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## Sale or Liquidation of a Deceased Partner's Interest

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## NOTES

### SALE OR LIQUIDATION OF A DECEASED PARTNER'S INTEREST

The Internal Revenue Code of 1954 contains detailed provisions relating to the consequences of the death of a partner.<sup>1</sup> The provisions do not achieve simplicity, but they settle many uncertainties of the prior law and preserve a degree of flexibility in the form of the elections and choices available to the partners and the partnership.<sup>2</sup> Under the 1954 Code, the provisions of a partnership agreement often determine important tax consequences, thereby placing a premium on advance planning.

It is usually undesirable to dissolve a partnership upon the death of a partner, although this is the result at common law<sup>3</sup> and, in the absence of an agreement to the contrary, under the Uniform Partnership Act.<sup>4</sup> If the partners wish to continue the partnership without interference by a decedent partner's assigns or his estate, the alternatives available are a purchase of his interest by the surviving partners or liquidation of his interest by the partnership.<sup>5</sup>

Sale and liquidation differ from a tax standpoint primarily with respect to characterization of the payments, termination of the partnership, and closing of the taxable year. In drafting the provisions of a partnership agreement, tax consequences of the alternative selected should be considered with reference to setting a value for the deceased partner's interest, determining the existence and value of good will, establishing the appropriate method of insurance funding, and avoiding possible disputes between the surviving partners and the decedent's successors in interest.<sup>6</sup>

#### SALE TO THE SURVIVING PARTNERS

##### *Characterization of Payments*

Section 741 of the 1954 Code provides that gain or loss on the sale or exchange of an interest in a partnership shall be considered as gain

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1. *E.g.*, INT. REV. CODE OF 1954, §§706, 708, 741, 753.

2. *E.g.*, INT. REV. CODE OF 1954, §§734, 736, 743, 754.

3. CRANE, PARTNERSHIP 480-86 (2d ed. 1952).

4. UNIFORM PARTNERSHIP ACT §31; see also FLA. STAT. §733.37 (1959).

5. Polasky, *Planned Disposition of a Partnership Interest*, 45 IOWA L. REV. 46, 52-58 (1959).

6. See Willis, *Drafting Partnership Agreements Under the 1954 Code: Provisions Applicable in Case of Death or Withdrawal of a Partner*, N.Y.U. 14TH INST. ON FED. TAX. 939 (1956).

or loss from the sale or exchange of a capital asset. This rule is modified by the fragmenting provisions of section 751 which foreclose capital gain or loss treatment for amounts attributable to unrealized receivables and substantially appreciated inventory items.<sup>7</sup>

The interest of a deceased partner takes on a new basis at death equal to its fair market value at the date of death or at the alternative valuation date.<sup>8</sup> Thus, in general there is no gain or loss if his interest is sold for a price that equals the fair market value at the selected valuation date. However, the presumptive tax basis of the decedent's partnership interest is reduced by the value of his interest in unrealized receivables of the partnership,<sup>9</sup> and amounts attributable to such interests constitute income in respect of a decedent<sup>10</sup> even though there would otherwise be no gain on the total transaction.<sup>11</sup> Moreover, a deceased partner's successor in interest will realize ordinary income to the extent that the portion of the sales price attributable to the decedent's interest in substantially appreciated inventory exceeds the firm's tax basis for the inventory.<sup>12</sup> It has been suggested, but it is by no means clear, that an election under section 754 to adjust basis under section 743 would allow the partnership to increase its basis for the decedent's portion of substantially appreciated inventory to equal the date of death value.<sup>13</sup> Such an adjustment would permit the decedent's estate to avoid tax on amounts equaling the difference between the date of death value and the prior basis for the decedent's interest in substantially appreciated inventory. In the absence of a section 754 election, a decedent's successor in interest who sells the partnership interest for its date of death value may have a capital loss in an amount equal to the ordinary income resulting from the decedent's interest in substantially appreciated inventory. This appears to depend on whether

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7. Driscoll, *The Collapsible Partnership Device and Sales or Exchanges of Partnership Interest*, N.Y.U. 14TH INST. ON FED. TAX. 987, 998 (1956). H.R. REP. No. 9662, 86th Cong., 2d Sess. (1959), which failed to pass, would have made a number of important changes in this area.

