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James E. Tierney
The University of Toledo College of Law

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Recommended Citation

Tierney, James E. () "Reassessing Sales and Liquidations of Partnership Interests After the Omnibus Budget Reconciliation Act of 1993," *Florida Tax Review*. Vol. 1: No. 1, Article 17.
Available at: <https://scholarship.law.ufl.edu/fttr/vol1/iss1/17>

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FLORIDA TAX REVIEW

VOLUME 1

1994

NUMBER 12

Reassessing Sales and Liquidations of Partnership Interests after the Omnibus Budget Reconciliation Act of 1993

*James E. Tierney**

I. INTRODUCTION

Subchapter K of the Internal Revenue Code has historically afforded considerable flexibility in determining the federal income tax consequences of the retirement or withdrawal of a partner from a partnership. In general, the departure of a partner can be structured either as a purchase of the retiring partner's interest by the remaining partners or as a liquidation of the partner's interest by the partnership. Although these two transactions are essentially similar in economic consequences, they have been governed by two separate sets of provisions in Subchapter K, often resulting in significantly different tax consequences. The sale of a partner's interest is governed primarily by sections 741 and 751(a), whereas the liquidation of a partner's interest by the partnership is governed primarily by section 736.

Under sections 741 and 751(a), the sale of a partnership interest generates capital gain or loss to the selling partner, except to the extent that he or she is being compensated for an interest in certain ordinary income items of the partnership—namely, its unrealized receivables and substantially appreciated inventory. The purchasing partners receive few, if any, immediate tax benefits. Under section 736, by contrast, the liquidation of a partner's interest by a partnership could result in significant immediate tax benefits to the remaining partners. Specifically, under section 736(a), certain payments for a retiring partner's share of the partnership's good will and unrealized receivables would give rise to an immediate deduction or its equivalent for the remaining partners and usually result in ordinary income to the retiring partner. Payments for the partner's share of other partnership property would

* Associate Professor of Law, The University of Toledo College of Law. B.A. 1978, Rutgers College; J.D. 1981, LL.M. (in Taxation) 1984, New York University School of Law. The author wishes to thank Mark J. Dinsmore of The University of Toledo College of Law, Class of 1994, for his perceptive and diligent research assistance. The author also gratefully acknowledges research support from the University of Toledo College of Law Summer Research Grant Program.

be treated under section 736(b) as a distribution from the partnership to the partner, resulting in no deduction for the remaining partners and, for the most part, generating capital gain or loss for the retiring partner.

In enacting the Omnibus Budget Reconciliation Act of 1993 (hereinafter "OBRA 1993") Congress made a number of amendments to the Internal Revenue Code affecting the withdrawal or retirement of a partner. Outside the specific context of Subchapter K, it increased the maximum individual tax rates on ordinary income to 39.6% but left the maximum capital gains rate at 28%, thus making it even more desirable for individuals to obtain capital gain treatment. It also added new section 197, providing for the amortization of certain intangible assets, including good will. Within Subchapter K, it amended various provisions in an effort to address areas of potential abuse that it perceived as existing under prior law.

Part III of this article analyzes Congress's amendments in this area and compares their effects on services-oriented and capital-oriented partnerships. It observes that Congress virtually has repealed section 736(a) insofar as capital-oriented partnerships are concerned, and contends that Congress's reforms in this area were in some respects too broad and in others too narrow. They unfairly preclude capital-oriented partnerships from currently deducting payments for a departing partner's share of traditional "unrealized receivables," for which the opportunity for abuse was minimal. By the same token, they leave open to services-oriented partnerships a significant opportunity for abuse that existed under prior law, namely, the ability currently to deduct payments representing a retiring partner's share of unstated partnership good will. By thus creating two separate sets of rules under section 736—one for partnerships in which capital is a material income-producing factor and another for partnerships in which it is not—Congress has not achieved its intended goal of reducing confusion in this area. Finally, the article explores the changes effected by OBRA 1993 and illustrates that notwithstanding Congress's amendments, different tax consequences will still follow, depending upon whether a partner's interest is sold or liquidated.

Part II of this article describes the tax treatment resulting from the sale and the liquidation of a partnership interest prior to the enactment of OBRA 1993. Readers already familiar with this area may wish to proceed directly to part III, which analyzes the specific amendments made to prior law. Part IV concludes by summarizing and commenting upon these amendments and their effects on partners and partnerships.

II. THE SALE OR LIQUIDATION OF A PARTNER'S INTEREST PRIOR TO THE ENACTMENT OF OBRA 1993

A. Introduction

This part first describes the tax treatment of the sale of a partnership

interest for both the selling and purchasing partners under section 741 and related provisions that, relatively speaking, was only slightly affected by OBRA 1993. Then, it outlines the tax consequences of the liquidation of a partner's interest by a partnership under section 736 and related provisions as in effect before the enactment of OBRA 1993. Although OBRA 1993 did significantly affect these provisions, this discussion is of more than historical interest for three reasons. First, it provides a frame of reference for analyzing the OBRA 1993 amendments. Second, as discussed in part III, the rules of section 736 as in effect under prior law will continue to apply in modified form to the liquidation of the interest of a general partner in a partnership for which capital is not a material income-producing factor. Third, although the amendments to section 736 made by OBRA 1993 generally apply to partners retiring or dying on or after January 5, 1993, they are inapplicable if a written contract to purchase such partner's interest was binding on January 4, 1993, and at all times thereafter before such purchase.¹ In such cases, the pre-OBRA 1993 rules will apply.

It is convenient to demonstrate the application of the law through the use of an example. For simplicity, the article uses for this purpose a general example involving the ABC Partnership consisting of Ms. A and Messrs. B and C, each of whom has a one-third interest in capital and profits. The partnership's balance sheet is as follows.

<u>Asset</u>	ABC Partnership		
	<u>Basis</u>	<u>FMV</u>	<u>Gain</u>
Cash	6000	6000	--
Inventory	270	300	30
Machine*	0	150	150
Accounts			
Receivable	0	150	150
Capital Asset	30	300	270
Good Will	0	300	300
Total	6300	7200	900
Partners' Equity			
A	2100	2400	300
B	2100	2400	300
C	2100	2400	300
Total	6300	7200	900

*The machine is section 1245 property that originally cost \$200 and has been fully depreciated under section 168.

1. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13262(a), (c)(2), 107 Stat. 312, 541 [hereinafter OBRA 1993].

If the ABC Partnership were to sell its assets for cash equal to their fair market value, the amount and character of the gain and loss realized on each asset would pass through to the partners.² Since the partnership would recognize \$330 of ordinary income from its inventory, machine, and accounts receivable and \$570 of capital gain from its capital asset and good will, each partner would be allocated income of \$300, consisting of \$110 of ordinary income and \$190 of capital gain.³ The basis of each partner's interest in the partnership would increase by \$300, to \$2,400.⁴ A liquidating distribution of \$2,400 in cash to each partner would result in recognition of no further gain or loss.⁵

Under an ideal system of flow-through taxation, the same results should follow if the partners, either together or separately, disposed of their partnership interests; each would be taxed on ordinary income of \$110 and capital gain of \$190. Accordingly, in the following discussion, recognition by each partner of \$110 of ordinary income and \$190 of capital gain is referred to as the "theoretically correct result."

B. The Sale of a Retiring Partner's Interest to Remaining Partners Under Section 741 and Related Provisions Prior to Amendments by OBRA 1993

Assume that B and C will each purchase one-half of A's interest in the partnership using \$1,200 of their individual funds. The aggregate \$2,400

2. IRC § 702(a), (b).

3. The example assumes that the good will has been generated by the ABC Partnership's operations. Such good will historically has given rise to capital gain when transferred in connection with the sale of a business. See, e.g., *Cox v. Commissioner*, 17 T.C. 1287 (1952); *Schilbach v. Commissioner*, T.C. Memo 1991-556 (CCH) 1991. Cf. *Danielson v. Commissioner*, 378 F.2d 771 (3d Cir. 1967) (holding that although good will gives rise to capital gain on sale of business, amounts attributable to a covenant by the seller not to compete give rise to ordinary income and are amortizable by the purchaser of a business), cert. denied, 389 U.S. 858. Under § 197, as added by OBRA 1993, taxpayers may amortize the basis of certain intangibles, including certain "acquired" good will. If such acquired good will subsequently is disposed of at a gain, prior amortization deductions are recaptured as ordinary income. See IRC § 197(f)(7). See also *infra* text accompanying notes 98-121.

4. Under § 705, the adjusted basis of a partner's interest in the partnership is increased by the partner's distributive share of taxable income of the partnership and decreased for distributions and losses of the partnership. A partner's basis in her interest in the partnership, referred to as a partner's "outside basis," is thus distinct from the partnership's own basis in its assets, referred to as "inside basis."

5. "In the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution . . ." IRC § 731(a)(1).

purchase price represents A's share of the fair market value of the partnership's assets, including good will.

1. Tax Consequences to Selling Partner

a. *In General: Overview of Sections 741 and 751(a).*—Sections 741 and 751(a) prescribe the tax consequences for the seller of an interest in a partnership. The selling partner will realize and recognize gain to the extent that her amount realized exceeds the adjusted basis of her partnership interest, or loss to the extent that the adjusted basis of her partnership interest exceeds the amount realized on the sale.⁶ Such gain or loss will be treated as capital gain or loss, except as otherwise provided by section 751(a).⁷

b. *Operation of Section 751(a): Unrealized Receivables and Substantially Appreciated Inventory.*—If the partnership has “unrealized receivables” and “inventory items that have appreciated substantially in value” (collectively referred to herein as “section 751 property”), the partner who sells a partnership interest will be treated under section 751(a) as if she directly sold her interest in these items, resulting in ordinary income treatment.⁸

For purposes of section 751, the term “unrealized receivables” is defined by section 751(c) as including, to the extent not previously includible in the partnership's income, any rights to payment for goods delivered or to be delivered or services rendered or to be rendered.⁹ Thus, a cash-method

6. IRC §§ 741, 1001.

7. IRC § 741.

8. Thus, even a partner who sells her interest at an overall loss may have ordinary income under § 751(a) and a capital loss under § 741.

9. As amended by OBRA 1993, § 751(c) provides as follows.

(c) Unrealized Receivables.—For purposes of this subchapter, the term “unrealized receivables” includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for—

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

(2) services rendered, or to be rendered.

