital Gain, and Assignment of Income — The* Ferrer *Case*, 29 TAX L. REV. 1 (1964); Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the* P.G. Lake *Case*, 17 TAX L. REV. 293 (1962).

63. Reg. §1.721-1(a).

subject to a leasehold and contributes the leasehold to a partnership, and assuming the nonrecognition rule of section 721(a) applies, then *A* may be able to convert ordinary income into capital gain, for a sale of the leasehold generally would result in ordinary income,[64] whereas a sale of a partnership interest generally would result in capital gain.[65] Thus arguably the leasehold should not be considered property for purposes of section 721(a).

In sum, the term property is intended to have a broad reach.[66] Difficulties arise if the transfer is a disguised device for compensating the transferor for services or the transferor attempts to convert ordinary income into capital gain.

Assignment of Income, Tax-Benefit, Court Holding Company Doctrine

The courts have developed several tax doctrines which may cause recognition of gain or loss to the transferor on a transfer which otherwise would be non-taxable. These doctrines include the assignment of income doctrine, the tax-benefit principle, and the *Court Holding Company* doctrine. In addition, the Commissioner has authority to require the taxpayer to employ a method of accounting and to re-allocate income and deductions in order to clearly reflect income.[67] In the partnership context, the need to apply these doctrines is most evident in the family partnership context, which has its own statutory rules,[68] but they are potentially applicable in other contexts as well. For example, when a sole proprietorship is transferred to a partnership, the transferred assets typically include accounts receivable, inventory, work in progress, and materials and supplies the cost of which was deducted by the transferor. The issues raised in these cases bring into sharp focus the policy of sections 721, 722, and 723. In each case, the question should be asked whether the policy of tax deferral and continuity of tax characteristics should give way to cause taxation of the transferor. Unfortunately, there are no definitive rules which can be applied to answer the question, and no attempt is made here to give an exhaustive treatment of the subject. Instead, the discussion which follows merely points out some of the trouble spots which are frequently encountered.[69]

The assignment of income doctrine[70] generally should be subordinated to the nonrecognition rule of section 721(a).[71] For example, if accounts receivable are contributed to a partnership, it should report the income on the collection of the receivables.[72] Although there is some potential for shifting of tax between partners, the general rule of section 704(c)(1) (which provides that gain or loss

64. Hort v. Commissioner, 313 U.S. 28 (1941).

65. I.R.C. §741.

66. E. I. Dupont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973).

67. I.R.C. §§446(b), 482.

68. I.R.C. §704(e). *See* Reg. §1.704(e).

69. *See* Benjamin, *Problems in Transition from Sole Proprietorship or Partnership to Corporation*, 26 N.Y.U. INST. ON FED. TAX. 791 (1968). Eustice, *supra* note 62; Lyon & Eustice, *supra* note 62.

70. *See* Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

71. *Cf.* Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir. 1974) (assignment of income doctrine subordinate to non-recognition rule of §351(a)). *Accord*, Rev. Rul. 80-198, 1980-30 I.R.B. 10.

72. *Id.*

with respect to contributed property is allocated among the partners in the same manner as if the property had been purchased by the partnership) clearly sanctions this shifting.[73] In egregious cases, however, the assignment of income doctrine may prevail. This would occur, for example, when there is no business reason for the transfer and the transfer is made solely for tax avoidance.[74] But in the typical case of a contribution of a cash method going business, the nonrecognition rule of section 721(a) should prevail.

In *Nash v. United States*[75] the Supreme Court held that there had been no recovery of the transferor's bad debt reserve in a section 351 non-taxable incorporation exchange and therefore he could not be taxed on the reserve. The theory of *Nash* also applies to a section 721(a) non-taxable exchange. The authors of a leading corporate tax treatise, however, postulate that the theory of *Nash* may not apply to an otherwise tax-free transfer to a corporation of previously expensed materials and supplies.[76] The authors reason that there is a recovery of the items in the exchange because the stock received in the exchange has a value in excess of the transferor's zero basis for them. But the absence of reported cases suggests that the Commissioner does not intend to take this position. To do so would, for all practical purposes, make a nullity of sections 351(a) and 721(a). Besides, there is little potential for tax avoidance here because the transferee partnership will obtain a carryover basis for the contributed property, and the partnership will recognize the income when it sells the contributed property. Thus the policy of section 721(a), tax deferral and continuity of tax characteristics, should in most cases prevail over the tax-benefit principle.

It has been pointed out that in the absence of a business purpose the assignment of income doctrine may prevail over the nonrecognition rule of section 721(a) on the contribution of accounts receivable to a partnership.[77] Similarly, if property is transferred to a partnership with no purpose other than to sell the partnership interest in the hope of converting ordinary income into capital gain, the transaction may be recast as a direct sale of the property by the contributing partner.[78] While the collapsible partnership rules of section 751 would in most instances statutorily characterize the selling partner's gain attributable to ordinary income assets of the partnership as ordinary income, there are some situations in which section 751 would not apply.[79] For example, if a dealer

73. See text accompanying notes 138-151 *infra* for a discussion of partnership allocations.

74. Rev. Rul. 80-198, 1980-30 I.R.B. 10 (absence of business motive may vitiate non-taxable transfer of accounts receivable to a corporation). *See* Gregory v. Helvering, 293 U.S. 465 (1935); Villere v. Commissioner, 133 F.2d 905 (5th Cir. 1943); Brown v. Commissioner, 115 F.2d 337 (2d Cir. 1940); Adolph Weinberg, 44 T.C. 233 (1965), *aff'd per curiam*, 386 F.2d 836 (9th Cir. 1967).

75. 398 U.S. 1 (1970).

76. 1 B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶3.17 (4th ed. 1979).

77. See note 74 and accompanying text, *supra*.

78. *See* James M. Hallowell, 56 T.C. 600 (1971) (transfer of property to a corporation followed promptly by a sale by the corporation deemed a direct sale by the transferor). *See also* West Coast Marketing Corp., 46 T.C. 32 (1966).

79. See notes 195-202 and accompanying text, *infra* for a discussion of §751.

contributes unimproved land to a newly formed partnership and thereafter sells his partnership interest, section 751 would not apply because the transferor's status as a dealer would not taint the contributed property in the hands of the partnership. Under the general rule of section 741 the dealer's gain from the sale of his partnership interest would be capital gain.[80] But if the contribution and sale are part of a single integrated transaction, it may be recast as a direct sale by the partner, resulting in ordinary income to him.[81]

The *Court Holding Company*[82] doctrine parallels the business purpose doctrine. Under the doctrine a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. For example, if, after negotiating to sell property to *B*, *A* contributes the property to a newly formed partnership and the partnership sells the property to *B*, the transaction may be recharacterized as a direct sale by *A*. The Commissioner has applied the *Court Holding Company* doctrine to distributions of property from a partnership to a partner,[83] and would probably also apply it in appropriate circumstances to contributions to a partnership.

In addition to the above-mentioned tax doctrines, several statutory provisions require the transferor to recognize gain in an otherwise non-taxable exchange. For example, depreciation is recaptured under sections 1245(a) and 1250(a) notwithstanding any other provision in the Code.[84] It has already been pointed out, however, that by statutory exception depreciation is not recaptured in an exchange in which gain is not recognized under section 721(a).[85] By administrative regulation such an exchange of a section 453 installment obligation is not a disposition for purposes of section 453B(a).[86] Further, such an exchange of section 38 investment credit property is not a "disposition" for purposes of section 47(a), provided the exchange is a mere change in the form of conducting the trade or business in which the section 38 property is used.[87] The regulations[88] under section 47 provide that the required condition exists if: (1) the section 38 property is retained as section 38 property in the same trade or business, (2) the transferor retains a substantial interest in the trade or business, (3) substantially all the assets necessary to operate the trade or business are transferred to the transferee, and (4) the basis of the section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of the transferor. Thus a transfer of a going business to a

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80. Alan S. Davis, 29 T.C.M. (CCH) 749 (1970) (partnership's status as a dealer does not taint partner's sale of investment property to the partnership). *See also* Hyman Podell, 55 T.C. 429 (1970).

81. *See* James M. Hallowell, 56 T.C. 600 (1971) (transfer of property to a controlled corporation promptly followed by the sale of property directly to transferor).

82. Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

83. Rev. Rul. 75-113, 1975-1 C.B. 19.

84. I.R.C. §§1245(d), 1250(i).

85. *But see* Reg. §1.1245-4(c)(4), Example (3), discussed in text accompanying notes 190-194 *infra*.

86. Reg. §1.453-9(c)(2).

87. I.R.C. §47(b) (flush language).

88. Reg. §1.47-3(f).

partnership should satisfy the condition, provided the transferor retains a substantial interest in the partnership.[89]

Receipt of Boot

What if, in addition to a partnership interest, a contributing partner receives money or other consideration (boot) in exchange for property? The nonrecognition rule of section 721(a) is not conditioned on the contribution being solely in exchange for a partnership interest,[90] but section 721 does not expressly state how boot is treated.[91] Three possible approaches suggest themselves.

Under the first approach, the transferor would be required to recognize gain, but not in an amount in excess of the boot. This essentially is the approach taken in section 351,[92] regarding transfers of property to controlled corporations, as well as several other[93] nonrecognition provisions in the Code. The approach has much to commend it: it is relatively simple to apply and finds support in other nonrecognition provisions. But the failure of Congress to enact a specific statutory provision, as it has done elsewhere,[94] suggests that Congress did not intend this approach to apply to contributions of property to a partnership. Further, application of the approach would create distortions in bases to the contributing partner and the partnership, which would require adjustments not provided for in the statute.[95] It should be assumed, therefore, that the first approach, though commendable, cannot be applied in the absence of a specific statutory enactment. The correct tax treatment of boot received in a section 721(a) exchange is thus limited to either of the following approaches.

Under the second approach, the transaction would be divided into two parts: one a non-taxable contribution of property solely in exchange for a partnership interest and the other a taxable sale of property in exchange for the boot. This is, in effect, a part sale approach.[96]

Under the third approach, the transaction likewise would be divided into two parts: an entirely non-taxable contribution of property in exchange for a partnership interest followed by a separate, simultaneous distribution of boot

89. *See* Reg. §1.47-3(f)(6), Example (1) (a transfer of sole proprietorship to a newly formed corporation in exchange for 45 percent of the corporation's stock a retention of a substantial interest). *See also* Reg. §1.47-3(f)(6), Example (5).

90. See text accompanying notes 33-34 *supra*.

91. *See* I.R.C. §721(a).

92. I.R.C. §351(b).

93. I.R.C. §1031 (regarding like-kind exchanges); I.R.C. §1033 (regarding involuntary conversions).

94. *Id.*

95. Under §358(a) the shareholder's basis for stock and securities received in a §351(a) exchange is the same as that of the transferred property, decreased by the value of any boot received and the amount of loss recognized by the transferor, and increased by the amount of gain recognized by the transferor. Under §362(a) the corporation's basis for property received in a §351(a) exchange is the same as that of the transferor, increased by the amount of gain recognized by the transferor. These adjustments were not provided for in the partnership provisions.