8. INT. REV. CODE OF 1954, §1014(a).

9. Treas. Reg. §1.742-1.

10. INT. REV. CODE OF 1954, §641. See, however, Bromberg, *Taxable Income Without Gain on the Sale of a Deceased Partner's Interest*, 13 SW. L.J. 343, 350-52 (1959).

11. Bromberg, *Sale of a Deceased Partner's Interest*, 37 TAXES 685, 686 (1959).

12. Treas. Reg. §7.751-1(a)(2); Repetti, *Death of a Partner*, N.Y.U. 13TH INST. ON FED. TAX. 921, 929-30 (1955).

13. Repetti, *supra* note 12, at 929-32. *But see* Grant & Paul, *Tax Problems of Professional Partnership*, U. SO. CAL. 1960 TAX INST. 517, 533. The authors conclude: "However, as a matter of planning too much reliance should not be placed on this method of escaping tax on unrealized receivables. . . . Congress undoubtedly did not intend this result."

such ordinary income is properly viewed as income in respect of a decedent.<sup>14</sup>

### *Termination and Closing the Taxable Year*

Termination of a partnership for federal tax purposes is not governed by local law.<sup>15</sup> Section 708 provides that a partnership terminates if the firm's business operations are not continued by two or more surviving partners or if there is a sale or exchange of at least a fifty-per-cent interest in capital and profits within a twelve-month period. One of the principal tax consequences of termination is that it closes the partnership taxable year automatically as to all partners, with a possibility of bunching more than twelve months' income into the partners' individual returns.<sup>16</sup>

The partnership taxable year closes with respect to the interest of a deceased partner only on the date of the sale or final liquidation of the entire interest.<sup>17</sup> However, if the deceased partner's sole or primary income was derived from the partnership, it may be advantageous to his estate to have the partnership taxable year close on the day that he dies, so that the partnership income for the elapsed portion of the year will be reported in the final return of the decedent rather than in the fiduciary return. The attendant advantages of income-splitting in a joint return and of personal deductions not available to the estate may decrease taxes on the decedent's pre-death partnership income. Perhaps this can be accomplished by a properly drafted agreement.<sup>18</sup>

### LIQUIDATION BY THE PARTNERSHIP

Liquidation of a deceased partner's interest occurs when the partnership, rather than the individual partners, is the purchaser.

### *Characterization of Payments*

Payments in liquidation of a deceased partner's interest are divided into two basic classes:<sup>19</sup> (a) payments considered either a distributive share of partnership income<sup>20</sup> or guaranteed payments<sup>21</sup>

14. Treas. Reg. §1.742-1; Bromberg, *Taxable Income Without Gain on the Sale of a Deceased Partner's Interest*, 13 Sw. L.J. 343, 352 (1959).

15. Treas. Reg. §1.706-1 (c) (1); WILLIS, *PARTNERSHIP TAXATION* 362 (1957).

16. WILLIS, *PARTNERSHIP TAXATION* 363 (1957). But if the partners and the partnership have the same taxable year, the problem of bunching does not arise.

17. INT. REV. CODE OF 1954, §706 (c) (2) (A) (i); Treas. Reg. §1.706-1 (c) (3).

18. Treas. Reg. §1.706-1 (a) (3) (iv); WILLIS, *PARTNERSHIP TAXATION* 366 (1957).

19. INT. REV. CODE OF 1954, §736.

20. Treas. Reg. §1.736-1 (a) (3) (i): "[T]he amount of the payment is determined with regard to income of the partnership."