For purposes of this section and sections 731 and 741 (but not for purposes of section 736), such term also includes mining property (as defined in section 617(f)(2)), stock in a DISC (as described in section 992(a)), section 1245 property (as defined in section 1245(a)(3)), stock in certain foreign corporations (as described in section 1248), section 1250 property (as defined in section 1250(c)), farm land (as defined in section 1252(a)).

partnership's outstanding accounts receivable constitute unrealized receivables. The term also includes other "ordinary income" items, such as unrealized depreciation recapture inherent in the partnership's property.¹⁰ Because the distinction is significant after the enactment of OBRA 1993, this article will refer to the first type of unrealized receivables (i.e., rights to payment for services rendered or goods sold) as "traditional" unrealized receivables and to the second type (i.e., depreciation recapture) as "nontraditional" unrealized receivables.¹¹

The term "substantially appreciated inventory" is defined by section 751(d). Before its amendment by OBRA 1993, that section provided that the partnership's inventory items had appreciated substantially in value if their fair market value exceeded both 120% of their adjusted basis to the partnership and 10% of the value of all partnership property, other than money.¹²

franchises, trademarks, or trade names (referred to in section 1253(a)), and an oil, gas, or geothermal property (described in section 1254) but only to the extent of the amount which would be treated as gain to which section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1252(a), 1253(a) or 1254(a) would apply if (at the time of the transaction described in this section or section 731, 736, or 741, as the case may be) such property had been sold by the partnership at its fair market value. For purposes of this section and, sections 731 and 741 (but not for purposes of section 736), such term also includes any market discount bond (as defined in section 1278) and any short-term obligation (as defined in section 1283) but only to the extent of the amount which would be treated as ordinary income if (at the time of the transaction described in this section or section 731 or 741, as the case may be) such property had been sold by the partnership.

IRC § 751(c), amended by OBRA 1993, *supra* note 1, § 13262(b)(1)(A)-(B), 107 Stat. at 541. OBRA 1993 added the parenthetical references indicating that the items referred to in the flush language constitute unrealized receivables for purposes of §§ 751, 731, and 741, but not for purposes of § 736.

10. IRC § 751(c) (flush language). For example, assume that a partnership owns a depreciable machine having a basis of \$75 and an original cost (recomputed basis under § 1245) of \$100. If the machine has a fair market value of \$80, all \$5 of gain that would be realized on a sale of the asset at its fair market value would be considered ordinary income under § 1245. Hence, the machine would constitute an "unrealized receivable" to the extent of \$5. By contrast, if the machine were worth \$120, a sale for its fair market value would generate gain of \$45, of which only \$25 would be ordinary income under § 1245, and \$20 would be gain from the sale of property used in the trade or business under § 1231. In that case, the machine would be an "unrealized receivable" only to the extent of \$25.

11. After the enactment of OBRA 1993, "traditional" unrealized receivables are considered unrealized receivables for purposes of § 736, but "nontraditional" unrealized receivables are not. See *supra* note 9 and *infra* text accompanying notes 83-88.

12. As amended by OBRA 1993, § 751(d) provides as follows.

(d) Inventory Items Which Have Appreciated Substantially in Value.—

(1) Substantial Appreciation.—

For this purpose, inventory items include not only property held for sale to customers in the ordinary course of business, but also any other property of the partnership which, if sold or exchanged by the partnership, would give rise to ordinary income or loss. Therefore, because a partnership's traditional and nontraditional unrealized receivables would give rise to ordinary income if sold, they are treated as "inventory" (along with any actual inventory held by the partnership) in applying the substantial appreciation test.

For the ABC Partnership, the \$150 of depreciation recapture inherent in the machine and the \$150 worth of accounts receivable constitute unrealized receivables under section 751(c). These unrealized receivables have, in the aggregate, a basis of zero and a value of \$300.¹³ The partnership's actual inventory has a basis of \$270 and a value of \$300. Because the value of the partnership's section 751(d) "inventory" (actual inventory plus unrealized receivables) is thus \$600, which exceeds both 120% of its \$270 basis and 10% of the \$1,200 value of the partnership's noncash property, it is "sub-

(A) In general.—Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property.

(B) Certain Property Excluded.—For purposes of subparagraph (A), there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this section relating to inventory items.

(2) Inventory Items.—For purposes of this subchapter the term "inventory items" means—

(A) property of the partnership of the kind described in section 1221(1),

(B) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231,

(C) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and

(D) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A), (B), or (C).

IRC § 751(d), amended by OBRA 1993, *supra* note 1, § 13206(e)(1), 107 Stat. at 467. Before the enactment of OBRA 1993, inventory was substantially appreciated under this section if its fair market value exceeded both 120% of the adjusted basis to the partnership of such property, and 10% of the fair market value of all partnership property, other than money. OBRA 1993 eliminated the latter requirement for sales, exchanges, and distributions occurring after April 30, 1993. OBRA 1993, *supra* note 1, § 13206(e)(2), 107 Stat. at 467. See *infra* text accompanying notes 76-82.

13. Depreciation recapture is treated as an asset having a basis of zero. See Regs. § 1.751-1(c)(5).

stantially appreciated.” Therefore, under section 751(a), A is treated as selling her \$100 share of the partnership’s actual inventory and her \$100 share of its unrealized receivables.¹⁴ The remaining \$2,200 received by her is used to compute her capital gain or loss under section 741.

To determine the amount treated as ordinary income, the selling partner must allocate a portion of the basis of her partnership interest to the section 751 property treated as sold by her under section 751(a). This is done by determining the basis that she would have had in such section 751 property if she had received it from the partnership in a current distribution.¹⁵ In a current distribution, a partner succeeds to the partnership’s basis in the property immediately before the distribution and must reduce the basis of her partnership interest by that amount.¹⁶ However, the partner’s basis in the distributed property may not exceed the basis of her partnership interest immediately before the distribution, reduced by any money distributed in the same transaction.¹⁷

In a current distribution of her one-third share of the partnership’s section 751 property, A would have succeeded to a zero basis in the machine and the accounts receivable (each having a value of \$100) and a \$90 basis in the inventory (having a value of \$100). This aggregate basis of \$90 is used in determining the amount of A’s ordinary income under section 751(a), and the remaining basis of her partnership interest (\$2,010) is used in determining the amount of A’s capital gain or loss under section 741.

c. Final Determination of Selling Partner’s Gain.—The portion of a selling partner’s amount realized and the basis of her partnership interest not dealt with under section 751(a) yields a capital gain or loss under section 741. Here, A realizes \$110 of ordinary income and \$190 of capital gain on the sale of her partnership interest, corresponding to the theoretically correct result, and calculated as follows:

14. Although the partnership’s unrealized receivables (as defined in § 751(c)) are within the definition of inventory under § 751(d), they are not subjected to tax twice. However, because such unrealized receivables will typically have a low or zero basis, their inclusion makes it more likely that traditional inventory of the partnership, which might not be considered substantially appreciated when viewed alone, will be considered substantially appreciated when considered together with the partnership’s unrealized receivables.

15. Regs. § 1.751-1(a)(2). For this purpose, a current distribution is one other than in liquidation of a partner’s interest.

16. IRC §§ 732(a)(1), 733.

17. IRC § 732(a)(2).

	<u>Total</u>	<u>Sec. 751(a)</u>	<u>Sec. 741</u>
Amount Realized	2400	200	2200
Adjusted Basis	2100	90	2010
Gain (Loss)	300	110	190

2. Tax Consequences to Purchasing Partners

a. *Effect on Basis in Partnership Interest.*—The basis of an interest in a partnership acquired other than by contribution is determined by the Code's general basis rules.¹⁸ Thus, the basis of a purchased interest is its cost.¹⁹ Because a partnership interest is a unitary asset, a partner who purchases an additional interest in a partnership will increase the basis of his existing interest by the amount paid.²⁰ Therefore, by purchasing one-half of A's interest for \$1,200 cash, B and C increase their respective interests in the partnership from one-third to one-half and will increase the basis in their partnership interests by \$1,200, to a total of \$3,300 each.

b. *Adjustments to Basis of Partnership Property.*—The basis of partnership property is not adjusted on the transfer of an interest in a partnership by sale or exchange unless the partnership has made an election under section 754.²¹

(1) *Tax Consequences if Section 754 Election Not in Effect.*—The purchasing partners can be affected adversely by the failure to make a section 754 election where the partnership's assets have appreciated in value.²² To illustrate, assume that immediately after B and C purchase A's interest, the partnership sells its assets for \$7,200 in cash and distributes \$3,600 to each partner in liquidation. The partnership's assets and the amount and character of its gain on the sale are as follows:

18. IRC § 742.

19. Regs. § 1.742-1. See IRC § 1012 (providing that basis of property is cost).

20. See Rev. Rul. 84-53, 1984-1 C.B. 159 (holding that a partnership interest is a unitary asset having a single basis, even if portions of such interest have been acquired at different times).

21. IRC § 743(a).

22. However, where the partnership's basis exceeds the value of such assets, the purchasing partners may prefer that a § 754 election not be in effect, so that they may use the higher inside basis of the partnership's property. If, in such circumstances, an election is already in effect at the time of the purchase, the pertinent regulations indicate that an application to revoke the election would not be approved when the purpose of the revocation is primarily to avoid a reduction in the basis of partnership assets upon a transfer or distribution. Regs. § 1.754-1(c).

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>	<u>Gain</u>	<u>Character</u>
Cash	6000	6000	0	--
Inventory	270	300	30	Ordinary
Machine	0	150	150	Ordinary
Accounts				
Receivable	0	150	150	Ordinary
Capital Asset	30	300	270	Capital
Good Will	0	300	300	Capital
Total	6300	7200	900	

The partnership will realize \$900 of gain on the sale of its assets, of which \$330 is ordinary income and \$570 is capital gain. But because A has left the partnership, B and C as the remaining partners will each be allocated one-half, rather than one-third, of these amounts. Accordingly, B and C each will be allocated \$450 of gain, of which \$165 is ordinary income and \$285 is capital gain, and each will increase the basis of his partnership interest by \$450, to \$3,750. On receiving \$3,600 in liquidation, each will recognize a capital loss of \$150.²³

Thus, although the theoretically correct result (\$110 of ordinary income and \$190 of capital gain) has been achieved as to A, partners B and C each have \$165 of ordinary income and \$135 of overall capital gain (capital gain of \$285 and a capital loss of \$150), or \$55 too much ordinary income and \$55 too little capital gain. This occurs because the basis of the partnership's property was unchanged after A's sale of her partnership interest, even though B and C have paid fair market value for A's one-third interest in the partnership's property and even though A has been taxed on one-third of the inherent but unrealized gain on such property.²⁴ Indeed, the additional aggregate \$110 of ordinary income allocated to B and C represents the ordinary income previously taxed to A.²⁵ Accordingly, B and C should

23. Under § 731(a)(2), loss is recognized only on distributions in liquidation where no property other than money, unrealized receivables, and inventory are distributed. Such loss is measured by the excess of the partner's adjusted basis in her partnership interest over the sum of money distributed and the basis to the distributee under § 732 of any unrealized receivables and inventory.