96. *See* I.R.C. §1011(b) (regarding bargain sales to charity). *See also* Reg. §1.1011-2.

under section 731(a), which generally would result in no recognition of gain or loss but instead in a reduction in the contributing partner's basis for his partnership interest under section 733. This is, in effect, a return of capital approach.

To illustrate, assume *A* contributes property with a value of $10 and a basis of $4 to partnership *Y* in exchange for a partnership interest with a value of $8 and cash of $2 (boot). *A*'s realized gain is $6, the difference between the value of the property received and his basis for the transferred property.[97] *A*'s recognized gain, if any, depends on the proper treatment of the boot, for under section 721(a) the contribution of property to a partnership in exchange for a partnership interest is generally a non-taxable event.

Under the part sale approach, to compute *A*'s recognized gain his basis for the transferred property must be apportioned between the non-taxable contribution and taxable sale.[98] Since 20 percent of *A*'s amount realized consists of boot, 20 percent of his basis for the transferred property ($.8) is apportioned to the taxable sale, and the balance ($3.2) is apportioned to the non-taxable contribution. *A*'s recognized gain is therefore $1.2, the difference between the boot received and his basis for the transferred property apportioned to the taxable sale.[99] Under section 722, *A*'s basis for his partnership interest is $3.2, his basis for the transferred property apportioned to the non-taxable contribution.[100] The partnership's basis for the transferred property is $5.2, which consists of a carryover basis under section 723 of $3.2 plus a cost basis under section 1012 of $2.[101]

Under the return of capital approach, *A* recognizes no gain or loss on the transfer of the property to the partnership.[102] Under section 722, *A*'s basis for his partnership interest initially is $4, his basis for the contributed property.

97. I.R.C. §1001(a).

98. *See* Reg. §1.61-6(a) (requiring equitable apportionment of basis when part of a larger property is sold). *Cf.* I.R.C. §1011(b) (regarding bargain sales to charity).

99. If the boot distributed to *A* by the partnership had consisted of appreciated (depreciated) property instead of cash, then the partnership would have recognized gain (loss) in the transaction under the part sale approach. To illustrate, assume the boot consisted of property with a value of $2 and a basis to the partnership of $1. Pursuant to §1001(c), the partnership recognizes gain of $1, §721(a) being inapplicable. The partnership's basis for the property acquired in the exchange would not be increased to take into account the gain recognized by the partnership. *See* Rev. Rul. 72-327, 1972-2 C.B. 197. The partner who receives the boot obtains a cost basis under §1012. Under the return of capital approach, by contrast, the partnership would not recognize gain (loss) in the exchange, §721(a) being applicable. Further, under §732(a)(1), subject to the limitation contained in §732(a)(2), the distributee partner would obtain a carryover, not cost basis, for the boot.

100. *A*'s basis for his partnership interest is not increased to take account of his recognized gain, because the gain relates to the receipt of the boot, not the partnership interest received in the exchange. Similarly, there is no reduction under §733 in *A*'s basis for his partnership interest to take account of the distribution of boot, because the boot received by him is not received in his capacity as a partner.

101. The partnership's holding period for the sale portion of the transferred property commences with the transfer to the partnership, since its basis is not determined by reference to the basis of the transferor partner. I.R.C. §1223(2).

102. I.R.C. §721(a).

However, under section 733,[103] *A*'s basis for his partnership interest is reduced to $2, his initial basis reduced by the amount of boot distributed to him.[104] The partnership's basis for the contributed property is $4, *A*'s basis for the transferred property, unaffected by the distribution to him.[105]

Note that, under either of the two approaches, if *A* were to sell his partnership interest for $8, the aggregate amount of gain he would recognize would be $6, which is equal to the pre-contribution appreciation in the value of the transferred property. The difference between the two approaches is that under the part sale approach *A* recognizes $1.2 of the gain at the time the property is transferred to the partnership, whereas under the return of capital approach *A* recognizes the entire $6 of gain at the time he sells his partnership interest. With respect to the partnership, however, the results under the two approaches differ significantly. If the partnership sells the contributed property, the partnership will report gain measured by the difference between the selling price (which is assumed to be $10) and its basis for the property. The partnership's basis for the property, however, differs under the two approaches. Under the part sale approach the partnership will report gain of $4.8, whereas under the return of capital approach the partnership will report gain of $6. The reason for the difference is that under the part sale approach the partnership obtains in part a cost basis for the property, whereas under the return of capital approach the partnership obtains solely a carryover basis for the property.

To determine which of the two approaches is correct, the starting point is section 1001(c), which provides that the entire amount of realized gain or loss shall be recognized except as otherwise provided in the Code. Section 721(a) contains an exception to recognition in the case of "a contribution of property to the partnership in exchange for a partnership interest." The nonrecognition rule applies to every contribution of property to a partnership. The essential question then is whether a particular transfer is a contribution or some other transaction, such as a sale.[106]

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103. I.R.C. §733 provides:

> In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by —
>
> (1) the amount of any money distributed to such partner, and
>
> (2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

104. If the amount of boot consisting of money received by *A* had exceeded his basis for his partnership interest, then he would have recognized gain under §731(a) in the amount of the excess, such gain being treated as gain from the sale or exchange of his partnership interest, generally capital gain under §741.

105. If *A* had recognized gain under §731(a), because the amount of boot consisting of money exceeded his basis for his partnership interest, nevertheless the partnership's basis for the transferred property generally would be unaffected. *But see* I.R.C. §734(b) discussed in text accompanying notes 216-223 *infra*.

106. When a partner engages in a transaction with a partnership the tax treatment depends on whether an entity or aggregate approach to the treatment of partnerships is adopted. Under the entity theory, a partner who sells property to a partnership is taxed as if he were an outsider. By comparison, under the aggregate theory a partner could not be taxed on the portion of the sale which is to himself. Although pre-1954 cases were in conflict, the 1954 Code

A transfer of property to a partnership in exchange for a partnership interest and boot has characteristics of both a non-taxable contribution and a taxable sale. The Code does not state how such hybrid transactions are to be treated. The regulations, however, do offer some guidance. Regulation section 1.721-1(a) provides:

> Rather than contributing property to a partnership, a partner may sell property to the partnership. . . . Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, . . . the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

Note, however, that the regulation apparently deals with a transfer of property to a partnership solely in exchange for money or other consideration, implying that it deals not at all with transfers of property to a partnership in exchange for a partnership interest as well as money or other consideration. Under this interpretation of the regulation, a transfer of property to a partnership is either a non-taxable contribution or a taxable sale, but not both. In fact, this interpretation finds support in the legislative history of section 707:

> Section [707](a) provides the general rule that a partner who engages in a transaction with the partnership, other than in his capacity as a partner, shall be treated as though he were an outsider. Such transactions include the sale of property to the partnership. . . . Transactions *involving* contributions of money or property to the partnership by the partner . . . are not governed by this section.[107]

The use of the word involving implies that section 707(a) does not apply to transactions which have characteristics of a non-taxable contribution as well as a taxable sale and that those transactions are governed entirely by the nonrecognition rule of section 721(a). Further, this interpretation of sections 707 and 721 is in harmony with section 731, which deals with the tax treatment of distributions to partners by a partnership.

Under the general rule of section 731(a), no gain is recognized to a partner upon a non-liquidating distribution of money or other property to him. Instead, under section 733 the distributee partner's basis for his partnership interest is reduced by the amount of money distributed or the basis to the partner of property other than money distributed.[108] The policy reason for not taxing distributions relates to the aggregate treatment of partnerships adopted in sec-

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adopted an entity theory of partnerships for this purpose. I.R.C. §707(a). *See* H.R. REP. No. 2543, 83d Cong., 2d Sess. 59 (1954). *Compare* Harvey M. Toy, 11 B.T.A. MEMO. (P-H) 1128 (1942), *with* Benjamin v. Hoey, 139 F.2d 945 (2d Cir. 1944). I.R.C. §707(a) provides that, if a partner engages in a transaction with a partnership other than in his capacity as a partner, the transaction shall be considered as occurring between the partnership and an outsider. Thus, if a partner sells property to a partnership, he will be taxed on the transaction under the general rule of §1001, not §721(a). *See* Reg. §§1.707-1(a), 1.721-1(a).

107. H.R. REP. No. 2543, 83d Cong., 2d Sess. 59 (1954) (emphasis added). *See also* S. REP. No. 1622, 83d Cong., 2d Sess. 386 (1954).

108. See notes 103-104 *supra*.

tions 701 through 704, under which partnership income is taxed directly to the partners, whether distributed or not. Since the partners are taxed directly on partnership income, generally no tax is imposed on distributions to partners.

There is no direct and unambiguous authority which sanctions the return of capital approach. But the recent Tax Court case of *John H. Otey, Jr.*[109] does lend support to it. In *Otey* the taxpayer transferred land with a value of $65,000 and a basis of $18,500 to a newly formed partnership in exchange for a 50 percent interest in the partnership. The other partner contributed no property but instead contributed services. The partners intended to construct an apartment building on the land with borrowed funds secured by a mortgage on the land. The other partner was to construct the building and the taxpayer was to manage the apartments. The partnership agreement provided that as soon as the partnership obtained the loan, the partnership was to distribute $65,000 of the loan proceeds to the taxpayer. The partnership obtained the loan (on which the partners were personally liable) and promptly distributed $64,750 to the taxpayer. The taxpayer treated the transaction as a non-taxable contribution followed by a non-taxable return of capital,[110] whereas the Commissioner argued that it was a taxable sale. The Tax Court stated that there were two methods of analyzing the transaction: a taxable sale under section 707(a) or a non-taxable contribution under section 721(a) followed by a non-taxable return of capital under sections 731(a) and 733.[111] The Tax Court held that the transaction was a non-taxable contribution followed by a non-taxable return of capital.[112] The holding in *Otey* thus affirms that distributions to partners should be taxed, if at all, under the general distribution provisions, sections 731(a) and 733.[113]

109. 70 T.C. 312 (1978), *aff'd*, 634 F.2d 1046 (6th Cir. 1980).

110. The taxpayer's basis for his partnership interest exceeded the amount of the distribution to him, his basis having been increased under §752(a) by his share of the mortgage. See text accompanying notes 152-166 *infra* for a discussion of §752.

111. 70 T.C. at 316.