21. Treas. Reg. §1.736-1 (a) (3) (ii): "[T]he amount of the payment is de-

and (b) payments made in liquidation of the deceased partner's interest in partnership property. Class (a) payments reduce the taxable income of the surviving partners but constitute income in respect of a decedent for the payee.<sup>22</sup> Class (b) payments are capital transactions.<sup>23</sup> Surviving partners may adjust the basis of partnership property to reflect class (b) payments,<sup>24</sup> but they cannot apply them in reduction of taxable income.<sup>25</sup>

If a deceased partner's interest is liquidated by a distribution equaling its fair market value at the selected valuation date, there will ordinarily be no taxable gain, for the amount received will equal basis. But payments attributable to the decedent's interest in unrealized receivables and for good will, if no payment therefor is provided in the partnership agreement, will constitute either a distributive share or guaranteed payments.<sup>26</sup> This classifies such payments as fully taxable income in respect of a decedent.<sup>27</sup>

A deceased partner's interest in inventory constitutes property for which liquidating payments can be made under section 736 (b).<sup>28</sup> If the inventory is substantially appreciated, payments attributable to the increase of the market value over the deceased partner's proportionate share of the firm's basis for the total inventory are ordinary income.<sup>29</sup>

The characterization of liquidating payments depends to a large extent on the terms of the partnership agreement. An agreement setting a high value on partnership property as defined by section 736 and providing a reasonable payment for good will insures a minimum of ordinary income to the payee.<sup>30</sup> On the other hand, an agreement providing for payments that constitute either a distributive share of partnership income or guaranteed payments to the deceased partner's estate, making no mention of payment for good will, allows the greatest reduction of taxable income to the surviving partners and the maximum tax to the deceased partner's estate.<sup>31</sup>

### *Termination and Closing the Taxable Year*

Liquidating payments do not terminate the partnership or close

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terminated without regard to income of the partnership."

22. INT. REV. CODE OF 1954, §753; Treas. Reg. §1.736-1 (a) (4).

23. Treas. Reg. §1.736-1 (b) (1).

24. INT. REV. CODE OF 1954, §734 (b).

25. Treas. Reg. §§1.732-2 (a), 1.736-1 (a) (2) (ii).

26. INT. REV. CODE OF 1954, §736 (b) (2); Treas. Reg. §1.736-1 (a) (2) (ii).

27. INT. REV. CODE OF 1954, §§753, 1014 (c).

28. Treas. Reg. §1.736-1 (b) (4).

29. *Ibid.*; Treas. Reg. §1.751-1 (b) (3) (iii).

30. WILLIS, PARTNERSHIP TAXATION §26.05 (1957).

31. Polasky, *supra* note 5, at 87, 91, 109.

the tax year for either the decedent or the surviving partners.<sup>32</sup> The partnership taxable year closes as to the deceased partner's interest when the last payment is made, but even then it remains open to its normal end for the surviving partners.<sup>33</sup> Termination of a partnership on the date of death of a partner who owned an interest of fifty per cent or more, or who was a member of a two-man partnership, is avoided if the agreement provides for liquidating payments to the successor in interest of the deceased partner.<sup>34</sup>

It may be desirable to close the taxable year with respect to a deceased partner as of the date of death, but this result cannot be achieved under the present law if liquidating payments are made.<sup>35</sup>

## THE PARTNERSHIP AGREEMENT

### *Valuation*

The regulations indicate that a binding arms-length agreement will establish the value of the partners' respective interests for estate tax<sup>36</sup> and usually for income tax purposes.<sup>37</sup> Either a fixed dollar amount or an amount determined by a formula included in the agreement will be acceptable.<sup>38</sup> The agreement must be bona fide and not a testamentary disposition in disguise.<sup>39</sup> To establish a value for estate tax purposes, the deceased partner must not have been free to dispose of the interests for a different price during his life.<sup>40</sup> Since the characterization of payments as class (a) or class (b), and thus as ordinary income or capital transactions, will depend to a large degree upon the value of the decedent's interest in partnership assets, the partners can control characterization to some extent by their valuation of assets.<sup>41</sup>