24. That is, the partnership only realized the gain inherent in its assets after A sold her interest therein.

25. Because B and C are each taxed on an excess \$55 of ordinary income (representing A's one-third share thereof), they acquire an additional \$55 of basis in their partnership interests. This increases their capital loss on liquidation of the partnership by \$55 and reduces *pro tanto* their capital gain. But this loss is a capital loss that can be recognized only upon complete liquidation of the partnership or sale of their interests. Thus, when characterization and time value of money considerations are taken into account, this loss will not fully compensate B and C for the extra ordinary income they have been allocated.

consider causing the partnership to make a section 754 election, the consequences of which are described immediately below.²⁶

(2) *Tax Consequences if Section 754 Election in Effect*

(a) *Overview of Section 754.*—If a partnership makes a section 754 election, it will adjust the basis of its property under section 734(b) in connection with partnership distributions and under section 743(b) in connection with transfers of partnership interests.²⁷ These adjustments are allocated to specific partnership assets in accordance with the rules set forth in section 755 and the regulations thereunder.²⁸

(b) *Basis Adjustments Under Section 743(b) upon Transfer of a Partnership Interest.*—If a partnership interest is transferred while a section 754 election is in effect, the partnership must either increase the basis of its property by the excess of the transferee's basis in his partnership interest over his proportionate share of the basis of the partnership's property, or decrease the basis of its property by the excess of the transferee's proportionate share of the basis of partnership property over the basis of his partnership interest.²⁹ The adjustment applies with respect to the transferee partner only, which partner will have a special basis for those partnership properties which are adjusted, consisting of his share of the common partnership basis, plus or minus his special basis adjustments.³⁰

Basis adjustments resulting from a partnership's section 754 election are allocated to specific partnership assets under section 755 and the regulations thereunder, which provide two guiding principles.³¹ First, adjustments ordinarily must be allocated in a manner that reduces the difference between

26. See IRC §§ 734, 743, 754.

27. Once made, the election applies to all distributions of property and all transfers of interests in the partnership during the taxable year with respect to which the election is made and for all subsequent taxable years. IRC § 754. If a § 754 election is made, the adjustments prescribed under §§ 734 and 743 are mandatory; a partnership cannot elect to make adjustments only under one or the other of the sections. Regs. § 1.754-1(a). An election may be revoked in accordance with limitations contained in the pertinent regulations. IRC § 754. The procedure for revoking an election and the grounds on which an application for revocation may be granted are set forth in Regs. § 1.754-1(c).

28. IRC §§ 734(c), 743(c); Regs. §§ 1.734-1(c), 1.743-1(c).

29. IRC § 743(b). A partner's proportionate share of the partnership's basis in its property is the "sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities." Regs. § 1.743-1(b)(1). If, for example, a partner holds a one-third interest in partnership capital and profits, his share of the adjusted basis of partnership property generally will be one-third of the partnership's basis. *Id.*

30. IRC § 743(b); Regs. § 1.743-1(b)(1)(ii).

31. IRC §§ 734(c), 743(c); Regs. §§ 1.734-1(c), 1.743-1(c).

the fair market value and adjusted basis of such properties.³² Thus, an adjustment that increases basis usually must be allocated only to assets whose fair market values exceed their bases, while one that decreases basis must be allocated only to assets whose bases exceed their fair market values.³³ Second, in allocating basis adjustments, the partnership's property is divided into two classes: one, capital assets and property described in section 1231(b)

32. IRC § 755(a)(1).

33. Regs. § 1.755-1(a)(1)(i), (ii). Thus, an upward adjustment can only reduce gain, and not increase loss inherent in partnership property, and a downward adjustment can only reduce loss and not increase gain. Therefore, such adjustments will not always conform a transferee partner's share of the basis of the partnership's property to his share of the fair market value of such property. For example, assume that the balance sheet of the WXY Partnership, which has a § 754 election in effect, is as follows:

	<u>Basis</u>	<u>FMV</u>	<u>Gain (or Loss)</u>
Asset 1	0	300	300
Asset 2	90	60	(30)
Total	90	360	270
Partners' Equity			
W	30	120	90
X	30	120	90
Y	30	120	90
Total	90	360	270

If Z purchases W's one-third capital and profits interest for \$120, W will recognize gain of \$90. By paying the equivalent of his share of the fair market value of the partnership's assets, Z should be entitled to an overall basis of \$100 in Asset 1 and \$20 in Asset 2 (one-third of each asset's fair market value). If so, he would be allocated no gain or loss if the partnership sold either asset for its fair market value.

But that result does not occur under the general provisions of the regulations. The \$90 upward special basis adjustment to which Z is entitled under § 743(b) must be allocated entirely to Asset 1, whose value exceeds its adjusted basis, giving Z a special basis therein of \$90. Thus, Z would be allocated \$10 of gain from the sale of Asset 1 and \$10 of loss from the sale of Asset 2 representing, for Asset 1, the difference between \$100 (Z's one-third share of the asset's \$300 fair market value) and \$90 (Z's special basis in Asset 1) and for Asset 2, the difference between \$30 (Z's one-third share of the partnership's basis in the asset) and \$20 (Z's one-third share of the asset's \$60 fair market value).

Z could avoid allocation of such gain or loss if he obtained a net \$90 of basis adjustments linked to each asset's fair market value—that is, a \$100 upward special basis adjustment with respect to Asset 1 and a \$10 downward special basis adjustment with respect to Asset 2. His special basis would then be equal to one-third of each asset's fair market value. Partnerships may apply for authority to make special basis adjustments in the manner just described, in lieu of that initially prescribed by the regulations; such an application must be made no later than 30 days after the close of the partnership's taxable year in which the proposed adjustment is to be made. Regs. § 1.755-1(a)(2).

(hereinafter "capital and 1231(b) assets") and two, all other property.³⁴ A positive basis adjustment is allocated first, between the two classes of property according to the relative net appreciation of assets in the two groups and then, to specific assets within each class on the basis of relative net appreciation when compared with other assets within that class.³⁵ A negative basis adjustment would similarly be made on the basis of relative net depreciation in assets.

These considerations can be illustrated with reference to the ABC Partnership, which had the following assets when B and C purchased A's interest:

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>	<u>Gain and Character</u>	
Cash	6000	6000	0	--
Inventory	270	300	30	Other
Machine	0	150	150	Other
Unrealized				
Receivables	0	150	150	Other
Capital Asset	30	300	270	Capital/1231(b)
Good Will	0	300	300	Capital/1231(b)
Total	6300	7200	900	

After the purchase, B and C each have a basis in their respective partnership interests of \$3,300 and a \$3,150 proportionate share of the basis of the partnership's property, so that each of them is entitled to an upward special basis adjustment of \$150.

The partnership has net appreciation of \$570 in its capital and section 1231(b) assets,³⁶ and \$330 in its "other" property, or total appreciation of

34. Regs. § 1.755-1(b). The pertinent regulations provide that to the extent that an amount paid by the purchaser of a partnership interest is attributable to the partnership's capital and § 1231(b) assets, any difference between the amount so attributable and the transferee partner's share of the partnership's basis of such property shall constitute a special basis adjustment with respect to such capital and § 1231(b) assets. Regs. § 1.755-1(b)(2). Similarly, any such difference attributable to other property of the partnership shall constitute a special basis adjustment with respect to such other property. *Id.*

35. See Regs. § 1.755-1(c) ex. 2. For this purpose, net appreciation is the excess of aggregate fair market value over aggregate basis of the properties being considered. Thus, if a partnership's capital assets and § 1231(b) property had appreciated by \$400, while its other property had not appreciated, an upward § 743(b) adjustment must be allocated entirely to the partnership's capital assets and § 1231(b) property. If, instead, the capital assets and § 1231(b) property had appreciated by \$200 and its other property by \$100, then two-thirds (200/300) of the adjustment is allocated to the partnership's capital assets and § 1231(b) property, and one-third (100/300) is allocated to its other property.

36. It is unnecessary to classify cash as either capital and § 1231(b) assets or "other" property, since its basis and fair market value always will be equal.

\$900.³⁷ Therefore, of each partner's \$150 special basis adjustment, 570/900 (\$95) is allocable to the partnership's capital and section 1231(b) assets and 330/900 (\$55) to its other property. The total adjustment to each class of property is allocated among specific assets within that class, again based on relative net appreciation. Of the total \$570 of net appreciation in the first class, having total appreciation of \$570, \$270 was attributable to the capital asset and \$300 to the good will. Therefore, of each partner's allocable \$95 special basis adjustment, 270/570 (\$45) is allocable to the capital asset and 300/570 (\$50) to the good will. Similarly, the partnership's other property had total net appreciation of \$330, of which \$150 was attributable to the accounts receivable, \$150 to the machine, and \$30 to the inventory. Therefore, of each partner's allocable \$55 special basis adjustment, 150/330 (\$25) is allocable to the accounts receivable, 150/330 (\$25) to the machine, and 30/330 (\$5) to the inventory.

With these special basis adjustments, the partnership's balance sheet would be as follows:

<u>Asset</u>	<u>Basis</u>	<u>Special Basis Adj.</u> ³⁸	<u>Total Basis</u>	<u>FMV</u>
Cash	6000	0	6000	6000
Inventory	270	10	280	300
Machine	0	50	50	150
Accounts				
Receivable	0	50	50	150
Capital Asset	30	90	120	300
Good Will	0	100	100	300
Total	6300	300	6600	7200
Partners' Equity				
B	3300		3300	3600
C	3300		3300	3600
Total	6600		6600	7200

Now, if the partnership sold its assets for \$7,200 and distributed \$3,600 of cash to B and C in liquidation, it would recognize ordinary income of \$220 (\$20 from the inventory, \$100 from the machine and \$100 from the

37. Although the machine is described in § 1231(b), it should not be placed in the § 1231(b) category for this purpose since the entire gain from its sale at fair market value would be characterized as ordinary income under § 1245.

38. For convenience, the table aggregates the special basis adjustments for B and C. Technically speaking, however, the partnership must make separate special basis adjustments for each partner entitled thereto. See IRC § 743(b); Regs. § 1.743-1(b).

accounts receivable) and capital gain of \$380 (\$180 from the capital asset and \$200 from the good will). B and C would each be allocated \$110 of ordinary income and \$190 of capital gain, and would recognize no further gain or loss on liquidation.³⁹ In this example, the theoretically correct result has been obtained as to B and C because of the basis adjustments resulting from the section 754 election.

3. *Summary of Results to Selling and Purchasing Partners.*— Sections 741 and 751(a) can tax a selling partner on the theoretically correct amounts of capital gain and ordinary income, almost as if she sold her proportionate interest in the partnership's underlying assets.⁴⁰ The selling partner, therefore, will usually be neither overtaxed nor undertaxed.⁴¹ By contrast, if the partnership does not make a section 754 election and holds appreciated assets, the purchasing partners may be overtaxed. Where a section 754 election is in effect, however, the purchasing partners obtain an adjustment to the basis of partnership property that reflects both their payment of the value of the selling partner's interest in the partnership's property and the taxation of the selling partner on the sale of her interest. That basis adjustment can shield them from being taxed on the selling partner's share of the inherent gain on such property when the partnership subsequently disposes

39. B and C will each increase the basis of his partnership interest by \$300, from \$3,300 to \$3,600. If the partnership then were liquidated, each partner would receive cash (\$3,600) equal to the basis of his interest in the partnership and would recognize no further gain or loss.

40. Since § 751(a) provides ordinary income treatment to the selling partner only with regard to her share of unrealized receivables and substantially appreciated inventory, she will not always be taxed in the same manner as if she directly sold her interest in the partnership's assets. For example, if a partner directly sold an appreciated inventory item, ordinary income invariably would result. Under § 751(a), ordinary income treatment follows on the sale of a partnership interest only if the inventory held by the partnership is "substantially appreciated."