112. 70 T.C. at 321. The court in *Otey* listed six factors present in the case which supported the conclusion that the transaction was a contribution rather than a sale: (1) the partners treated the transaction as a contribution; (2) the property transferred to the partnership was the *raison d'etre* of the partnership; (3) the property transferred to the partnership was its only capital; (4) there was no guarantee that the contributing partner would be paid the boot or get to keep it (he was personally liable on the mortgage); (5) the preferential distribution was made in order to equalize the capital accounts of the partners; and (6) the facts did not reveal a disguised sale, for the contributing partner could have mortgaged the property prior to the transfer of the property to the partnership and retained the proceeds.

113. *See also* Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980). *Cf.* Stackhouse v. United States, 441 F.2d 465 (5th Cir. 1971). In *Stackhouse* the court considered the tax treatment to a partnership and its partners of discharge of indebtedness income, the partnership having satisfied a $126,882.86 debt by paying only $30,000. The Internal Revenue Service contended that §61(a)(12) (discharge of indebtedness income) governed. The court, however, held that the discharge of indebtedness caused a constructive distribution of money to the partners under §752(b), and that the partners' gain, if any, was to be determined under the distribution rule of §731(a), not §61(a)(12), because §731 "sets forth the rules for the recognition of gain or loss upon distributions of money and property by the partnership to a partner." 441 F.2d at 47, *quoting from* S. REP. No. 1622, 83d Cong., 2d Sess.

The return of capital approach, however, is not without its faults. In particular, the approach applies to every contribution of property to a partnership, and distinguishing between a contribution and a sale is problematical. A particular transaction may have characteristics of both, but under the return of capital approach it must be either one or the other. To make a proper determination the transaction must be viewed in the context of the policy underlying section 721(a).

Contributions of property to a partnership are not deemed appropriate occasions for the imposition of tax because the transferor has not cashed in his investment but rather has made a mere change in form of ownership only.[114] In the case of a transfer of property to a partnership in exchange for a partnership interest and a small amount of boot, the policy of section 721(a) is clearly satisfied, for it must be said that there has been a mere change in form of ownership only. By comparison, in the case of a transfer of property to a partnership in exchange for a partnership interest with a negligible value and boot in an amount about equal to the value of the transferred property, the policy of section 721(a) is just as clearly not satisfied, for it must be said that there has *not* been a mere change in form of ownership only. But transactions between these two extremes may cause difficulties, because they resemble a contribution as well as a sale, and it cannot be said that the policy of section 721(a) is or is not clearly satisfied. In these cases an analogy can be made to the corporate reorganization provisions,[115] which are also based on the underlying policy that there has been a mere change in form of ownership.

In determining whether a particular transaction comes within the reorganization provisions, the courts have developed a continuity of interest requirement.[116] If continuity of interest is lacking, the transaction is said to more closely resemble a taxable sale.[117] Continuity is said to exist only where the transferor receives a proprietary interest (i.e. stock) in the transferee corporation which must represent a substantial part of the value of the property transferred.[118] Whether the value of the proprietary interest received represents a substantial part of the value of the transferred property is not determined under a definite formula, but the Commissioner has ruled that the continuity of interest requirement will be satisfied if the transferor receives no more than 50 percent of the value of the transferred property in boot.[119]

To be sure, the analogy between a corporate reorganization and a contribu-

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389 (1954). The result in *Stackhouse* would be different under the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389-3413 (1980).

114. See note 6 and accompanying text, *supra.*

115. I.R.C. §§351-368.

116. Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir.), *cert. denied,* 288 U.S. 599 (1932). *See also* LaTulle v. Scofield, 308 U.S. 415 (1940); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir.), *cert. denied,* 342 U.S. 860 (1951).

117. *Id.*

118. *Id.*

119. Rev. Rul. 66-224, 1966-2 C.B. 114. *See* Rev. Proc. 74-26, 1974-2 C.B. 478, *superseded by,* Rev. Proc. 77-36, 1977-2 C.B. 568.

tion of property to a partnership is not a perfect one. As noted earlier, however, their underlying policies are basically the same. Further, their purposes too are basically the same: to facilitate business readjustments, whereby the transferor continues his interest in the transferred property in modified form. It must be emphasized, however, that the continuity of interest analysis, like the return of capital approach itself, has no direct and unambiguous authority supporting it.[120]

Despite the support for the return of capital approach found in the legislative history and statutory scheme regarding distributions to partners, the Commissioner has adopted the part sale approach.[121] In Revenue Ruling 78-357,[122] *A* and *B* were equal partners in a foreign limited partnership, *AB*. For the purpose of transferring additional capital to the partnership while remaining equal partners, *A* transferred stock of *T* Corporation, which had a value of $101x and basis of $50x, to *AB* in exchange for a life annuity with a present value of $75x. *B* transferred $26x in cash and received nothing in exchange. The ruling discusses the different tax treatment accorded sales by partners to a partnership and contributions, citing Regulation section 1.721-1(a), quoted above. The ruling concludes:

> Accordingly, under the above circumstances, the exchange by *A* of the *T* stock for the annuity of *AB* is a taxable exchange between a partnership and one who is not acting in the capacity of a partner to the extent the fair market value of the *T* stock is equal to the present value of the annuity of 75x dollars. The excess of the fair market value of the *T* stock transferred over the present value of the annuity, or 26x dollars, is a nontaxable contribution of property under section 721 of the Code.[123]

Note, however, that the transaction described in the ruling bears the indicia of a taxable sale under the return of capital approach; that is, the value of the boot received in the exchange ($75x) was well in excess of 50 percent of the value of the property transferred.[124] In this respect the ruling is consistent with

120. *But see* B. BITTKER & J. EUSTICE, *supra* note 76, at ¶3.01, where the authors suggest that the continuity of interest requirement could be applied to a §351(a) incorporation exchange. *See also* Rev. Rul. 80-285, 1980-43 I.R.B. 9; Rev. Rul. 80-284, 1980-43 I.R.B.

John H. Otey, Jr., 70 T.C. 312 (1978), *aff'd*, 634 F.2d 1046 (6th Cir. 1980), suggests an alternative to the continuity of interest approach to determining whether a particular transfer to a partnership constitutes a contribution or a sale. In *Otey* the Tax Court listed several factors present in the case which supported the conclusion that the transaction was a contribution. See note 112 *supra*. Among those was that the preferential (or boot) distribution was made to restore the capital accounts of the partners to equality. In effect, the court was saying that there was a business purpose for the distribution. The business purpose test therefore may offer an alternative to the continuity of interest test discussed in the text. The business purpose test, however, is more ambiguous than the continuity of interest test. Further, its scope is more limited. The tax treatment of a property transfer to a partnership in which the transferor partner receives consideration from the partnership is considered in Rubinstein, *Transfers of Property to a Partnership: Contributions or Sales and Related Uncertainties*, 34 TAX LAW. 371 (1981).

121. Rev. Rul. 78-357, 1978-2 C.B. 227.

122. *Id.*

123. *Id.*

124. Also see notes 126-128 and accompanying text, *infra*.

the return of capital approach. Indeed, under the return of capital approach the amount of *A*'s recognized gain would have been greater assuming the transaction was in substance a sale and not a contribution.[125]

The method for determining the transferor's gain in the ruling differs from that in the return of capital approach. In the ruling the transaction is treated as a sale only to the extent of the value of the boot received, whereas under the return of capital approach the entire transaction would be treated as a taxable sale, assuming the transaction was in substance a sale and not a contribution. But the ruling fails to state how the amount of the transferor's gain is to be determined, nor does it state how *A*'s basis for his partnership interest and the partnership's basis for the *T* stock are to be determined. If the part sale approach previously discussed were applied, *A*'s gain in the ruling would be determined by first apportioning his basis for the *T* stock between the taxable sale and the non-taxable contribution. Since about 75 percent of *A*'s amount realized consists of boot, 75 percent of his basis for the transferred property ($37.5x) would be apportioned to the sale and the balance ($12.5x) would be apportioned to the non-taxable contribution. *A*'s recognized gain therefore would be $37.5x (the excess of $75x over $37.5x). *A*'s basis for his partnership interest received in the exchange would be only $12.5x, his basis for the *T* stock apportioned to the non-taxable contribution, and his basis for the annuity received in the exchange would be a cost basis of $75x. The partnership's basis for the *T* stock would be $87.5x, which consists of a carryover basis of $12.5x plus a cost basis of $75x.

The revenue ruling may be criticized on several grounds. First, it contains no analysis of sections 707 and 721, their legislative history, or the purposes for which they were enacted. Indeed, the ruling contains no analysis at all, nor does it cite any authority for its holding, other than Regulation section 1.721-1(a), which, as already pointed out, is ambiguous. Second, the ruling fails to state how the amount of the transferor's gain is to be determined, nor does it state how the partner's basis for his partnership interest or the partnership's basis for the transferred property is to be determined. The part sale approach does supply a solution, but other approaches are possible. For example, instead of apportioning the transferor's basis for the transferred property between the taxable sale and non-taxable contribution, his entire basis could be applied to determine the amount of his gain.[126] Finally, the issue regarding the proper tax treatment of boot received in a section 721(a) exchange should not have arisen in the ruling, for under traditional debt/equity principles the transaction in the ruling should have been treated as a contribution to capital, not as a sale.[127]

It is fundamental that an ostensible sale of property by a partner to a partnership may be recharacterized as a capital contribution if the transaction does not bear the indicia of a bona fide sale. Where payment of the purchase price is deferred, as occurred in the ruling, traditional debt/equity principles are

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125. Under the part sale approach only a portion of the transferor's gain is recognized. But under the return of capital approach all of the transferor's gain is recognized assuming the non-recognition rule of §721(a) is inapplicable.

126. *See* Reg. §1.1001-1(e)(1).

127. *See* Joseph W. Hambuechen, 43 T.C. 90 (1964).

applied to determine whether in substance there has been a sale.[128] The transfer of property by a 50 percent-partner to a partnership in exchange for a life annuity clearly resembles a capital contribution, not a taxable sale, because payment of the purchase price is entirely dependent on the success of the enterprise and the transferred property is subject to the risks of the venture.[129]

In sum, Revenue Ruling 78-357 is not the final word. Indeed, the ruling brings into sharp focus the potential for manipulation under the part sale approach. For example, assume *A* owns unimproved investment property that he intends to transfer to a newly formed partnership for subdivision and sale. If *A* recognizes gain (which generally will be capital gain[130]), on the transfer of the property to the partnership, then the partnership's basis for the property is increased by the amount of the gain, thereby reducing the partnership's potential gain (which generally will be ordinary income[131]) on the subsequent sale of the subdivided lots. In effect, *A* converts potentially ordinary income into capital gain, usually a worthwhile objective. On the other hand, a partner may prefer that the transfer of depreciated property to a partnership be treated as a taxable sale, thereby permitting the partner to recognize a loss on the transfer. Assume in the preceding example that *A*'s basis for the property is $100 and its value is $80. Assume further that he transfers the property to a partnership in exchange for a 20 percent interest in the partnership and $40 in cash. Under the part sale approach, *A* would recognize a loss of $10 (the excess of one-half of his basis for the property over the amount of boot received). In effect, *A* is permitted to recognize a loss, even though he has not closed out a losing venture, having retained indirect ownership of the property through his ownership of his partnership interest. Under the return of capital approach, however, if *A* receives a partnership interest and boot in a section 721(a) exchange, gain or loss will go unrecognized, and the partnership will obtain a carryover basis for the contributed property. *A*'s objective of converting potentially ordinary income into capital gain, or recognizing a tax loss, will be thwarted.[132]

If the transfer of property to a partnership is to be treated partially or fully as a sale, then the transferor partner should be made aware of section 707(b). Under that section, no deduction is allowed for losses from sales or exchanges, directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership.[133] In those cases, the transferee (the partnership) may offset its gain

128. *But see* Alan S. Davis, 29 T.C.M. (CCH) 749 (1970).