### *Good Will*

The partners have the option of characterizing payments for good will as capital or as income transactions if liquidation is the method of purchase selected.<sup>42</sup> If the partners want payments attrib-

32. INT. REV. CODE OF 1954, §§706 (c), 708.

33. Treas. Reg. §§1.706-1 (c) (2), (3).

34. Treas. Reg. §§1.708-1 (b) (1) (ii), 1.736-1 (a) (6).

35. WILLIS, PARTNERSHIP TAXATION 366 (1957).

36. Treas. Reg. §20.2031-2 (h) (valuing corporate stock); Polasky, *supra* note 5, at 99-102.

37. Treas. Reg. §1.736-1 (b).

38. See Treas. Reg. §1.736 (b) (3).

39. Commissioner v. Childs' Estate, 147 F.2d 368 (3d Cir. 1945).

40. Giannini v. Commissioner, 148 F.2d 285 (9th Cir. 1945).

41. Polasky, *supra* note 5, at 109.

42. INT. REV. CODE OF 1954, §736; Treas. Reg. §1.736 (b) (3).

utable to good will to constitute ordinary income to the payee, the agreement should expressly state that no part of the payment shall constitute a payment for good will.<sup>43</sup> If the agreement sets a value to be paid for good will, the payment will be a capital transaction under section 736 (b). A reasonable value set by an arms-length agreement will generally be regarded as correct.<sup>44</sup> Failure to mention good will in the agreement results in classification of payments for good will as ordinary income and in a reduction of taxable income for the surviving partners. But an express statement designed to produce this result will show that it is not inadvertent and may tend to allay ill feeling.

### *Insurance*

Provision for a source of funds for purchase of a deceased partner's interest is a basic non-tax function of a purchase agreement. This is often accomplished through the use of life insurance, and the selection of the method of purchase may be influenced by insurance considerations.<sup>45</sup> For example, funding a cross purchase or sale agreement can be cumbersome if there are more than two or three partners, because each must obtain a policy on the life of each of the other partners.<sup>46</sup> Another possible drawback of the cross-purchase plan is that the younger and less affluent partners usually must pay larger premiums on policies on the lives of the older members.<sup>47</sup>

The liquidation purchase arrangement is better suited to insurance funding if there are more than two or three partners. The partnership owns a policy on the life of each partner and pays the premiums,<sup>48</sup> each partner sharing the cost in proportion to his share of partnership profit and loss.<sup>49</sup> This often means that in effect the older members of the firm will be furnishing a large part of the funds with which the younger partners will ultimately acquire their interests.

### *Conflict of Interests*

The death of a partner raises a conflict of interests between the

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43. WILLIS, *PARTNERSHIP TAXATION* §26.05 (1957).

44. Treas. Reg. §1.736 (b) (3).

45. Anderson, *Disposition of Business Interests*, 9 U. FLA. L. REV. 459, 470-71 (1956).

46. MacKay, *Disability, Retirement or Death of a Partner*, 13 J. AM. Soc'Y C.L.U. 53, 72-73 (1958).

47. Laikin, *Survivor Purchase Agreements and Taxes*, 42 MARQ. L. REV. 307, 323 (1959).

48. Forster, *Entity Approach to Partnership Insurance*, 90 TRUSTS AND ESTATES 752 (1951).

49. Polasky, *supra* note 5, at 110.

surviving partners and the decedent's family and estate.<sup>50</sup> Improper planning, resulting in favorable tax treatment of one side at the expense of the other, may lead to hostility and even to litigation.