41. This conclusion assumes that, as was true for A on the facts of the example, the selling partner's proportionate share of basis of the partnership's property corresponds to her proportionate share of the value of such assets. Such a correspondence may be lacking where, for example, the selling partner purchased an interest in an existing partnership that holds appreciated assets and that has not made an election under § 754. As an example, consider again the facts illustrated above. If, after purchasing one-half of A's interest, C sold his interest in the partnership to D for \$3,600, he would have realized ordinary income of \$165 and capital gain of \$135 if the partnership had not made a § 754 election.

of the property.⁴² The partnership's section 754 election will not alter or adversely affect the tax consequences to the selling partner.⁴³

C. Liquidation of a Partner's Interest Under Section 736 and Related Provisions Prior to Amendments by OBRA 1993

As an alternative to the purchase of a partner's interest by her fellow partners, the partnership itself could liquidate a partner's interest. The tax consequences of this form of transaction are governed by section 736 and related Code provisions. The amendments made to these provisions by OBRA 1993 are discussed in detail in part III, below, while this part describes such provisions as in effect immediately prior to the enactment of OBRA 1993.

1. *Overview of Section 736: Subsections (a) and (b).*—Since its addition to the Internal Revenue Code in 1954, section 736 has divided partnership payments to retiring partners into two categories. Payments for the partner's interest in partnership property are treated under section 736(b)(1) as a liquidating distribution. Section 736 does not itself prescribe the tax consequences of such a distribution, but leaves that task to other provisions of subchapter K dealing with distributions, in particular, section 731. Thereunder, except as otherwise provided by section 751(b), gain or loss on the distribution of money in liquidation of a partner's interest results in capital gain or loss.⁴⁴ The remaining partners may not deduct these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).⁴⁵

Payments for the retiring partner's share of unrealized receivables and "unstated good will" of the partnership are not treated as payments for a partner's interest in partnership property within the meaning of section 736(b).⁴⁶ Instead, such payments fall within section 736(a), where they are

42. If upward special basis adjustments resulting under § 743(b) are allocated to depreciable or amortizable property, the partners obtaining such special basis adjustments are entitled to claim deductions for depreciation or amortization with respect thereto. See *infra* text accompanying notes 111-12.

43. In closing this discussion of § 741, it should be noted that the same consequences, albeit with slightly different numbers, would have resulted if B and C caused the partnership to distribute \$1,200 to each of them and used such funds to purchase A's interest in the partnership.

44. IRC § 731.

45. Regs. § 1.736-1(a)(2).

46. IRC § 736(b)(2). A payment for good will is not considered to be made in exchange for an interest in partnership property and is thus outside the scope of § 736(b) "except to the extent that the partnership agreement provides for a payment with respect to

considered either a distributive share of the partnership's income (if the amount thereof is determined with regard to the partnership's income) or a guaranteed payment (if the amount thereof is determined without regard to the partnership's income). Section 736(a) payments usually constitute ordinary income to the retiring partner and result in a deduction or its equivalent to the partnership (consisting of the remaining partners).⁴⁷

The tax consequences of a liquidation under section 736 under pre-OBRA 1993 law can be illustrated by again considering the ABC Partnership, whose balance sheet is reproduced here for convenience:

<u>Asset</u>	ABC Partnership		
	<u>Basis</u>	<u>FMV</u>	<u>Gain</u>
Cash	6000	6000	—
Inventory	270	300	30
Machine	0	150	150
Accounts			
Receivable	0	150	150
Capital Asset	30	300	270
Good Will	0	300	300
Total	6300	7200	900
Partners' Equity			
A	2100	2400	300
B	2100	2400	300
C	2100	2400	300
Total	6300	7200	900

The partnership will liquidate A's interest for \$2,400 in cash. Although \$100 of this payment represents her share of the partnership's good will, it is assumed that the partnership agreement does not "provide" for a payment with respect to good will, so that payment therefore is considered a section 736(a) payment.

good will." IRC § 736(b)(2)(B). Thus, a payment for unstated good will is a § 736(a) payment, and a payment for good will that is provided for in the partnership agreement is a § 736(b) payment.

47. A guaranteed payment is considered a payment made to a nonpartner and results in ordinary income to the recipient partner. See IRC § 707(a), (c). If a payment is considered a distributive share of income to a partner, it reduces the distributive shares of income allocable to the other partners, affording them the equivalent of a deduction. See Regs. § 1.736-1(a)(4).

2. Tax Consequences to Retiring Partner

a. *Section 736(a) Payments.*—Under section 736(a), the \$200 paid for A's interest in the partnership's unrealized receivables⁴⁸ and unstat- ed good will is treated as a guaranteed payment and results in ordinary income to A.⁴⁹

b. *Section 736(b) Payments.*—The remaining \$2,200 of the partnership's payment is treated under section 736(b) as a distribution in liquidation of A's interest. Under section 731(a), A will recognize a capital gain or loss from these payments, except as provided by section 751(b).⁵⁰

c. Effect of Section 751(b)

(1) *In General.*—Section 751(b) seeks to prevent partners from shifting the partnership's ordinary income and capital gain items among themselves through current or liquidating distributions that alter their respective interests in such items. It divides property of the partnership into two groups: one, unrealized receivables and substantially appreciated inventory (section 751 property)⁵¹ and two, all other property, including money (non-section 751 property). It asks whether, after any distribution, each partner has retained a proportionate share of each group of property or has instead relinquished an interest in one group of property in exchange for a larger interest in the other group. If a partner receives in a distribution either section 751 property in exchange for all or part of her interest in non-section 751 property or non-section 751 property in exchange for all or part of her interest in section 751 property, the distribution is, to this extent, considered a sale or exchange of such properties between the distributee partner and the partnership as constituted after the distribution.⁵² Therefore,

48. Before the amendment of § 751(c) by OBRA 1993, unrealized receivables meant for this purpose both traditional and nontraditional unrealized receivables. See *infra* text accompanying notes 83-88.

49. See IRC § 707(c).

50. IRC § 731(a)(1), (c). A will have a gain to the extent that the money distributed exceeds the adjusted basis of her partnership interest immediately before the distribution, or a loss to the extent that the basis of her partnership interest exceeds the amount of money distributed to her in liquidation.

51. These terms are defined, respectively, in §§ 751(c) and (d). For § 751 purposes, both before and after enactment of OBRA 1993, the term "unrealized receivables" means both traditional and nontraditional unrealized receivables.

52. IRC § 751(b). Because § 751(b) operates by reference to the overall value of, rather than appreciation or depreciation in, the partnership's § 751 property, it does not always succeed in preventing disproportionate shifting of gains and losses among partners. For

section 751(b) can apply whenever a partner receives money, which is non-section 751 property, in exchange for her interest in section 751 property.

(2) *Application of Section 751(b) to Section 736 Payments.*—Section 751(b) is inapplicable to payments under section 736(a), but it does apply to payments under section 736(b).⁵³ If a retiring partner receives section 736(b) payments for her interest in the partnership's section 751 property, section 751(b) treats her as if she received her proportionate share of such section 751 property in a current distribution and resold it to the partnership.⁵⁴ Only the 736(b) payments in excess of this amount are treated as a distribution in liquidation of the retiring partner's interest.⁵⁵

When A received a \$2,400 payment in liquidation of her interest, the ABC Partnership's balance sheet was as follows.

<u>Asset</u>	<u>Basis</u>	<u>FMV</u>	A's share of <u>FMV</u>
Cash	6000	6000	2000
Inventory	270	300	100
Machine	0	150	50
Accounts			
Receivable	0	150	50
Capital Asset	30	300	100
Good Will	0	300	100
Total	6300	7200	2400

example, assume that a partnership having two equal partners owns, among other assets, Inventory Items 1 and 2. Each item has a value of \$100, but Item 1 has a basis of \$30 and Item 2 has a basis of \$80. Section 751(b) will not apply to the distribution of Item 1 to one partner and Item 2 to the other, because each partner is receiving in the distribution a pro rata \$100 share of § 751 property. This is the case even though the distribution shifts disproportionate amounts of gain and loss among the partners (i.e., the partner receiving Item 1 has property containing \$70 of built-in ordinary income and the partner receiving Item 2 has property containing \$20 of built-in ordinary income).

53. IRC § 751(b)(2)(B). Because § 736(a) generally treats payments for a partner's share of unrealized receivables (which are § 751 property) as ordinary income, it is unnecessary to apply § 751(b) to characterize such payments. Under OBRA 1993's amendment of IRC § 751(c), only certain payments for a retiring partner's share of traditional unrealized receivables qualify as § 736(a) payments. See *infra* text accompanying notes 83-88.

54. See Regs. § 1.751-1(b), (g) ex. 2.

55. See Regs. § 1.751-1(b)(4), which provides that if there is an exchange of substantially appreciated inventory items for other property, § 736(b) payments must be divided between the payments treated as a sale or exchange under § 751(b) and payments treated as a distribution under §§ 731 through 736.

Because section 751(b) does not apply to the section 736(a) payments of \$200 for A's interest in the accounts receivable, the machine, and the unstated good will, only the section 736(b) payment of \$2,200 for her interest in the cash, inventory, and capital asset need be considered. Regarding these assets, A initially had a proportionate interest of \$2,100 in non-section 751 property (the money and the capital asset) and \$100 in section 751 property (the substantially appreciated inventory), but she received non-section 751 property of \$2,200 (money) and no section 751 property (inventory). Section 751(b) treats this \$100 disparity as if A actually received her proportionate \$100 share of inventory in a current distribution and sold it to the partnership for the excess non-section 751 property received by her (the \$100 of money).

At the time of the deemed distribution, A's basis for her partnership interest was \$2,100 and the partnership's \$300 worth of inventory had a basis of \$270, so that \$100 worth of inventory deemed distributed to A under section 751(b) would have had a basis of \$90. That deemed distribution would result in nonrecognition of gain or loss,⁵⁶ with A taking a \$90 basis in the distributed inventory⁵⁷ and reducing the basis of her partnership interest from \$2,100 to \$2,010.⁵⁸ On the deemed sale of this inventory to the partnership for \$100, A realizes \$10 of ordinary income.⁵⁹

The remainder of the section 736(b) payment, in the amount of \$2,100, is treated as a liquidating distribution that results in gain to the extent that A receives money in excess of the basis of her interest in the partnership.⁶⁰ Since the deemed distribution of inventory under section 751(b) reduced the basis of her partnership interest to \$2,010, A will recognize a capital gain of \$90.⁶¹

In summary, A's total gain was \$300. Of this amount, \$200 was treated as a guaranteed payment taxable as ordinary income under section 736(a), \$10 was treated as ordinary income under section 751(b), and \$90 was treated as capital gain under sections 736(b) and 731. Therefore, A had \$210 of ordinary income and \$90 of capital gain which, when compared with the theoretically correct result (\$110 of ordinary income and \$190 of capital gain) is \$100 too much ordinary income and \$100 too little capital gain. This

56. IRC § 731(a), (b).

57. IRC § 732(a).

58. IRC § 733(2).

59. This deemed sale transaction under § 751(b) generates ordinary income even if the property would not otherwise be considered inventory when held by the selling partner. See IRC § 735(a)(2) (treating gain or loss on the sale or exchange by a distributee partner of inventory items within five years of distribution as ordinary income or ordinary loss, as the case may be).