129. *See* Joseph W. Hambuechen, 43 T.C. 90 (1964). *But see* Alan S. Davis, 29 T.C.M. (CCH) 749 (1970). *See* Rubinstein, *supra* note 120.

130. I.R.C. §1221. *See* Alan S. Davis, 29 T.C.M. (CCH) 749 (1970) (partnership's status as a dealer does not taint partner's sale of investment property to the partnership). *See also* Hyman Podell, 55 T.C. 429 (1970).

131. I.R.C. §1221(1).

132. In Rev. Rul. 78-357, 1978-2 C.B. 227, the Commissioner did not heed the first circuit's dictum, "interpretative chickens may come home to roost at a time when the barnyard wears quite a different aspect." Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir. 1940).

133. I.R.C. §707(b)(1) provides:

on the subsequent sale of the transferred property by the amount of loss disallowed to the transferor (the partner).[134] More importantly, in the case of a sale, directly or indirectly, of property that in the hands of the transferee (the partnership), is property other than a capital asset as defined in section 1221 between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital or profits interest in the partnership, any gain recognized is treated as ordinary income.[135]

To illustrate, assume *A*, who owns more than 80 percent of the capital or profits interest in the partnership,[136] sells unimproved investment property, which is a capital asset in *A*'s hands, with a value of $10 and basis of $4, to the partnership, which the partnership intends to subdivide and sell in lots, for $10 cash. *A*'s recognized gain is $6, which, under section 707(b)(2)(A), is treated as ordinary income.

Note also that for purposes of section 707(b), the constructive-ownership rules of section 267(c) (other than paragraph (3)) apply in determining ownership of a partnership capital or profits interest.[137]

Partnership Allocations: The Fundamentals

A partnership is not a separate taxpaying entity.[138] Instead, partnership income and loss is passed through to the partners, who must report their distributive shares of partnership income or loss.[139] The partnership generally determines its taxable income in the same manner as an individual[140] and must file an informational return under section 6031. In computing its taxable income,

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(b)(1) No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between —

(A) a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferree described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1).

134. *Id.*

135. I.R.C. §707(b)(2) provides:

(2) In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221 —

(A) between a partnership and a partner owning, directly or indirectly, more than 80 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own directly or indirectly, more than 80 percent of the capital interests or profits interests, any gain shall be considered as ordinary income.

136. It is unclear whether the transferor partner's interest in the partnership is determined before or after the sale; the statute and the regulations do not contemplate a transaction in which the transferor partner receives a partnership interest in the sale. *See* Moore v. Commissioner, 202 F.2d 45 (5th Cir. 1953).

137. I.R.C. §707(b)(3). For a discussion of §707(b), in particular the application of the constructive ownership rules, *see* 1 W. McKee, W. Nelson & R. Whitmire, *supra* note 46, at ¶13.04.

138. I.R.C. §701.

139. I.R.C. §702(a).

140. I.R.C. §703(a).

however, a number of items of income and loss must be separately stated, which has the effect of preserving the character of the separately stated items at the partner level.[141] Items of income and loss not separately stated are lumped together in computing partnership taxable income or loss, sometimes called residual or bottom line income or loss.[142]

A partner's distributive share of partnership income or loss generally is determined by the partnership agreement.[143] This added flexibility is of course a major incentive for the use of the partnership organization. Within limits, the partners may agree to allocate items of partnership income or loss, as well as bottom line income or loss, in a manner best suited for the partners. If an allocation of an item under the partnership agreement lacks substantial economic effect, however, then each partner's share of the item is determined in accordance with the partner's interest in the partnership.[144]

With respect to partnership property contributed by a partner, under section 704(c)(1) each partner's distributive share of gain, loss, depreciation generally is determined in the same manner as if the property has been purchased by the partnership. Accordingly, upon the sale of contributed property, the partnership's gain includes any pre-contribution, as well as any post-contribution, appreciation or depreciation in the value of the contributed property, and each partner includes in income his distributive share. Application of the general rule of section 704(c)(1), however, can cause significant distortions.

For example, assume *A* and *B* form equal partnership *Y*, to which *A* contributes $10 of cash and *B* contributes a building with a value of $10 and a basis of $4. Under section 723, the partnership's basis for the building is $4. Assume the partnership later sells the building for $10, recognizing gain of $6. Under the general rule of section 704(c)(1), the $6 gain is allocable equally to *A* and *B*. Thus *A* includes $3 in his income, even though the partnership has not realized any economic gain. In effect, *B* has shifted $3 of gain to *A*. If the partnership is liquidated, the disparity will be eliminated, for *A* will recognize an off-setting $3 loss[145] and *B* will recognize a gain of $3,[146] giving *B* a total gain of $6. But the sale of the building by the partnership and the liquidation of the partnership may occur in different taxable years, thereby creating a timing distortion. Further, if the sale of the building had generated ordinary income,

141. I.R.C. §702(a).

142. I.R.C. §702(a)(8). Partnership taxable income or loss so computed is not to be confused with the overall taxable income of the partnership as defined in §703(a), which includes the separately stated items as well as bottom line income.

143. I.R.C. §704(a).

144. I.R.C. §704(b)(2). *See* Reg. §1.704-1(b)(2).

145. *A*'s loss is determined as follows: under §705(a)(1)(A) his basis for his partnership interest is increased by his share of partnership taxable income; then, under §731(a)(2) his loss on the liquidation is equal to the excess of his basis for his partnership interest over the amount of money distributed to him.

146. *B*'s gain is determined as follows: under §705(a)(1)(A) his basis for his partnership interest is increased by his share of partnership taxable income; then, under §731(a)(1) his gain on the liquidation is equal to the excess of the amount of money distributed to him over his basis for his partnership interest.

because, for example, of depreciation recapture under section 1250(a), a distortion in the character of income would have been created, for *A*'s loss on the liquidation of the partnership generally would be a capital loss.[147]

The distortions which are present in the preceding example will occur whenever the value of contributed property at the time of contribution differs from the contributing partner's basis for the property. Recognizing this, Congress created two exceptions to the general rule of section 704(c)(1).[148]

Section 704(c)(2)

Under section 704(c)(2), if the partnership agreement so provides, gain, loss, depreciation with respect to property contributed by a partner may be allocated among the partners to take account of the variation between the basis of the property to the partnership and its value at the time of contribution.

Returning to the preceding example, if *A* and *B* had agreed to allocate partnership gain or loss so as to take into account the variation between the basis of the building to the partnership and its value at the time of contribution, then the timing and character distortions would have been avoided. If the allocation is made, on the sale of the building by the partnership the entire $6 of gain would be allocable to *B*. On liquidation of the partnership neither partner would recognize gain or loss.[149]

Similarly, the partners may agree under section 704(c)(2) to allocate the depreciation deductions with respect to contributed property so as to take into account the variation between the basis of the property to the partnership and its value at the time of contribution. For example, assume in the preceding example the building contributed by *B* depreciates at an annual rate of 10 percent. Note that, with his contribution of $10 cash, *A* has, in effect, purchased a one-half interest in the building contributed by *B* for $5. Since the building depreciates at an annual rate of 10 percent, *A* should be entitled to a depreciation deduction of $.5 per year (10 percent of $5). Since the partnership's annual allowance for depreciation is only $.4 (10 percent of its basis of $4), however, the most that the partners may agree to allocate to *A* under section 704(c)(2) is $.4. The ability of the partners to allocate depreciation among the partners under section 704(c)(2) is subject to a significant limitation, called the ceiling rule, under which the depreciation (or gain or loss) that can be allocated cannot exceed the depreciation allowable (or gain or loss realized) to the partnership.[150]

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147. I.R.C. §§731(a) (flush language), 741.

148. I.R.C. §704(c)(2)-(3).

149. *A* would receive $10 in cash on the liquidation, which exactly equals his basis for his partnership interest, generating no gain or loss. *B*'s basis for his partnership interest first would be increased under §705(a)(1)(A) by $6, his share of partnership taxable income, giving him a basis of $10 (the initial basis of $4 plus taxable income of $6). Since *B* also would receive $10 in cash on the liquidation, which exactly equals his basis for his partnership interest, he too would realize no gain or loss. Note that the effect of §704(c)(2) is similar to that of the credited value approach, discussed in the text accompanying notes 22-26 *supra*.

150. Reg. §1.704-1(c)(2)(i). *See* Reg. §1.704-1(c)(2)(i), Example (1).

Section 704(c)(3)

The second exception to section 704(c)(1), under which gain, loss, and depreciation with respect to property contributed by a partner to a partnership is determined as if such property has been purchased by the partnership, is found in section 704(c)(3). That section provides that with respect to property contributed to a partnership by all of its partners where the relative individual interests of the partners in the property prior to the contribution are in the same ratio as their interests in the capital and profits of the partnership, gain, loss, and depreciation with respect to the individual interests is determined as though the undivided interests continued to be held by the partners outside the partnership, unless the partners otherwise agree.

To illustrate, assume *A* and *B* are tenants in common owning undivided one-half interests in improved real estate consisting of land and a factory with a value of $20. *A*'s basis for his undivided interest is $4, allocable $1 to the land and $3 to the factory. *B*'s basis for his undivided interest is $10, allocable $3 to the land and $7 to the factory. *A* and *B* contribute their undivided interests to newly formed partnership *Y*, and the partnership agreement contains no provision regarding allocation of gain, loss, and depreciation with respect to the property, thus section 704(c)(3) applies. The factory depreciates at an annual rate of 10 percent per year. The annual partnership allowance for depreciation of $1 (10 percent of the $10 basis for the factory) is allocable as follows: since *A*'s basis for his undivided interest in the factory is $3, his share of the depreciation is $.3 (10 percent of $3); since *B*'s basis for his undivided interest in the factory is $7, his share of the depreciation is $.7 (10 percent of $7). The deduction for depreciation reduces *A*'s basis for his undivided interest in the factory to $2.7 and *B*'s to $6.3. If the partnership later sells the land and factory for $20, each partner's share of the gain or loss would be as follows: *A*'s gain is $6.3, the difference between his share of the proceeds ($10) and his basis for the land and factory ($3.7); *B*'s gain is $.7, the difference between his share of the proceeds ($10) and his basis for the land and factory ($9.3).