It appears that a sale will generally be more advantageous to a deceased partner's estate. The Code's basic approach to a sale is that while amounts attributable to the decedent's interest is unrealized receivables and in substantially appreciated inventory to the extent that they exceed the firm's tax basis are ordinary income, the entire balance is considered as received from the sale or exchange of a capital asset. For liquidation, the Code indicates that any amount paid in excess of the value of the decedent's share of partnership property will be income in respect of a decedent. The parties are given some latitude in the valuation of interests, but unrealized receivables and good will, except to the extent that there is a provision for payment for good will, are not treated as partnership property. Payments attributable to a decedent's interest in substantially appreciated inventory, to the extent that they exceed the firm's tax basis for the inventory, are taxable as ordinary income.

The question of termination and closing the taxable year may also be troublesome. The surviving partners may wish to continue the business, extending liquidating payments over several years, while the decedent's successor in interest prefers immediate payment to permit the discharge of debts, administration costs, and taxes. A sale effective on the date of death might be advantageous to the deceased partner's estate, since his share of the partnership income would thereby be included in his final return rather than in the fiduciary return. But such a plan can be burdensome to surviving partners.

#### CONCLUSION

The complexity and inconsistencies of the 1954 Code's treatment of sale and liquidation arise largely from the application of the fragmentation rules of section 751 and the classification of payments under section 736. These anti-collapsible provisions are designed to convert ordinary income into capital gain on sale or liquidation of a partner's interest. It appears that the application of sections 751 and 736 should have been limited to the voluntary sale or liquidation of a retiring partner's interest, with separate provisions applicable upon the death of a partner, when such restraints are hardly needed.

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50. See WILLIS, *PARTNERSHIP TAXATION* 380-81 (1957), suggesting that a "lively three-corner dispute" may occur between the executor of a deceased partner and the continuing partners, with the Commissioner of Internal Revenue "in the third corner"; Polasky, *supra* note 5, at 90, n.187.



Under the present Code, tax consequences for the surviving partners and for the deceased partner's estate are dependent to a large extent upon the terms of the partnership agreement. The potential conflicts of interest resulting from the relative advantages and disadvantages to surviving partners and successors in interest of the decedent, depending upon the method of purchase selected, are foreseeable; they will be avoided to a large extent if the partners have carefully drawn and periodically reviewed a suitable plan.

ANNE CAWTHON BOOTH

## STATUTORY REGULATION OF MARRIAGE COUNSELORS<sup>1</sup>

The rapidly climbing divorce rate indicates that an increasing number of married couples find it impossible to resolve their marital difficulties and suggests a growing necessity for skilled marriage counseling. How often have marital problems been further complicated as a result of counseling by unscrupulous persons with little or no formal training? One writer has estimated that in 1953 there were approximately 25,000 charlatans selling personal counsel in the United States, with an annual take of \$375,000,000.<sup>2</sup> Such a lucrative field is likely to attract an increasing number of smooth operators, and the developing public awareness of counseling as a remedy for marital problems seems to assure a steady market for their services.

Marriage counseling is not specifically mentioned in the Florida statutes governing licensing of trades and professions. Section 205.49 states that miscellaneous businesses for which there is no specific statutory licensing provision must pay a license tax of \$100; this is the sole prerequisite for marriage counseling for a fee. The most readily apparent solution is regulatory legislation. Assuming a need for legislation, many questions as to the form and extent of coverage arise.

### PREREQUISITES FOR THE PROFESSIONAL MARRIAGE COUNSELOR

Marriage counseling has been defined as "the process of helping persons, mainly through interviewing, to help themselves in regard

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1. The author acknowledges the helpful information derived from an interview with Dr. James C. Dixon, Department of Psychology, University of Florida, Feb. 28, 1961, and from letters from Dr. Richard W. Husband, Chairman, Florida State Board of Examiners of Psychology, to Prof. Walter O. Weyrauch, University of Florida College of Law, Jan. 28, 1961, and to the author, Mar. 7, 1961. These sources are hereinafter cited as "Dixon" and "Husband."

2. Steiner, *Figures on Charlantanism*, 8 AMERICAN PSYCHOLOGIST 708 (1953).