60. IRC § 731(a)(1).

61. IRC § 731(a). It is appropriate that this \$90 of gain be taxed as capital gain because it represents A's share of appreciation in the partnership's capital asset.

disparity results because the payment for unstated good will is treated as an ordinary income item under section 736(a). Had the partnership agreement "provided for" a payment for good will, that amount would have been a section 736(b) payment, yielding the theoretically correct amounts of \$110 of ordinary income and \$190 of capital gain.

3. Tax Consequences to Remaining Partners

a. *In General.*—Upon retiring A's interest, the partnership deducts \$200 under section 736(a) for its payment for A's share of unrealized receivables and unstated good will. This deduction passes through to B and C equally and reduces the bases of their respective partnership interests. Because it is deemed under section 751(b) to have distributed and repurchased \$100 worth of inventory, the partnership obtains a \$10 increase in the basis of its inventory.⁶² No further adjustments would be made to the basis of its property unless a section 754 election is in effect.⁶³ If such an election is in effect, the partnership must increase the bases of its assets under section 734(b) by the \$90 of gain recognized to A on the section 736(b) distribution.⁶⁴ Because such gain represented A's share of the appreciation in the capital asset and was taxed to her as capital gain, the basis of the partnership's capital asset is increased by this amount.⁶⁵ This adjustment is made at the partnership level and is not specific to a particular partner.⁶⁶

62. Immediately before A's retirement, the partnership's inventory had a value of \$300 and a basis of \$270. The deemed distribution of \$100 worth of inventory to A (representing her proportionate share thereof) under § 751(b) left the partnership holding \$200 worth of inventory with a basis therein of \$180. The deemed repurchase of \$100 worth of inventory from A under § 751(b) for cash of \$100 increased the total value of the partnership's inventory back to \$300 and increased its total basis therein to \$280.

63. IRC § 734(a).

64. IRC § 734(b)(1)(A).

65. Where a distribution results in an adjustment under § 734(b)(1)(A) or (b)(2)(A) (because capital gain or loss has resulted to the partner on the distribution), "such adjustment must be allocated only to capital assets or § 1231(b) property." Regs. § 1.755-1(b)(1)(ii). Although the partnership's good will is arguably a capital asset or § 1231(b) property, it seems inappropriate to give the partnership any basis whatsoever in the good will on these facts because the partnership (consisting of B and C) effectively has deducted its \$100 cost of purchasing A's share of the partnership's good will under § 736(a). Otherwise, if A's share of good will were considered an amortizable intangible asset under new § 197, the partnership might obtain double tax benefits (immediate deduction and amortization deductions) for the same economic outlay. Thus, the partnership should emerge from the transaction with a zero basis in the good will. See generally *infra* text accompanying notes 98-121.

66. IRC § 734(b)(1).

b. *Illustration of Tax Consequences.*—It is useful to consider the result if, after acquiring A's interest, the partnership sold all its assets and liquidated. With no section 754 election in effect, its balance sheet would be as follows:

<u>Asset</u>	<u>BC Partnership</u>		
	<u>Basis</u>	<u>FMV</u>	<u>Gain</u>
Cash	3600	3600	--
Inventory	280 ⁶⁷	300	20
Machine	0	150	150
Accounts			
Receivable	0	150	150
Capital Asset	30	300	270
Good Will	0	300	300
Total	3910	4800	890
Partners' Equity			
B	2000 ⁶⁸	2400	400
C	2000	2400	400
Total	4000	4800	800

The sale of the partnership's assets would result in \$890 of gain, of which \$320 is ordinary income and \$570 is capital gain. Of the ordinary income, \$20 is attributable to the sale of the inventory, and corresponds to the amount that would have been allocable to B and C if the partnership had sold its inventory before A's retirement. The remaining \$300 is attributable to its "unrealized receivables" (the accounts receivable and the machine). If A had not retired, B and C would have been allocated only \$200 of income from the sale of the partnership's unrealized receivables, so it initially seems that a \$100 increment of gain with respect to these items is taxed twice, once to A and again to B and C. However, B and C have already obtained a \$100 deduction from ordinary income under section 736(a) with respect to these unrealized receivables that effectively offsets the additional income later attributed to them. Moreover, depending upon the length of time between the making of the section 736(a) payment and the realization of gain on the unrealized receivables by the partnership, B and C have obtained the benefit of an immediate deduction coupled with deferral of income.

67. See *supra* note 62 and accompanying text.

68. B and C each had a basis of \$2,100 in his partnership interest before A's retirement. Because the \$200 § 736(a) payment to A was a guaranteed payment that resulted in a partnership level deduction that passed through to them in the amount of \$100 each, B and C must each reduce the basis of his partnership interest by \$100. IRC § 705(a)(2).

Of the partnership's capital gain of \$570, \$300 is attributable to the good will and \$270 to the capital asset. If the partnership had sold these assets before A's retirement, B and C would have been allocated only \$200 of gain from the good will and \$180 of gain from the capital asset, so they initially appear to be overtaxed on these items. But at least as to the good will, B and C have obtained a \$100 deduction from ordinary income under section 736(a) that will offset this additional income later attributed to them.⁶⁹ It is true that, as to the sale of the capital asset, B and C will be taxed on \$90 of excess capital gain (\$45 per partner), which will be adjusted for by an aggregate \$90 capital loss (\$45 per partner) upon liquidation of the partnership or sale of the partner's interest.⁷⁰ If a section 754 election had been in effect, the partnership would have had \$90 less capital gain on the disposition of its assets and there would have been no further gain or loss to B or C on liquidation of the partnership.⁷¹

4. *Summary of Results to Retiring and Remaining Partners.*—Where the partnership liquidated A's interest and in doing so made a payment for unstated good will, A was taxed on \$210 of ordinary income and \$90 of capital gain. Thus, she has been overtaxed as compared with the theoretically correct result (\$110 of ordinary income and \$190 of capital gain). By contrast, B and C have fared better than under the theoretically correct result. Each of them has been taxed on \$60 of ordinary income and \$240 of capital gain, or \$50 less ordinary income and \$50 more capital gain than under the

69. Indeed, even ignoring the time value of money considerations, B and C have obtained deductions against ordinary income for the \$100 good will payment to A, at a cost of having \$100 more of capital gain upon the disposition of the good will.

70. The partnership's \$890 gain will be allocated equally to B and C, increasing the basis of each partner's interest in the partnership by \$445, to \$2,445. On liquidation, each partner will receive cash of only \$2,400. The \$45 excess of each partner's basis in his partnership interest over the amount of money received constitutes a capital loss; this aggregate loss of \$90 (\$45 per partner) corrects for the \$90 of capital gain that was taxed once to A under § 736(b) and later recognized by the partnership because no § 754 election was in effect.

71. If a § 754 election were in effect, the partnership would increase the basis of its capital asset under § 734(b)(1)(A) by the \$90 gain recognized by A under §§ 736(b) and 731. See Regs. § 1.755-1(b)(1)(ii). See also *supra* note 65. Therefore, the partnership would have a basis of \$120 in its capital asset (its original basis of \$30 plus the \$90 basis adjustment under § 734(b)(1)(A)). With that basis, the partnership would recognize only \$180 of gain on the sale of the capital asset at its \$300 fair market value. This amount (\$90 per partner) corresponds exactly to the amount that would have been taxable to B and C if the partnership had sold the capital asset immediately before A's retirement. On this scenario, the partnership's total gain on the sale of its assets is \$800. B and C would increase the bases of their partnership interests by \$400 each. Since each partner would have a basis of \$2,400 in his partnership interest, no further gain or loss would be recognized on the distribution of \$2,400 to each partner in liquidation.

theoretically correct result.⁷² Because the payment for A's share of the partnership's unstated good will was within section 736(a), \$100 of ordinary income shifted to A and away from B and C. In the process, B and C's aggregate capital gain was increased by \$100 and A's was decreased by that amount. B and C have also benefitted from time value of money considerations by obtaining immediate deductions for the partnership's section 736(a) payments, even though income from its unrealized receivables and good will may not be realized until some point in the future. Lastly, because the transaction was structured as a liquidation of A's interest under section 736, section 751(b) applied and resulted in an automatic adjustment to the basis of the partnership's substantially appreciated inventory, even where a section 754 election was not in effect.

Where B and C purchased A's interest, the theoretically correct result was reached as to A under sections 741 and 751(a) but not as to B and C unless a section 754 election was made. By causing the partnership to make such an election, however, B and C would be made better off and A would be no worse off. Thus, the tax treatment of A will not adversely affect, or be adversely affected by, the tax treatment to B and C. But where the partnership liquidates A's interest, a different regime operates. By allowing the payments for good will to be designated as either section 736(a) or section 736(b) payments, the Code encourages a zero-sum game among the partners. If the payments for good will are designated as section 736(b) payments, the theoretically correct result will be reached as to A. That result will also be reached to B and C if a section 754 election is in effect and their making such an election will not adversely affect A. But where the payments for A's share of good will were unstated and hence within section 736(a), A had more, and consequently B and C had less, ordinary income than the theoretically correct result would prescribe. This is the case even though good will has historically been treated as a nondeductible capital expenditure that gives rise to capital gain on its disposition.⁷³

Because of these disparate results, an evident tension existed in the positions that the various parties might take when a partner left a partnership, at least where capital gains were taxed more favorably than ordinary income.

72. The partnership has ordinary income of \$320 (\$300 from the disposition of the accounts receivable and the machine and \$20 from the disposition of its inventory) and \$200 of deductions from ordinary income for the § 736(a) payments to A. This results in net ordinary income of \$120 to the partnership, or \$60 per partner. It had capital gains of \$300 from the disposition of its good will and \$180 with regard to the capital asset, or a total of \$480 of capital gain, or \$240 per partner.

73. See Regs. § 1.263(a)-2(h) (providing that "[t]he cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure"). See also *supra* note 3.

Typically, the departing partner would seek to maximize capital gain treatment by asserting that her interest had been sold or, instead, liquidated by the partnership, with most of the consideration constituting section 736(b) payments. The remaining partners, on the other hand, would be likely to assert that the partnership had liquidated the partner's interest, with most of the consideration constituting section 736(a) payments, including payments for unstated good will.⁷⁴ For the Treasury, the worst situation was that in which the retiring and remaining partners treated and reported the transaction inconsistently. Indeed, the issue of whether a particular transaction constituted a sale or instead a retirement of a partner's interest has been the focus of numerous litigated cases.⁷⁵ Partly in response to these disparate results under sections 741 and 736, Congress effected a number of changes to this regime in OBRA 1993.

III. AMENDMENTS UNDER OBRA 1993 AFFECTING SALES AND LIQUIDATIONS OF A PARTNERSHIP INTEREST

A. Description of Amendments

The following section discusses five specific changes made by OBRA 1993 that affect the foregoing statutory scheme. As will be seen, Congress's specific amendments to Subchapter K were targeted more at liquidations under section 736 than at sales of partnership interests under section 741.

1. *Increased Ordinary Income-Capital Gain Rate Differential.*—First, OBRA 1993 increased the maximum individual tax rate on ordinary income from 31% to 39.6%, but left the maximum individual tax rate on capital gains at 28%. Accordingly, most individuals, including partners in partnerships, will prefer to maximize capital gains and minimize ordinary income.