Section 704(c)(3) applies (provided its conditions are met) unless the partners elect otherwise. Also, if the condition that each partner's interest in capital and profits of the partnership must be identical to his undivided interest in the contributed property is broken (for example, because of the admission of a new partner), section 704(c)(3) no longer applies, although the partners may agree to continue the allocation under section 704(c)(2).[151] Finally, section 704(c)(3) contains no ceiling rule, so one partner may recognize loss and another partner may recognize gain on the same transaction.

The rationale for section 704(c)(3) is relatively simple. On occasion co-ownership of property may give rise to an unintentional partnership. If the general rule of section 704(c)(1) were to apply, then each partner's share of gain, loss, and depreciation with respect to the co-owned property would be determined as if the property had been purchased by the partnership. Thus in the preceding example, in the absence of section 704(c)(3), *A* and *B* each would be entitled to one-half of the depreciation deduction. Congress determined that

151. Reg. §1.704-1(c)(3)(ii).

with respect to co-owned property, the tax results should be the same as if the property had not been contributed to a partnership, certainly a justifiable result in the case of an unintentional partnership. But as was implicit in the example, section 704(c)(3) is not limited to unintentional partnerships.

TREATMENT OF LIABILITIES

If the property transferred to a partnership in exchange for a partnership interest is mortgaged, or if the partnership assumes a liability of the transferor in the exchange, the nonrecognition rule of section 721(a) nevertheless applies, even if the sum of the liabilities transferred exceeds the aggregate adjusted basis of the assets transferred.[152] But by virtue of section 752(b), the sum of the liabilities transferred to the partnership that are allocable to other partners is treated as a distribution of money to the transferor partner,[153] and under section 733 the constructive distribution of money reduces (but not below zero) the transferor partner's basis for his partnership interest.[154] If the amount of the distribution of money to the transferor partner exceeds his basis for his partnership interest, then he recognizes gain under section 731(a) in the amount of the excess, any such gain being treated as gain from the sale or exchange of his partnership interest (not the transferred property), generally capital gain under section 741.

To illustrate, assume *A* contributes property with a value of $10, basis of $4, and subject to a mortgage of $2 to partnership *Y* in exchange for a 20 percent interest in the partnership. Neither *A* nor the partnership recognizes gain on the transfer.[155] *A*'s basis for his partnership interest is $2.4, computed as follows:

Adjusted basis to *A* of property transferred	$4
less portion of mortgage allocable to other partners (80 percent of $2)	1.6
Basis of *A*'s interest	$2.4

If the contributed property is mortgaged in excess of basis, the contributing partner may recognize gain under section 731(a). If in the preceding example the property had been subject to a mortgage of $6, the amount of the mortgage allocable to the other partners (80 percent of $6, or $4.8) would be treated under section 752(b) as a distribution of money to *A*, and to the extent the distribution exceeds *A*'s basis for his partnership interest (the excess of $4.8 over $4) *A* recognizes gain under section 731(a) in the amount of the excess. *A's* recognized gain is treated under section 731(a) as gain from the sale or exchange of his partnership interest (not the transferred property), generally capital gain under section 741.

The treatment of partnership and partner liabilities under section 752 is

152. I.R.C. §721(a).
153. See note 156 *infra*.
154. See note 103 *supra*.
155. I.R.C. §721(a).

relatively simple.[156] The general rule of section 752 is that any increase in a partner's share of partnership liabilities is treated as a contribution of money by him[157] and any decrease in a partner's share of partnership liabilities is treated as a distribution of money to him.[158] The assumption of a partnership liability by a partner or acceptance of property subject to a liability[159] is treated as a contribution of money by him,[160] and the assumption of a partner's liability by a partnership or acceptance of property subject to a liability is treated as a distribution of money to him.[161] Under section 722, contributions of money to a partnership increase the contributing partner's basis for his partnership interest, and under section 733 distributions of money to a partner decrease (but not below zero) the distributee partner's basis for his partnership interest. Any distribution of money in excess of the partner's basis for his partnership interest generates gain under section 731(a) in the amount of the excess, which is treated as gain from the sale or exchange of his partnership interest. The general rule of section 752 may be confusing in application, however, because partnership liabilities are subject to almost continuous change, generating constructive contributions and distributions of money under section 752.

A partner's share of partnership liabilities is determined under Regulation section 1.752-1(e). In the case of a general partnership, a partner's share of recourse liabilities is determined in accordance with his ratio for sharing losses, and a partner's share of non-recourse liabilities is determined in accordance with his ratio for sharing profits. In the case of a limited partnership, a partner's share of non-recourse liabilities also is determined in accordance with his ratio for sharing profits, but a limited partner's share of recourse liabilities is limited to the difference between his contribution to the partnership and the total contribution which he is obligated to make. Recourse liabilities not allocated to limited partners are allocated to the general partners in accordance with their ratio for sharing losses.

To illustrate, assume *A* contributes property with a value of $10, basis of $4,

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156. I.R.C. §752 provides:

(a) Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

157. I.R.C. §752(a).
158. I.R.C. §752(b).
159. I.R.C. §752(c).
160. I.R.C. §752(a).
161. I.R.C. §752(b).

Aylward: Contributions of Property to a Partnership: A Primer (and Beyond)

and subject to a liability of $6 to partnership *Y*, which has pre-existing liabilities of $10, in exchange for a 20 percent interest in the partnership. Neither *A* nor the partnership recognizes gain on the transfer. The amount of pre-existing partnership liabilities allocable to *A* (20 percent of $10, or $2) is treated under section 752(a) as a contribution of money by him, and the amount of the mortgage allocable to other partners (80 percent of $6, or $4.8) is treated under section 752(b) as a distribution of money to him. *A*'s basis for his partnership interest is $1.2, computed as follows:

Adjusted basis to *A* of property transferred	$4
plus portion of pre-existing partnership liabilities allocable to *A* (20 percent of $10)	2
	$6
less portion of mortgage allocable to other partners (80 percent of $6)	4.8
Basis of *A*'s interest	$1.2

Note that *A* recognizes no gain, even though the mortgage exceeds his basis for the transferred property. If the constructive distribution of money were given independent significance, then *A* conceivably would recognize gain of $.8 (the excess of $4.8 over $4). But the legislative history[162] of section 752 and the regulations[163] clearly indicate that constructive contributions and distributions of money in connection with contributions of property are netted, so that only the net decrease in the contributing partner's liabilities is taken into account. Note also that the basis of the partnership interest of each non-contributing partner is decreased by his share of pre-existing liabilities allocable to *A*. Conceivably, the entry of a new partner could result in a constructive distribution of money to an existing partner in an amount in excess of his basis (after taking into account any increase in his basis for his share of the new partner's liabilities which the partnership assumes, or takes subject to) for his partnership interest, thereby generating taxable gain to the partner under section 731(a).[164]

Upon the formation of a new partnership, the shifting of liabilities of the partners will create simultaneous constructive contributions and distributions of money to the partners, which may well have quite unexpected tax results. Assume *A* and *B* agree to form equal partnership *Y*. *A* contributes property with a value of $10, basis of $4, and subject to a mortgage of $6, and *B* contributes property with a value of $15, basis of $4, and subject to a mortgage of $11. Neither *A* nor *B* recognizes gain on the transfers. The shifting of liabilities

162. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 68 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 94 (1954).

163. Reg. §§1.752-1(b)(2), 1.752-1(c).

164. For example, assume *A* contributes property to existing partnership *Y*, which has pre-existing liabilities of $100, in exchange for a 50% interest in the partnership. Prior to *A*'s entry into the partnership, *B*, a 25% partner, has a basis of $10 for his partnership interest. By virtue of *A*'s entry into the partnership and the resulting shift to *A* of $50 in partnership liabilities under §752, *B* receives a constructive distribution of money in the amount of $12.50 (25% of $50), generating gain to him under §731(a)(1) in the amount of $2.50 (the excess of $12.50 over $10).

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results in a net constructive contribution of money by *A* in the amount of $2.5 and a net constructive distribution of money to *B* in the amount of $2.5. *A*'s basis for his partnership interest is $6.5 and *B*'s basis for his partnership interest is $1.5, computed as follows:

A

Adjusted basis to *A* of property transferred	$4
plus portion of *B*'s liabilities allocable to *A* (50 percent of $11)	5.5
less portion of *A*'s liabilities allocable to *B* (50 percent of $6)	3
Basis of *A*'s interest	$6.5

B

Adjusted basis to *B* of property transferred	$4
plus portion of *A*'s liabilities allocable to *B* (50 percent of $6)	3
less portion of *B*'s liabilities allocable to *A* (50 percent of $11)	5.5
Basis of *B*'s interest	$1.5

It is highly unlikely that the partners contemplated the adjustments to basis resulting from the shifts in liabilities.[165] In fact, it would appear that *A* has converted a potential gain of $6 on the sale of the contributed property (the excess of the value of the property, $10, over his basis, $4) into a potential loss of $2.5 on the sale of his partnership interest (the excess of his basis, $6.5, over the value of one-half of the partnership, $4). But this is not the case; under section 752(d) *A*'s share of partnership liabilities (one-half of $17) would be included in his amount realized on the sale of his partnership interest, producing a gain of $6.[166] The rule of section 752(d) also would apply to *B*, thus preserving his potential gain of $11.

Contributions of Property Subject to a Liability in Excess of Basis

Significant tax distortions may be created when property subject to a liability in excess of basis or a cash method going business is transferred to a partnership in exchange for a partnership interest. Although the tax consequences of the two types of transfers are similar, the problems created and the possible solutions differ. This section deals with the distortions created when property subject to a liability in excess of basis is transferred to a partnership.

Assume *A* and *B* agree to form equal partnership *Y*, to which *A* contributes $5 in cash and *B* contributes equipment (held for more than one year) with a value of $20, a basis of $5, a recomputed basis of $15,[167] and subject to a mortgage of $15. Further assume that the partnership sells the equipment for $20, pays off the $15 mortgage, and liquidates by distributing $5 in cash to each partner.

B recognizes no gain or loss on the transfer of the equipment to the partner-

165. See note 164 *supra*.
166. See note 156 *supra*.
167. *See* I.R.C. §1245(a)(2).

ship.[168] But he does recognize gain equal to the difference between his basis for his partnership interest (which under section 722 is the same as his basis for the equipment) and the amount of the constructive distribution of money to him (which is the amount of the mortgage allocable to *A*).[169] *B*'s gain of $2.5 is treated as gain from the sale or exchange of his partnership interest,[170] which, for now, we will assume to be capital gain under the general rule of section 741.[171] *B*'s basis for his partnership interest is zero: his basis for the transferred property ($5) reduced (but not below zero) by the amount of the mortgage allocable to *A* ($7.5).[172] *A* realizes no gain on his contribution of cash to the partnership. His basis for his partnership interest is $12.5: the amount of cash contributed ($5), increased by the amount of the mortgage allocable to him ($7.5).[173] The partnership also recognizes no gain or loss on the transfers.[174] Its basis for the equipment is $5.[175]

Upon the sale of the equipment by the partnership, it recognizes $10 of ordinary income (the depreciation recapture under section 1245) and $5 of capital gain, allocable equally to *A* and *B*.[176] Each partner's basis for his partnership interest is increased by his distributive share of partnership income.[177] Further, upon payment of the mortgage by the partnership, the $15 reduction in partnership liabilities results in a constructive distribution of money to each partner in the amount of $7.5, which decreases each partner's basis for his partnership interest in an amount exactly equal to the increase.[178]

When the partnership is liquidated, *B* recognizes capital gain in the amount of $5, the difference between his basis for his partnership interest (zero) and the amount of cash distributed to him ($5).[179] *A* recognizes a capital loss in the amount of $7.5, the difference between his basis for his partnership interest ($12.5) and the amount of cash distributed to him ($5).[180]

Though each partner recognizes gain, in the aggregate, equal to his economic gain, the timing of the gain is distorted. *B* recognizes gain of $2.5 on the transfer of the equipment to the partnership, even though he has not cashed in his investment. Further, upon the sale of the equipment by the partnership, *A* recognizes one-half of the gain, even though he has not realized any economic gain. True, *A*'s gain on the sale is exactly off-set by his loss on the liquidation

168. I.R.C. §721(a).
169. I.R.C. §§752(b), 731(a).
170. I.R.C. §731(a).
171. The possibility that *B*'s gain is ordinary income is explored in the text accompanying notes 189-202 *infra*.
172. I.R.C. §§722, 733. *A*'s basis for his partnership interest is not increased to take account of the gain recognized by him.
173. I.R.C. §§752(a), 722.
174. I.R.C. §721(a).
175. I.R.C. §723. The partnership's basis for the equipment is not increased by the amount of gain recognized by *A* unless a §754 election is in effect. See text accompanying notes 216-223 *infra* for a discussion of §754.
176. I.R.C. §704(c)(1).
177. I.R.C. §705(a)(1)(A).
178. I.R.C. §§752(b), 733.
179. I.R.C. §§731(a), 741.
180. *Id.*

of the partnership, but there is no guarantee that the two transactions will occur in the same taxable year. In effect, *B* temporarily shifts the incidence of tax on one-half of the gain in the equipment to *A*. Similarly, though *B* recognizes total gain of $15 ($2.5 on the formation of the partnership, $7.5 on the sale of the equipment, and $5 on the liquidation of the partnership), which is equal to his economic gain, there is no guarantee that the three transactions will occur in the same taxable year.

Distortions in the character of the gain also result. When the partnership sells the equipment, the partnership realizes ordinary income of $10,[181] which is allocable equally to *A* and *B*. *A*'s off-setting loss on the liquidation of the partnership, however, is a capital loss.[182] In effect, *B* permanently shifts one-half of the recapture income to *A*. If *B* had sold the equipment, he would have recognified ordinary income in the full amount of $10. But by transferring the equipment to the partnership, *B* shifts $5 of the ordinary income taint to *A*.[183]

The distortions in the example can be eliminated. It was pointed out earlier that under section 704(c)(2) the partners may by agreement allocate gain, loss, and depreciation with respect to contributed property so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.[184] In the example, under a section 704(c)(2) allocation the entire $15 gain on the sale of the equipment by the partnership would be allocable to *B*. By making the allocation, the temporary shift of the amount of gain in the contributed property and the permanent shift of the character of the gain are avoided.

The section 704(c)(2) allocation does not eliminate all of the distortions. Upon the contribution of the equipment to the partnership, *B* recognizes gain of $2.5 by virtue of the constructive distribution of money to him under section 752(b). The section 704(c)(2) allocation will not eliminate this distortion. It will be recalled that the amount of the constructive distribution of money to *B* is the portion of the mortgage allocable to *A*, and the amount of *B*'s gain is the difference between the amount of the constructive distribution of money to *B* and his basis for his partnership interest, which is equal to his basis for the transferred equipment. The partners should attempt, therefore, to avoid a constructive distribution of money to *B* in an amount in excess of his basis for his partnership interest. Three possible approaches suggest themselves.

First, the partnership could incur additional liabilities prior to *B*'s contribution, so that the increase in *B*'s basis for his partnership interest would offset the amount of projected gain.[185] The feasability of this approach of course depends on many factors, including the availability and need of partnership credit. A second possible approach would be to prevent the partnership from assuming or taking subject to any portion of the mortgage. In a different context, the Tax Court has held that, by agreement between buyer and seller, mortgaged property can be transferred to the buyer without being "subject to"

181. I.R.C. §1245(a).
182. I.R.C. §§731(a), 741.
183. *See* I.R.C. §1245(a)(2) (flush language).
184. See text accompanying notes 149-150 *supra*.
185. I.R.C. §752(a).

the mortgage.[186] Thus, if in our example the partners agree that the partnership neither assumes nor takes the equipment subject to the mortgage and *B* agrees to discharge the liability with his funds, then arguably the mortgage will not be considered to have been transferred to the partnership. A third possible approach is available only if the mortgage is non-recourse. A partner's share of non-recourse partnership liabilities is allocable to each partner in accordance with his ratio for sharing profits.[187] Arguably, then, if a section 704(c)(2) allocation is made allocating all of the gain inherent in the property at the time of contribution to the transferor partner, any non-recourse mortgage on the property would be allocable entirely to the transferor.[188]

It was assumed in the example that if *B* recognizes gain under section 731(a) by virtue of a constructive distribution of money to him under section 752(b), his gain is capital gain. It was also assumed that *B*'s basis for his partnership interest received in the exchange and the partnership's basis for the contributed property are not increased to take account of *B*'s recognized gain. These assumptions require further explanation.

Contributions of Depreciable Property to a Partnership

In the example, *B* transfers depreciable property (equipment), which has a value of $20, a basis of $5, a recomputed basis of $15, and subject to a mortgage of $15, to the partnership. By virtue of a constructive distribution of money to him under section 752(b), *B* recognizes gain of $2.5. Since the transferred property is section 1245 property with a lurking recapture of $10, arguably *B*'s gain of $2.5 is ordinary income under section 1245(a). But as explained below, *B* recognizes gain in the transaction on a deemed sale or exchange of his partnership interest, not the transferred section 1245 property, and the recapture rule of section 1245(a) is therefore inapplicable.

It was pointed out earlier that depreciation generally is not recaptured in a transfer subject to the nonrecognition rule of section 721(a).[189] Section 1245 (b)(3) provides that in a transfer subject to section 721(a) (and certain other sections) the amount of depreciation recapture taken into account under section 1245(a) shall not exceed "the amount of gain recognized to the transferor *on the transfer* of such property." The emphasized portion of the statute clearly indicates that depreciation is recaptured only if gain is recognized on the transfer, that is only if the nonrecognition rule of section 721(a) is inapplicable. In the example, *B* recognizes no gain *on the transfer* of the equipment to the partnership: the nonrecognition rule of section 721(a) is applicable. Rather he recognizes gain on a separate, simultaneous constructive distribution of money to him under section 752(b), and the gain recognized by him is treated under section 731(a) as gain from the sale or exchange of his partnership interest, not the transferred equipment. And under section 741 this gain generally is treated

186. Stonecrest Corp., 24 T.C. 659 (1955). *See also* William J. Goodman, 74 T.C. 684 (1980); United Pacific Corp., 39 T.C. 721 (1963); Estate of Lamberth, 31 T.C. 302 (1958). *But see* Prop. Reg. §15A.453-1(b)(3)(ii).

187. Reg. §1.752-1(e).

188. *See* 1 W. McKee, W. Nelson & R. Whitmire, *supra* note 46, at ¶4.03[2].

189. See text accompanying notes 41-45 *supra*.

as capital gain. Clearly, then, the recapture rule of section 1245(a) does not apply, and *B*'s gain is entirely capital gain.

Under the plain meaning of sections 721(a) and 1245(b)(3), it is clear that section 1245(a) is not applicable to *B*'s gain. Nevertheless, the regulations[190] under section 1245 take the position that section 1245(a) does apply to *B*'s gain. In Example (3) of Regulation section 1.1245-4(c)(4) the transferor contributes section 1245 property with a value of $10,000, a recomputed basis of $8,000, an adjusted basis of $4,000, and subject to a mortgage of $9,000 to a newly formed partnership in exchange for a one-half interest in the partnership. The example states:

> Since under section 752(b) (relating to decrease in partner's liabilities) [the transferor] is treated as receiving a distribution in money of $4,500 (one-half of liability assumed by partnership), and since the basis of [the transferor's] partnership interest is $4,000 (the adjusted basis of the contributed property), the $4,500 distribution results in his realizing $500 gain under section 731(a) (relating to distributions by a partnership), determined without regard to section 1245. Accordingly, the application of section 1245(b)(3) limits the gain taken into account by [the transferor] under section 1245(a)(1) to $500.[191]

The example in the regulations is clearly wrong. Section 1245(b)(3) provides that gain shall be taken into account under section 1245(a) in a transfer subject to section 721(a) only if and to the extent any gain is recognized to the transferor on the transfer of section 1245 property to the partnership. The issue is whether the transferor recognizes gain on the transfer. If not, then no gain is taken into account under section 1245(a). Under section 721(a), no gain is recognized by the transferor on the transfer. Instead, the transferor recognizes gain on a separate constructive distribution of money to him under section 752(b), which, under section 731(a), is treated as gain from the sale or exchange of his partnership interest, not the transferred property. The example in the regulations conflicts with the statutory scheme, its legislative history,[192] and the clear wording of section 1245(b)(3). The example is wrong, and the Commissioner is unlikely to press the issue.[193] Besides there is no potential for tax avoidance here. The partnership will step into the shoes of the transferor, and when the partnership sells the section 1245 property, it will recognize the lurking recapture income.[194]

Although not mentioned in the example in the regulations, the possible application of section 751 to the facts in the example must be considered. It will be recalled that any gain recognized under section 731(a) by virtue of a distribution of money to a partner is treated as gain from the sale or exchange of his partnership interest; and under section 741 the gain typically is capital gain. Section 751, the so-called collapsible partnership provision, provides an

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190. Reg. §1.1245-4(c)(4), Example (3).
191. *Id.*
192. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 389 (1954).
193. I.R.C. §1245(a)(2) (flush language).
194. S. REP. No. 1622, 83d Cong., 2d Sess. 98 (1954).

exception to capital gain treatment. Under that section, the portion of money or property received by a partner in exchange for all or part of his partnership interest attributable to partnership unrealized receivables (defined to include section 1245 and section 1250 property) and substantially appreciated inventory is treated as gain from the sale or exchange of a non-capital asset. The purpose of section 751 is generally to prevent the conversion of potential ordinary income to capital gain and the shifting of ordinary income items between partners.[195]

Section 751 contains two operative subsections: subsection (a), which deals with sales or exchanges of partnership interests, and subsection (b), which deals with distributions from a partnership to a partner. The two subsections are exclusive, and an initial determination must be made whether a transaction is subject to one or the other subsection. The initial classification is problematical if a distribution of money to a partner results in gain to him under section 731(a), for such a transaction is at once a distribution and a sale or exchange of a partnership interest. The legislative history[196] of section 751 seems to resolve the conflict in favor of subsection (b), regarding distributions, and leading commentators have adopted this view.[197] In the discussion which follows it will be assumed that subsection (b), rather than subsection (a), applies.