74. Of course, where capital gain and ordinary income are taxed at the same rates (as they were from 1986 through 1990), retiring partners may be indifferent as to whether they are allocated "excess" ordinary income. Since they are generally taxed the same whether good will is treated as a § 736(a) or a § 736(b) payment, they may be more willing to allow their partners to obtain current deductions for payments by characterizing them as § 736(a) payments.

75. See, e.g., *Estate of Quirk v. Commissioner*, 928 F.2d 751 (6th Cir. 1991), *aff'g* in part, T.C. Memo 1988-286 (CCH) 1988; *Cooney v. Commissioner*, 65 T.C. 101 (1975); *Foxman v. Commissioner*, 41 T.C. 535 (1964); *Tolmach v. Commissioner*, T.C. Memo 1991-538 (CCH) 1991. For a discussion of the various factors applied by courts in determining how to characterize a transaction as a sale or liquidation of a partner's interest, and a proposal for the repeal of § 736, see John A. Lynch, Jr., *Taxation of the Disposition of Partnership Interests: Time to Repeal IRC § 736*, 65 Neb. L. Rev. 450 (1986).

2. *Section 751(d): Substantially Appreciated Inventory.*—OBRA 1993 amended the definition of “substantially appreciated inventory” under section 751(d)(1). Under prior law, inventory items were substantially appreciated if their fair market value exceeded both 120% of the partnership’s basis in such property and 10% of the fair market value of all partnership property, other than money. OBRA 1993 eliminated the latter requirement. For sales, exchanges, and distributions occurring after April 30, 1993, inventory items are substantially appreciated if their fair market value exceeds 120% of their adjusted basis to the partnership.⁷⁶ In making this determination, inventory items acquired by the partnership with a principal purpose of avoiding the provisions of section 751 are to be disregarded.⁷⁷ This definition of substantially appreciated inventory will apply both to sales of partnership interests implicating section 751(a) and to liquidations of partnership interests implicating section 751(b).

Given the increased rate differential created by OBRA 1993 between ordinary income and capital gain, Congress sought to strengthen existing provisions designed to prevent the conversion of ordinary income into capital gain, and amended section 751(d) with this goal in mind.⁷⁸ Congress was concerned that taxpayers could avoid the 10%-of-assets test of prior law, and hence avoid ordinary income treatment, by manipulating the partnership’s gross assets.⁷⁹

Prior law’s threshold requirement that the inventory’s value had to exceed 10% of the value of the partnership’s noncash property created a de minimis safe harbor under which partnerships having inventory of relatively minimal value generally could ignore provisions such as sections 751(a) and (b), which deal with substantially appreciated inventory. As a practical matter, however, the expansive definition of the term “inventory,” which includes all ordinary income items of the partnership, made this safe harbor more illusory than real for many partnerships. In any event, the amendment of section 751(d) will broaden the reach of Code sections dealing with substantially appreciated inventory, since partnerships holding any inventory items must now inquire whether that property’s value exceeds 120% of its basis to the

76. IRC § 751(d). See *supra* note 12 for the text of § 751(d) as amended by OBRA 1993.

77. IRC § 751(d)(1)(B).

78. Section 751(d) was amended by § 13206 of OBRA 1993, which also amended other Code sections designed to prevent the conversion of ordinary income into capital gain. OBRA 1993, *supra* note 1, § 13206, 107 Stat. at 462-67 (codified in scattered sections of 26 U.S.C.).

79. Staff of Senate Comm. on the Budget, 103d Cong., 1st Sess., Reconciliation Submissions of the Instructed Committees Pursuant to the Concurrent Resolution on the Budget 240 (Comm. Print 1993); H.R. Rep. No. 111, 103d Cong., 1st Sess. 642 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 873.

partnership. If so, these items will be considered substantially appreciated, even if of minimal value when compared with the total assets of the partnership.

Under section 751(d) as amended, assets acquired with a principal purpose of reducing appreciation to less than 120% in order to avoid ordinary income treatment will be disregarded.⁸⁰ The purpose of this rule was the same as the purpose for eliminating the 10%-of-total-assets test of prior law, to prevent circumvention of the rule through the manipulation of partnership assets.⁸¹ Such a provision seems appropriate to prevent abuse, but unfortunately reduces the predictability inherent in an otherwise bright-line, mathematical test by creating uncertainty as to whether particular inventory items will be disregarded in making the calculation required by section 751(d). Administrative guidance concerning this new aspect of section 751(d) will be welcome.⁸²

3. *Section 751(c): Unrealized Receivables.*—Before the enactment of OBRA 1993, the term “unrealized receivables” meant, for all purposes, both traditional unrealized receivables, such as accounts receivable, and nontraditional unrealized receivables, such as depreciation recapture. Thus, liquidating payments by a partnership for a retiring partner’s share of both traditional and nontraditional unrealized receivables were treated as payments for “unrealized receivables” and, therefore, were invariably within section 736(a).

OBRA 1993 amended section 751(c) to exclude nontraditional unrealized receivables from the definition of “unrealized receivables” for section 736 purposes only, so that under section 736, the term “unrealized receivables” now means only traditional unrealized receivables. Thus, payments for

80. IRC § 751(d)(1)(B).

81. Staff of Senate Comm. on the Budget, *supra* note 79, at 240; H.R. Rep. No. 111, *supra* note 79, at 642, reprinted in 1993 U.S.C.C.A.N. at 873.

82. In providing such guidance, the Service might consider using, by analogy, the anti-manipulation rules under § 336 with respect to corporate liquidations. Section 336 precludes liquidating corporations from deducting built-in losses on previously contributed property if such property was contributed as part of a plan a principal purpose of which was to recognize loss on liquidation. IRC § 336(d)(2)(B)(i)(II). The statute presumes that property contributed within two years of the date of adoption of a plan of liquidation is part of such a plan, except as provided in the regulations. IRC § 336(d)(2)(B)(ii). Such regulations are to provide that the presumed prohibited purpose will be disregarded, however, unless there is no clear and substantial relationship between the contributed property and the conduct of the corporation’s current or future business enterprises. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 343-44 (Prentice Hall 1987). A similar rule would be helpful in determining circumstances in which property acquired by a partnership will be disregarded in making the determination of substantial appreciation.

items such as a retiring partner's share of partnership depreciation recapture are no longer within the scope of section 736(a); rather, such payments will be section 736(b) payments considered made in exchange for the partner's interest in partnership property. For purposes of other Code sections, such as sections 731, 741 and 751, however, these nontraditional unrealized receivables remain within the definition of the term "unrealized receivables."⁸³

In thus amending section 751(c), Congress sought to prevent the timing advantages gained under section 736 by the nonretiring partners, who could immediately deduct payments for the retiring partner's share of nontraditional unrealized receivables, while deferring the recognition of income from such items. The legislative history notes that payments for unrealized receivables generally constitute nondeductible capital expenditures, and that when section 736 was enacted, the term "unrealized receivables" generally meant only traditional unrealized receivables; as to these items, the tax deferral resulting from immediate deduction was relatively short because payment is usually received in the near future.⁸⁴ However, the opportunity for deferral had increased given the expansion of the definition of unrealized receivables to include nontraditional items such as depreciation recapture and market discount.⁸⁵

OBRA 1993 thus creates two classes of unrealized receivables for section 736 purposes: one, traditional unrealized receivables, payment for which will, as discussed below, be governed for eligible partnerships by section 736(a),⁸⁶ and two, nontraditional unrealized receivables, such as depreciation recapture, payment for which will be governed in all cases by section 736(b). Thus, payments for a retiring partner's share of nontraditional unrealized receivables are now on a par with payments for the partner's share of the partnership's substantially appreciated inventory, which were already within section 736(b).⁸⁷ For purposes of section 751, these nontraditional unrealized receivables still constitute "unrealized receivables." Thus, section 736(b) payments for a retiring partner's share of both nontraditional unrealized receivables and substantially appreciated inventory must henceforth be analyzed under section 751(b), which will cause the retiring partner to have ordinary income and afford the partnership a partial cost basis with respect

83. IRC § 751(c). See *supra* note 9 for the text of § 751(c) as amended by OBRA 1993.

84. Staff of Senate Comm. on the Budget, *supra* note 79, at 426; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

85. Staff of Senate Comm. on the Budget, *supra* note 79, at 426; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

86. As discussed *infra* text accompanying notes 90-97, under OBRA 1993's amendments to § 736, only services-oriented partnerships may treat payments for a retiring partner's share of traditional unrealized receivables as § 736(a) payments.

87. See *supra* notes 53-54 and accompanying text.

to these items.⁸⁸ The remainder of the retiring partner's section 736(b) payments will be treated as a distribution under section 731.

4. *Amendment of Section 736(b).*—At the heart of the changes affecting the liquidation of a partner's interest under section 736 was Congress's amendment of section 736(b). As under prior law, section 736(b)(1) treats payments for a partner's share of partnership property as a distribution to the retiring partner, while section 736(b)(2) excludes from this treatment payments for a retiring partner's share of unstated good will and unrealized receivables (now meaning only traditional unrealized receivables)⁸⁹ and places them into section 736(a), where they are characterized as a distributive share of partnership income or a guaranteed payment. OBRA 1993 added a new paragraph (3) to subsection 736(b), which provides that section 736(b)(2) will apply only if the retiring or deceased partner was a general partner in a partnership for which capital is not a material income-producing factor.⁹⁰ The determination of whether capital is a material

88. The partnership will obtain an increased basis in the retiring partner's share of these nontraditional unrealized receivables and substantially appreciated inventory by being deemed to have purchased these items from the retiring partner under § 751(b). See *supra* note 62 and accompanying text.

89. Under the OBRA 1993 amendments to § 751(c), the term "unrealized receivables" means, for § 736 purposes, only traditional unrealized receivables. IRC § 751(c). See *supra* text accompanying notes 83-86 for a discussion of this change.

90. As amended by OBRA 1993, § 736 provides as follows:

(a) *Payments Considered as Distributive Share or Guaranteed Payment.*—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

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

(b) *Payments for Interest in Partnership.*—

(1) *General Rule.*—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) *Special Rules.*—For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

income-producing factor is to be made under principles of present and prior law.⁹¹

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- (A) unrealized receivables of the partnership (as defined in section 751(c)), or
 - (B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) Limitation on Application of Paragraph (2).—Paragraph (2) shall apply only if—

- (A) capital is not a material income-producing factor for the partnership, and
- (B) the retiring or deceased partner was a general partner in the partnership.

IRC § 736, amended by OBRA 1993, *supra* note 1, § 13262(a), 107 Stat. at 541.

91. For purposes of § 736 as thus amended,

capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.

H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 697-98 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1386-87; Staff of Senate Comm. on the Budget, *supra* note 79, at 426-27; H.R. Rep. No. 111, *supra* note 79, at 782-83, reprinted in 1993 U.S.C.C.A.N. at 1013-14.