Under section 751(b), a partner recognizes ordinary income to the extent he receives a distribution from a partnership of non-section 751 property in exchange for his relinquishing all or part of his interest in section 751 property.[198] Conversely, the other partners recognize ordinary income to the extent the distributee partner receives section 751 property in exchange for his relinquishing all or part of his interest in non-section 751 property.[199] Although the mechanics of section 751(b) are complex, its premise is simple: if a partnership makes a disproportionate distribution of either section 751 property or non-section 751 property, the partnership and the partner will be treated as though the partnership or the partner has realized the gain in such property.[200]

Arguably the unstated premise in the example in the regulations is the applicability of section 751(b) to the constructive distribution of money to the transferor. But even if this is the case, it is impossible to determine from the facts in the example whether section 751(b) applies. It must be remembered that section 751(b) does not apply to all distributions made by a partnership to a partner, but only to those in which the distributee partner receives either section 751 property for his relinquishing any part of his interest in non-section 751 property or non-section 751 property for his relinquishing any part of his interest in section 751 property, and the facts in the example do not indicate whether the distributee partner relinquished any part of his interest in section

195. *Id.*

196. *Id.* at 401-02.

197. *E.g.*, Anderson & Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX L. REV. 497, 528 (1960).

198. Reg. §1.751-1(b)(1)(i)-(ii).

199. *Id.*

200. The mechanics of §751(b) are explained in Reg. §1.751-1(b)(2)-(3). *See also* Reg. §1.751-1(g), Example (2).

751 property (the mortgaged section 1245 property contributed by him) in exchange for the constructive distribution of money from the partnership.[201]

It is clear that section 751(b) is inapplicable to the constructive distribution of money to *B* in the example above. *B* does receive a distribution, albeit constructive, but he does not relinquish any part of his interest in section 751 property (the equipment). Immediately before the distribution he had a 50 percent interest in $20 of section 751 property, and after the distribution he has an identical interest in that property. True, *B* relinquished a 50 percent interest in the section 751 property when he contributed it to the partnership. But the contribution is not the taxable event, rather the constructive distribution of money to him under section 752(b) is the taxable event.[202]

Determining Basis

The rationale for the second assumption, that *B*'s basis for his partnership interest and the partnership's basis for the contributed property are not increased to take account of the gain recognized to *B*, is the same as the rationale for the first assumption: because *B*'s gain is not recognized *on the transfer* of the equipment to the partnership. Sections 722 and 723 provide that the partner's basis for his partnership interest and the partnership's basis for the contributed property initially shall be the basis of the property to the contributing partner "*at the time of the contribution* increased by the amount (if any) of gain recognized to the contributing partner *at such time*."[203] As explained above, under section 721(a), *B* recognizes no gain *at the time of the contribution*, but rather he recognizes gain on a separate, albeit simultaneous, constructive distribution of money to him under section 752(b). Since *B*. recognizes no gain on the transfer of the equipment to the partnership no adjustment is to be made to the contributing partner's basis for his partnership interest or the partnership's basis for the contributed property to take account of the gain recognized to *B* under section 731(a). The plain meaning of the statutory provisions dictates this result, and the legislative history supports it.[204]

As originally enacted in 1954, sections 722 and 723 contained no provision for increases in basis to take account of any gain recognized by a contributing partner on the transfer of property to a partnership,[205] whereas under section 113(a)(13) of the Revenue Act of 1934 the partnership's basis for contributed

201. Rev. Rul. 57-68, 1957-1 C.B. 207. *See* Rev. Rul. 77-458, 1977-2 C.B. 222. *But see* Rev. Rul. 73-300, 1973-2 C.B. 215 (§751(b) applies if the amount of money distributed to a partner exceeds his basis for his partnership interest, to the extent of the partner's interest in partnership unrealized receivables, by the ruling does not state whether the partner receiving the distribution relinquished any part of his interest in the unrealized receivables).

202. I.R.C. §§721(a), 731(a). A constructive distribution of money under §752(b) could result in ordinary income to the distributee under §751(b). For example, a shift in a partner's share of profits and losses may trigger constructive distributions of money to the partner whose interest in the partnership is reduced. *See* W. McKEE, W. NELSON & R. WHITMIRE, *supra* note 46, at ¶19.03[1].

203. The quote in the text appears in §§722, 723.

204. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 389 (1954). *See also* S. REP. No. 938, 94th Cong., 2d Sess., pt. 2, 43 (1976).

205. Pub. L. No. 591, §§722, 723, 68A Stat. 245 (1954).

property was the contributing partner's basis for the property increased by any gain, or decreased by any loss, recognized on the contribution.[206] The adjustment to basis was included in the 1934 Act because it was unclear whether contributions of property to a partnership were taxable events, their being no statutory nonrecognition rule.[207] But the 1954 Code made clear that contributions of property to a partnership in exchange for a partnership interest are not taxable events, so the adjustment to basis for recognized gains and losses was deleted.[208] The Senate Report to the 1954 Code explained the reason for the change:

> That portion of section 113(a)(13) which requires that the basis of contributed property be increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such a transfer has been omitted *because no gain or loss is recognized in such a transaction.*[209]

But as pointed out earlier, in 1976 Congress created an exception to the nonrecognition rule of section 721(a) for transfers to a partnership swap-fund.[210] To take account of this exception, Congress also amended sections 722 and 723 so that the contributing partner's basis for his partnership interest and the partnership's basis for the contributed property would be adjusted to reflect the gain recognized to the contributing partner *on the transfer* of property to a partnership swap-fund.[211]

Actually, the 1976 amendments to sections 722 and 723 are unnecessary. Not all transactions between a partner and partnership are subject to the nonrecognition rule of section 721(a).[212] For example, a transfer of a partnership interest to a partner in exchange for services is not subject to section 721(a).[213] In such cases, the service partner takes a cost, not substituted, basis for his partnership interest.[214] Likewise, a partner who transfers appreciated property to a partnership swap-fund takes a cost basis for his partnership interest. In either case, the cost basis is identical to a substituted basis increased by the amount of gain recognized to the partner,[215] which proves that the 1976 amendments to sections 722 and 723 are unnecessary.

The rule that the basis of partnership property is not adjusted to take account of gain recognized to a partner with respect to a distribution of property to such partner under section 731(a), however, is subject to an exception. In the case of a distribution of property to a partner, if the partnership files an election under section 754,[216] then, under section 734(b)[217] the partnership is en-

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206. See note 9 *supra.*
207. See text accompanying notes 9-21 *supra.*
208. Pub. L. No. 591, §§722, 723, 68A Stat. 245 (1954).
209. S. REP. No. 1622, 83d Cong., 2d Sess. 389 (1954) (emphasis added).
210. See text accompanying notes 49-55 *supra.*
211. *See* S. REP. No. 94-938, 94th Cong., 2d Sess., pt. 2, 43 n.2 (1976).
212. I.R.C. §707.
213. Reg. §1.721-1(a).
214. I.R.C. §1012.
215. *See* Reg. §1.61-2(d)(2)(i) (last sentence).
216. I.R.C. §754 provides: "If a partnership files an election, in accordance with regula-

titled to increase the basis of partnership property (in accordance with allocation rules provided in section 755) by the amount of gain recognized under section 731(a) to the distributee partner with respect to the distribution. Section 754, however, applies to recognized losses as well as gains. If a section 754 election is in effect and a distribution results in a recognized loss to the distributee partner under section 731(a), then the partnership must decrease the basis of partnership property by the amount of loss recognized to the distributee partner.[218] Thus the decision whether to make an election under section 754 must take into account a number of factors.[219]

No attempt is made here to discuss the pros and cons of making the election or the complicated mechanics of making basis adjustments. What follows is a brief discussion of the effect of the section 754 election on the basis of partnership property in the simple example set forth above.

It will be recalled that in the example *A* contributes $5 in cash and *B* contributes equipment with a value of $20, a basis of $5, and subject to a mortgage of $15. Under section 731(a), *B* recognizes gain of $2.5 by virtue of the constructive distribution of money to him under section 752(b). Under the general rule, the basis of partnership property is not increased to take account of *B*'s gain. If, however, the partnership makes an election under section 754, then the basis of partnership property is increased to take account of *B*'s gain.[220]

The allocation of the basis adjustment to specific partnership assets is set forth in section 755. While the allocation rules are terribly complex, it is sufficient to know that if the basis adjustment is a consequence of gain recognition under section 731(a) with respect to a distribution to a partner, the adjustment is allocated entirely to capital and section 1231 assets.[221] The adjustment to that class of assets is allocated only to assets within the class whose values exceed their bases and in proportion to the differences between the value and basis of each.[222] In the example, the $2.5 adjustment to basis would be allocated entirely to the partnership's only capital or section 1231 asset, the equipment. If the partnership owns no capital or section 1231 assets, the adjustment to basis is deferred until the partnership subsequently acquires such property.[223]

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tions prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734."

217. I.R.C. §734(b) provides in pertinent part:

In the case of a distribution of property to a partner, a partnership, with respect to which the election provided in section 754 is in effect, shall —

(1) increase the adjusted basis of partnership property by —

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1) . . . .

(2) decrease the adjusted basis of partnership property by —

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2).

218. *Id.*

219. See Reg. §1.754-1(a)-(b).

220. See note 217 *supra*.

221. I.R.C. §755(b). *See* Reg. §1.755-1(b)(1)(ii).

222. I.R.C. §755(a). *See* Reg. §1.755-1(a)(1).

223. Reg. §1.755-1(b)(4).

The adjustments to basis under section 734 have the desirable effect of mitigating the distortions discussed earlier. The increase in the partnership's basis for the equipment will reduce the partnership's gain on its subsequent sale by the amount of the adjustment. But this will not entirely eliminate the timing and character distortions to each partner. Further, it has been pointed out that a section 754 election applies to recognized losses as well as gains. The decision whether to make the election must take into account many factors. To be sure, a section 754 election is not a complete solution to the problems created when mortgaged property is contributed to a partnership.