The pertinent legislative history cites § 401(c)(2) (relating to self-employed individuals), § 911(d) (excluding foreign earned income from gross income), and former § 1348(b)(1)(A) (defining personal service income) as relevant in determining whether capital is a material income-producing factor. H.R. Conf. Rep. No. 213, *supra*, at 697 n.36, reprinted in 1993 U.S.C.C.A.N. at 1386 n.36; Staff of Senate Comm. on the Budget, *supra* note 79, at 426 n.35; H.R. Rep. No. 111, *supra* note 79, at 783 n.158, reprinted in 1993 U.S.C.C.A.N. at 1014 n.158. The above-cited example regarding professional services is taken nearly verbatim from the regulations under former § 1348. See Regs. § 1.1348-3(a)(3). Thereunder, capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business as reflected, for example, by a substantial investment in inventories, plant, machinery, or other equipment. *Id.*

Under these cited provisions, the determination of whether capital is a material income-producing factor of a business is generally a facts and circumstances based determination. See, e.g., *id.* With respect to former § 1348, see Rev. Rul. 78-306, 1978-2 C.B. 218, 219-20 (holding under former § 1348 that capital need not directly produce income to be a material income-producing factor and was a material income-producing factor for an investment banking firm); Rev. Rul. 74-597, 1974-2 C.B. 272, 272-73 (holding capital was a material income-producing factor where individual engaged in farming activity, leased farmland, and owned several items of farm equipment); I.R.S. T.A.M. 7914016 (Dec. 28, 1978) (holding capital was material income-producing factor for naval architect who designed, constructed,

By thus restricting the application of section 736(b)(2), section 736(b)(3) precludes partnerships for which capital is a material income-producing factor from treating payments for both unstated good will and traditional unrealized receivables as section 736(a) payments.⁹² As to such partnerships, therefore, section 736(b)(3) effectively repeals section 736(a) with respect to payments for a retiring partner's share of partnership property.⁹³ By contrast, partnerships for which capital is not a material income-producing factor must continue to treat payments for nontraditional unrealized receivables as section 736(a) payments, and may also treat payments for unstated good will as section 736(a) payments.

In thus amending section 736, Congress was primarily concerned with the ability of partnerships under prior law to use section 736(b)(2) to deduct immediately payments for good will, which ordinarily would constitute a nondeductible capital expenditure.⁹⁴ It feared that such treatment could erode the rules requiring capitalization of such payments generally, and operated to mismeasure partnership income.⁹⁵ Finally, it noted that while the special treatment of good will under section 736 was predicated on the assumption that the partners' respective adverse interests would lead to a stated price equal to the true value of the good will, experience had proved that assump-

and sold hulls for ships); I.R.S. T.A.M. 7838007 (June 19, 1978) (holding facts and circumstances indicated that capital was a material income-producing factor for taxpayer's aerial crop spraying service, despite importance of taxpayer's skills to the business). With respect to § 911, see *Rousku v. Commissioner* 56 T.C. 548, 550-52 (1971) (indicating that the determination is "fundamentally factual in nature" and holding that capital was a material income-producing factor in the taxpayer's automobile body repair business).

92. As noted earlier, § 751(c), as amended by OBRA 1993, precludes all partnerships from treating payments for a retiring partner's share of nontraditional unrealized receivables as § 736(a) payments. See *supra* text accompanying notes 83-88.

93. Certain payments to a retiring partner in a capital-oriented partnership still will be outside the scope of § 736(b) and hence deductible by the partnership. For example, payments to compensate a retiring partner for services rendered to the partnership are not payments for that partner's interest in partnership property and are not § 736(b) payments. See H.R. Conf. Rep. No. 213, *supra* note 91, at 698, reprinted in 1993 U.S.C.C.A.N. at 1387 (indicating that OBRA 1993 "does not affect the deductibility of compensation paid to a retiring partner for past services"); Staff of Senate Comm. on the Budget, *supra* note 79, at 427; H.R. Rep. No. 111, *supra* note 79, at 783, reprinted in 1993 U.S.C.C.A.N. at 1014.

94. It noted that under prior law, acquisition transactions could be structured to permit the current deduction of good will by having the acquiror form a partnership with the seller and liquidating the seller's interest therein under § 736. See Staff of Senate Comm. on the Budget, *supra* note 79, at 425; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

95. See Staff of Senate Comm. on the Budget, *supra* note 79, at 425; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

tion false.⁹⁶ For these reasons, Congress sought to alter the treatment of good will payments by generally relegating them to section 736(b). However, it continued prior law's treatment of payments for unstated good will to general partners in partnerships for which capital is not a material income-producing factor because it believed that "general partners in service partnerships do not ordinarily value good will in liquidating partners."⁹⁷

5. *Enactment of New Code Section 197 Concerning Amortization of Intangibles.*—Finally, although it is a provision of broader application than the sale or liquidation of a partnership interest, it is appropriate to consider in this context the impact of section 197, added by OBRA 1993, which allows the amortization of certain intangibles.

a. *Purpose.*—Under prior law, taxpayers could amortize the basis of certain intangible assets acquired for use in a trade or business or income-producing activity if such property had a useful life that could be ascertained with reasonable accuracy.⁹⁸ In practice, this scheme led to considerable controversy between taxpayers and the Service in three particular areas: (1) whether an intangible asset existed; (2) in the case of the acquisition of a business, the portion of the purchase price allocable to an amortizable intangible asset, and (3) the proper method and period for recovering the cost of an amortizable intangible asset.⁹⁹ To alleviate such controversies, Congress enacted section 197 which provides a single method and period for recovering the cost of most acquired intangible assets and which treats acquired good will and going concern value as amortizable intangible assets.¹⁰⁰ In doing so, however, Congress did not seek to change the tax treatment of self-created intangible assets, such as good will created through advertising and other similar expenditures.¹⁰¹ The following discussion very

96. Congress noted that in many cases, the stated value of the good will and the total retirement payments could be set so as to maximize the combined tax savings for both retiring and continuing partners. See Staff of Senate Comm. on the Budget, *supra* note 79, at 425-26; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

97. Staff of Senate Comm. on the Budget, *supra* note 79, at 426; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

98. Regs. § 1.167(a)-3. See H.R. Conf. Rep. No. 213, *supra* note 91, at 672, reprinted in 1993 U.S.C.C.A.N. at 1361; Staff of Senate Comm. on the Budget, *supra* note 79, at 397; H.R. Rep. No. 111, *supra* note 79, at 760, reprinted in 1993 U.S.C.C.A.N. at 991.

99. See Staff of Senate Comm. on the Budget, *supra* note 79, at 397; H.R. Rep. No. 111, *supra* note 79, at 760, reprinted in 1993 U.S.C.C.A.N. at 991.

100. See Staff of Senate Comm. on the Budget, *supra* note 79, at 397; H.R. Rep. No. 111, *supra* note 79, at 760, reprinted in 1993 U.S.C.C.A.N. at 991.

101. See Staff of Senate Comm. on the Budget, *supra* note 79, at 397; H.R. Rep. No. 111, *supra* note 79, at 760, reprinted in 1993 U.S.C.C.A.N. at 991.

generally describes the operation of this new provision and examines its potential application in connection with the sale or liquidation of a partner's interest.

b. *Brief Overview of Section 197.*—Section 197(a) allows the adjusted basis of any amortizable section 197 intangible to be amortized ratably over a fifteen-year period beginning with the month in which the intangible was acquired.¹⁰² It provides the exclusive cost recovery method with regard to section 197 intangibles.¹⁰³ The term “amortizable section 197 intangibles” means section 197 intangibles acquired after the enactment of section 197 and used in connection with a trade or business or income-producing activity, but does not generally include intangibles created by the taxpayer other than in connection with a transaction (or series of transactions) involving the acquisition of assets constituting a trade or business or a substantial portion thereof.¹⁰⁴

The term “section 197 intangible” includes, among other items, good will,¹⁰⁵ going concern value,¹⁰⁶ workforce in place, business books, records, and other information bases, patents, know-how, governmental licenses and permits, covenants not to compete, and certain franchises, trademarks, and tradenames.¹⁰⁷ The term does not, however, include financial interests, including interests in corporations, partnerships, trusts, or estates.¹⁰⁸ Where intangibles are transferred in certain nonrecognition transactions, to the extent that the transferee's adjusted basis in the intangible does not exceed the transferor's adjusted basis therein, the transferee succeeds to any amortization

102. IRC § 197(a).

103. IRC § 197(b).

104. IRC § 197(c).

105. IRC § 197(d)(1)(A). For this purpose, good will means “the value of a trade or business that is attributable to the expectancy of continued customer patronage, whether due to the name of a trade or business, the reputation of a trade or business, or any other factor.” H.R. Conf. Rep. No. 213, *supra* note 91, at 674, reprinted in 1993 U.S.C.C.A.N. at 1363; Staff of Senate Comm. on the Budget, *supra* note 79, at 400; H.R. Rep. No. 111, *supra* note 79, at 762, reprinted in 1993 U.S.C.C.A.N. at 993.

106. IRC § 197(d)(1)(B). For this purpose, “going concern value is the additional element of value of a trade or business that attaches to property by reason of its existence as an integral part of a going concern,” and it includes value “attributable to the ability of a trade or business to continue to function and generate income without interruption notwithstanding a change in ownership.” H.R. Conf. Rep. No. 213, *supra* note 91, at 674, reprinted in 1993 U.S.C.C.A.N. at 1363; Staff of Senate Comm. on the Budget, *supra* note 79, at 400; H.R. Rep. No. 111, *supra* note 79, at 762, reprinted in 1993 U.S.C.C.A.N. at 993.

107. IRC § 197(d)(1)(C)-(F).

108. IRC § 197(e)(1)(A).

deductions to which the transferor was entitled.¹⁰⁹ Any amortizable section 197 intangible is treated as property which is of a character subject to the allowance for depreciation provided in section 167.¹¹⁰

c. Application to Sale or Liquidation of a Partnership Interest

(1) *In General.*—The foregoing provisions make it clear that the cost of a partnership interest may not be amortized under section 197. A question arises, however, as to whether a person acquiring an interest in a partnership may amortize the basis of any section 197 intangibles owned by the partnership. Of course, the acquiring partner will succeed to the transferor partner's share of any amortization deductions already being claimed by the partnership. Beyond this, however, the acquisition of an interest in an intangible held by a partnership will be treated as an acquisition to which section 197 applies only if, and to the extent that, the acquiring taxpayer obtains, as a result of the transaction, an increased basis for the intangible. Such an increased basis will ordinarily come about only where the partnership has made a section 754 election. A taxpayer who acquires an interest in a partnership which has made a section 754 election and does obtain an increased basis in a section 197 intangible is treated as owning an interest in two intangible assets. The first asset consists of the selling partner's share of the basis of the intangible; as to this, the acquiring taxpayer succeeds to the transferor's share of any allowable amortization deductions. The second asset consists of the basis increase obtained by the acquiring taxpayer; this amount is treated as a newly acquired item which is amortizable over a fifteen-year period.¹¹¹ Similarly, when a partnership owning an

109. IRC § 197(f)(2)(A). The transfers to which this rule applies are those described in §§ 332, 351, 721, 731, 1031, and 1033, as well as transfers between members of an affiliated group of corporations during any taxable year for which a consolidated return is made. IRC § 197(f)(2)(B)(ii).