Contributions of Cash-Method-Going-Business

Assume *A* and *B* agree to form equal partnership *Y*, to which *A* contributes $5 in cash and *B*, a sole proprietor and cash method taxpayer, contributes zero basis receivables worth $15 and equipment (held for more than one year) with a value and basis of $5 and also transfers, and the partnership assumes, accounts payable of $15. Further assume that the partnership collects the receivables, discharges the payables, and liquidates by distributing $5 in cash to *A* and the equipment to *B*.

B recognizes no gain or loss on the transfer of his sole proprietorship to the partnership, but recognizes gain under section 731(a) in the amount of $2.5, the difference between his basis for his partnership interest (which under section 722 is the same as his basis for the equipment) and the amount of the constructive distribution of money to him under section 752(b) (which is the amount of the payables allocable to *A*). *B*'s gain of $2.5 is treated as gain from the sale or exchange of his partnership interest, which we will assume to be capital gain under the general rule of section 741. *B*'s basis for his partnership interest is zero: his basis for the transferred property ($5) reduced (but not below zero) by the amount of the liabilities allocable to A ($7.5). *A* realizes no gain on his contribution of cash to the partnership. His basis for his partnership interest is $12.5: the amount of cash contributed ($5) increased by the amount of the liabilities allocable to him ($7.5). The partnership also recognizes no gain or loss on the transfers. Its basis for the equipment is $5.

When the partnership collects the receivables, it recognizes ordinary income of $15 but obtains an off-setting deduction of $15 when it discharges the payables,[224] producing a net taxable income of zero. Further, under section 752(b), the $15 decrease in partnership liabilities results in a constructive distribution of money to each partner in the amount of $7.5, which under section 731(a) results in capital gain to *B* in the amount of $7.5 (the difference between his basis for his partnership interest and the amount of the constructive distribution of money to him) and under section 733 decreases *A*'s basis for his partnership interest to $5.

When the partnership is liquidated, under section 731(a) *B* recognizes no gain or loss, and under section 732(b) he takes a zero basis for the equipment.

224. *See* Rev. Rul. 80-198, 1980-30 I.R.B. 10. *Compare* Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1973), *with* Holdcroft Transp. Co. v. Commissioner, 153 F.2d 324 (8th Cir. 1946).

Likewise, *A* recognizes no gain or loss on the liquidation. If *B* were to sell the equipment promptly, he would recognize gain of $5, having lost the benefit of his $5 basis for the equipment prior to the transfer to the partnership.

In the example, *B* recognizes $2.5 of capital gain on the formation of the partnership, $7.5 of capital gain when the partnership discharges the payables, and $5 of capital gain when he sells the equipment after liquidation of the partnership. *B*'s total taxable gain therefore is $15. But his economic gain is zero! In effect, *B* is being taxed on non-existent income.

The problem in the example is caused by the accounts payable. In effect, they are taken into account twice: once on the formation of the partnership (which produces a basis reduction and gain to *B*) and again when discharged by the partnership (which produces gain to *B*). Though this problem can be avoided by a special allocation in the partnership agreement, the problem should not arise at all, for section 752 should be construed so that a liability that would have been deductible by the transferor is not to be treated as a liability for purposes of that section.[225] So construed, the liability would be taken into account only once, when paid by the partnership, and the distortions illustrated in the example would be eliminated.

Assume in the example that the accounts payable are not liabilities for purposes of section 752. On the formation of the partnership *B* recognizes no gain or loss; there is no constructive distribution of money to him under section 752(b). *B*'s basis for his partnership interest is $5, his basis for the transferred property. *A* realizes no gain on the formation and his basis is $5, not $12.5, because there is no constructive contribution of money by him under section 752(a). When the partnership collects the receivables, it recognizes ordinary income of $15. It obtains an off-setting deduction of $15 when it discharges the payables,[226] producing net taxable income of zero. The discharge of the payables does not result in a decrease in basis or gain to *A* or *B* because there is no constructive distribution of money to them under section 752(b). When the partnership is liquidated, under section 731(a) *B* recognizes no gain or loss, and under section 732(b) he takes a $5 basis for the equipment. If he were to sell the equipment promptly, *B* would realize no gain or loss, having retained the benefit of his $5 basis for the equipment prior to the transfer to the partnership. Similarly, under section 731(a) *A* recognizes no gain or loss on the liquidation. Thus by not treating the deductible liabilities as liabilities for purposes of section 752, the distortions are eliminated.

Neither section 752, its legislative history, nor the regulations indicate whether deductible liabilities are liabilities for purposes of section 752. The authors of a leading partnership tax treatise postulate that the term liabilities as used in section 752 should be limited to partnership obligations that either increase the basis of partnership assets or are incurred in connection with a deductible expense of the partnership.[227] The authors reason that section 752 generally is intended to preserve the equality between the aggregate basis of

225. *See* Donald D. Focht, 68 T.C. 223 (1977) (deductible liabilities not "liabilities" for purposes of §357(c)). *But see* Rev. Rul. 60-345, 1960-2 C.B. 211.

226. See note 224 *supra*.

227. W. McKEE, W. NELSON & R. WHITMIRE, *supra* note 46.

the partners for their partnership interests and the aggregate basis of the partnership for its assets, and that the equality can be maintained by so limiting the meaning of the term liabilities. For example, if a partnership liability is incurred in connection with the acquisition of an asset, the liability is included in the basis of the asset acquired[228] and thus should be treated as a liability for purposes of section 752, thereby increasing in a like amount the aggregate basis of the partners for their partnership interests. Likewise, if loan proceeds are used to pay a deductible liability of the partnership, the increase in basis associated with the loan is offset by the decrease in basis associated with the payment of the expense, thus producing no net change in basis and preserving the equality between the aggregate basis of the partnership for its assets and the aggregate basis of the partners for their partnership interests.[229] Though the reasoning of the authors of the partnership tax treatise is sound, the Commissioner has held, without explanation, that the term liabilities includes accounts payable of a cash method taxpayer.[230]

In Revenue Ruling 60-345[231] the Commissioner ruled that the term liabilities includes "outstanding trade accounts, notes, and accrued expenses, whether or not recorded on the partnership books under its accounting method." No explanation is given; indeed, it would appear that no consideration was given to the ramifications of the ruling. The authors of the partnership tax treatise argue that the Commissioner's definition of liabilities is indeed overbroad, but they conclude that it is unlikely to be challenged because its only effect is to cause a transitory inequality between the aggregate basis of the partners for their partnership interests and the aggregate basis of the partnership for its assets. However, as shown in the example above, the Commissioner's definition of the term liabilities may cause significant distortions when a cash method going business is transferred to a partnership.

Surely Congress could not have intended the distortions that may result under the Commissioner's view. Indeed, when confronted with the same problem with regard to transfers of a cash method going business to a corporation, Congress amended section 357(c) (which contains an exception to the nonrecognition rule of section 351(a) if the liabilities transferred to a corporation exceed the aggregate basis to the transferor of the property transferred to the corporation) to make it clear that the term liabilities does not include liabilities which would have been deductible by the transferor.[232] Though the amendment to section 357(c) was not intended to affect the meaning of the term liabilities for purposes of any other provision of the Code,[233] nevertheless this should not preclude a court from construing the term liabilities in section 752 as excluding deductible liabilities. In fact, the Tax Court had held, prior to the amendment

228. *See* Crane v. Commissioner, 331 U.S. 1 (1947).

229. The loan will increase the partners' bases for their partnership interests under §752(a), and the payment of the expense will correspondingly decrease the partners' bases for their partnership interests under §705(a).

230. Rev. Rul. 60-345, 1960-2 C.B. 211.

231. 1960-2 C.B. 211.

232. Pub. L. No. 95-600, §365, 92 Stat. 2854-55 (1978).

233. S. Rep. No. 95-1263, 95th Cong., 2d Sess. 185 (1978).

to section 357(c), that the term liabilities as used in that section does not include deductible liabilities.[234]

But even under the Commissioner's view, the distortions present in the example can be eliminated. It will be recalled that, under section 704(c)(2), the partners may agree to allocate gain, loss, depreciation, etc. with respect to property contributed by a partner to a partnership to take into account the variation between the basis of the property to the partnership and its value at the time of contribution. Further, under section 704(a) the partners may agree to allocate partnership gain, loss, and deductions among the partners. Thus in the example, under section 704(c)(2) the entire $15 gain on the collection of the receivables could be allocated to *B* and, under section 704(a) the $15 deduction on the discharge of the accounts payable could be allocated to *B*. If the allocations are made, the distortions are eliminated, producing a result which is identical to the result if the accounts payable are not treated as liabilities. Arguably, then, there is no need to exclude deductible liabilities form the meaning of the term liabilities, because the partners can reach the same result under the Commissioner's view. But this places an unjust premium on a level of tax sophistication that is not shared by most and creates a particularly insidious trap for the unwary.[235]

In sum, section 721(a) was intended to facilitate the transfer of a going business to a partnership by precluding the imposition of tax on the transfer of the business to the partnership. If in the example *B* had not transferred his business to the partnership, he would have recognized gain of $15 on the collection of the receivables and received an off-setting deduction of $15 on the discharge of the payables, producing a net taxable income of zero. Under Revenue Ruling 60-345, if *B* had transferred his business to the partnership, he would have recognized net taxable income of $15; in effect, *B* would have been taxed on non-existent income. By contrast, if the accounts payable are not treated as liabilities for purposes of section 752, *B* would have recognized a net taxable income of zero, which is the same tax position *B* would have been in had he not transferred his business to the partnership. Surely, the policy of section 721(a), to facilitate the transfer of a going business to a partnership, would only be thwarted if the Commissioner's view is accepted.

CONCLUSION

The rules regarding contributions of property to a partnership are not terribly complex. They are very similar in purpose and operation to those regarding contributions of property to a corporation. Problems may arise, however, where property subject to a liability in excess of basis or a cash method going business is contributed to a partnership. Also, the tax treatment of boot received in a section 721(a) exchange is uncertain. But generally, the operative

234. Donald D. Focht, 68 T.C. 223 (1977). *See also* Thatcher v. Commissioner, 533 F.2d 1114 (9th Cir. 1976); Bongiovanni v. Commissioner, 470 F.2d 921 (2d Cir. 1973). In *Focht*, Judge Hall in a dissenting opinion raised the possibility of applying the holding in that case to partnerships. 68 T.C. at 244-45.

235. *See* Donald D. Focht, 68 T.C. 223 (1977).

statutory provisions provide a workable, flexible scheme for the tax treatment of contributions of property to a partnership.

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