110. IRC § 197(f)(7). Thus, an amortizable § 197 intangible is not a capital asset, but is § 1231 property if held for more than one year. IRC § 1231(b). Similarly, such property constitutes § 1245 property (giving rise to depreciation recapture) and § 1239 applies to characterize as ordinary income any gain on the sale or exchange of any amortizable § 197 intangible between related persons. See H.R. Conf. Rep. No. 213, *supra* note 91, at 688, reprinted in 1993 U.S.C.C.A.N. at 1377; Staff of Senate Comm. on the Budget, *supra* note 79, at 418; H.R. Rep. No. 111, *supra* note 79, at 775, reprinted in 1993 U.S.C.C.A.N. at 1006.

111. The legislative history provides the following example: A, B, and C each contribute \$700 to the P Partnership, which acquires a § 197 intangible for \$2,100. When the partnership's sole asset is the intangible having a basis of \$1,500 and each partner's partnership interest has a basis of \$500, A sells her interest to D, an unrelated individual for \$800. If no § 754 election is in effect, D will simply succeed to A's \$500 basis in the intangible, which will be amortizable over the amortization period remaining for the partnership. If, on the other hand, a § 754 election is in effect, D will have an \$800 basis in

amortizable section 197 intangible liquidates the interest of a partner and has a section 754 election in effect, it can generally amortize any resulting increase in the basis of section 197 intangibles over a fifteen-year period.¹¹² This fact provides an additional incentive for partnerships to make a section 754 election where the partnership holds depreciable or amortizable property that has appreciated in value.

(2) *Partnership Good Will as a Section 197 Intangible*

(a) *In General.*—Before the enactment of section 197, a taxpayer acquiring a basis in good will derived little benefit therefrom since it was not amortizable and thus could only reduce gain or increase loss realized upon the disposition thereof. Thus, the immediate deductibility of payments for unstated good will under section 736(a) was particularly attractive to partners in partnerships. After the enactment of OBRA 1993, however, only such payments by services-oriented partnerships to general partners remain deductible under section 736(a). In all other cases, therefore, it will be important to know whether any basis obtained for a retiring partner's share of partnership good will will be amortizable under new section 197. Subject to a number of qualifications, it appears that such basis will be so treated.

The examples in the legislative history deal only with situations in which a partnership purchases an amortizable section 197 intangible from a third party, and therefore do not explicitly address the question of partnership good will. One might view such good will as an asset created by the partnership itself, so that where a partnership liquidates a partner's interest and in doing so makes a payment for the partner's share of good will, it acquires a

the intangible. Of this, \$500 is his share of the partnership's \$1,500 basis and \$300 is his special basis adjustment. D is treated as owning an interest in two intangibles. As to the first, he will obtain amortization deductions of \$500 over the amortization period remaining for the partnership. As to the second, he will be entitled to claim amortization deductions of \$300 over a 15-year period beginning on the date of acquisition of his partnership interest. H.R. Conf. Rep. No. 213, *supra* note 91, at 686-87, reprinted in 1993 U.S.C.C.A.N. at 1375-76; Staff of Senate Comm. on the Budget, *supra* note 79, at 416; H.R. Rep. No. 111, *supra* note 79, at 774, reprinted in 1993 U.S.C.C.A.N. at 1005.

112. If, instead, the partnership described in the preceding footnote liquidates A's interest for \$800 and has made a § 754 election, it will be treated as owning two amortizable § 197 intangibles: one with a basis of \$1,500 that is amortizable over its remaining amortization period and the other with a basis of \$300 that is amortizable over a 15-year period from the month that the partnership retires A's interest. See H.R. Conf. Rep. No. 213, *supra* note 91, at 687, reprinted in 1993 U.S.C.C.A.N. at 1376; Staff of Senate Comm. on the Budget, *supra* note 79, at 417; H.R. Rep. No. 111, *supra* note 79, at 775, reprinted in 1993 U.S.C.C.A.N. at 1006.

“self-created” intangible that is not amortizable under section 197. However, the legislative history suggests that a partner’s share of partnership good will is generally amortizable under section 197, by providing as follows:

As discussed more fully below, the bill also changes the treatment of payments made in liquidation of the interest of a deceased or retired partner in exchange for goodwill. Except in the case of payments made on the retirement or death of a general partner of a partnership for which capital is not a material income-producing factor, such payments will not be treated as a distribution of partnership income. Under the bill, however, if the partnership makes an election under section 754, section 734 will generally provide the partnership the benefit of a stepped-up basis for the retiring or deceased partner’s share of partnership goodwill and an amortization deduction for the increase in basis under section 197.¹¹³

The foregoing language from the legislative history strongly suggests that payments for a partner’s share of partnership good will ordinarily will be amortizable where the payment results in a basis increase in such good will. Therefore, payments for a retiring partner’s share of good will that are not immediately deductible under the restrictive provisions of section 736(a) may qualify for amortization deductions under newly-added section 197. Any deductions claimed with respect to such good will may be recaptured as ordinary income.¹¹⁴

(b) *Anti-churning Rules for Existing Intangibles.*—Unfortunately, at least in the case of good will in existence on the date of enactment of OBRA 1993, the situation is somewhat more complex than the foregoing discussion suggests. This is so because Congress generally intended that section 197 apply only to intangibles acquired after the enactment of OBRA 1993. It was concerned that taxpayers could avoid this prospective aspect of section 197 by transferring previously-existing intangibles (for which no amortization deduction was allowable) to related taxpayers,

113. H.R. Conf. Rep. No. 213, *supra* note 91, at 687, reprinted in 1993 U.S.C.C.A.N. at 1376; Staff of Senate Comm. on the Budget, *supra* note 79, at 417; H.R. Rep. No. 111, *supra* note 79, at 774-75, reprinted in 1993 U.S.C.C.A.N. at 1005-06.

114. Section 197(f)(7) states that a § 197 intangible “shall be treated as property which is of a character subject to the allowance for depreciation provided in section 167.” This means that a § 197 intangible is § 1245 property, IRC § 1245(a)(3), and therefore subject to § 1245’s recapture rules. IRC § 1245(a)(1).

who would then seek to amortize them under section 197. To prevent such avoidance, it enacted several rather complex "anti-churning" rules.¹¹⁵

Generally, these rules preclude amortization of certain intangibles (including good will) in existence before, but acquired from a related person after, the date of enactment of OBRA 1993.¹¹⁶ Persons are related for this purpose if they bear a relationship specified in section 267(b) or 707(b)(1), with the modification that the usual 50% threshold ownership level required under those sections is reduced to 20%, thus expanding the potential universe of related persons.¹¹⁷ With respect to any increase in the basis of partnership property under section 732, 734, or 743, determinations under the anti-churning rules are to be made at the partner level and each partner is to be treated as having owned and used such partner's proportionate share of the partnership assets.¹¹⁸

Therefore, even if a partner's share of partnership good will is an amortizable section 197 intangible, the anti-churning rules will affect the ability of partners to claim amortization where such good will was in existence before the enactment of OBRA 1993. For example, since a partnership and a partner owning an interest greater than 20% therein are considered related persons,¹¹⁹ the partnership's payment for that partner's share of pre-OBRA 1993 good will appears not to qualify for amortization under section 197, even if it obtains a basis therefor under section 734(b). Similarly, a person who purchases a partnership interest from a related person will be unable to obtain an amortization deduction for pre-OBRA 1993 good will, even if the purchaser obtains a special basis adjustment therefor under section 743(b).¹²⁰

115. See IRC § 197(c)(3), (f)(9).

116. IRC § 197(f)(9)(A). OBRA 1993 was signed into law on August 10, 1993.

117. IRC § 197(f)(9)(C).

118. IRC § 197(f)(9)(E). The legislative history indicates that as a result of this provision, the anti-churning rules will not apply to any increase in the basis of partnership property that occurs upon the acquisition of partnership property if the person acquiring the partnership interest is not related to the person selling the partnership interest. See H.R. Conf. Rep. No. 213, *supra* note 91, at 692, reprinted in 1993 U.S.C.C.A.N. at 1381; Staff of Senate Comm. on the Budget, *supra* note 79, at 423; H.R. Rep. No. 111, *supra* note 79, at 779-80, reprinted in 1993 U.S.C.C.A.N. at 1010-11. Under the foregoing provision, therefore, the purchaser of an interest in a partnership will not be precluded from claiming amortization with respect to any basis thereby acquired in partnership good will, so long as the purchaser and seller are not otherwise related.

119. See IRC §§ 197(f)(9)(C)(i)(I), 707(b)(1)(A).

120. See IRC §§ 197(f)(9)(C)(i)(I), 267(b)(1), (c)(4). For example, if a mother sells her partnership interest to her daughter, these rules apparently preclude amortization of any basis increase for the benefit of the purchasing partner in the partnership's good will. Compare this example with the result between nonrelated parties. See *supra* note 118.

Congress provided an exception to the anti-churning rules where the parties are related only because of the last sentence of section 197(f)(9)(C), which reduces to 20% the otherwise applicable 50% threshold ownership levels under sections 267(b) and 707(b). In such cases, the persons acquiring amortizable basis may claim deductions to the extent that the seller recognizes gain on the transaction with respect to such intangible and agrees to pay tax on such gain at the highest applicable ordinary income tax rate.¹²¹ This exception thus allows certain deductions for amortization that would otherwise be precluded by the anti-churning rules, but exacts a high tax toll from the person who transfers the interest in the intangible.

B. *Summary of Amendments*

Several general observations can be made concerning the foregoing amendments effected by OBRA 1993. First, the increased tax rate differential between ordinary income and capital gains after OBRA 1993 provides an incentive for partners to take steps to maximize capital gains and minimize ordinary income. For example, where a partnership holds appreciated ordinary income items, partners who purchase a retiring partner's interest will generally prefer that the partnership make a section 754 election, since they may otherwise be overtaxed when the partnership realizes gain from these ordinary income items.¹²²

Second, a uniform definition of substantially appreciated inventory will apply to sales and liquidations of interests in all partnerships, irrespective of the nature of their business. All partnerships must determine whether the value of their inventory items exceeds 120% of the partnership's basis in such items; the relative value of the inventory items as compared with the gross assets of the partnership is no longer a relevant factor in determining substantial appreciation.

Third, liquidation payments by all partnerships for a retiring partner's share of nontraditional unrealized receivables (e.g., depreciation recapture, market discount, etc.) will be section 736(b) payments because, under section 751(c), such items are not "unrealized receivables" for section 736 purposes. Such items do remain "unrealized receivables" for section 751 purposes, so that henceforth, liquidating payments for a partner's share of these nontraditional unrealized receivables, together with any payments for the partner's share of substantially appreciated inventory, must be analyzed under section 751(b).

121. IRC § 197(f)(9)(B).

122. See *supra* text accompanying notes 22-26.

Beyond the foregoing rules, which are common to all partnerships, Congress has created a distinction between services-oriented partnerships and capital-oriented partnerships with respect to payments for a retiring partner's share of unstated good will and traditional unrealized receivables. Such payments will, as under prior law, continue to be deductible section 736(a) payments when made by services-oriented partnerships, but will be nondeductible section 736(b) payments when made by capital-oriented partnerships. Virtually all liquidation payments by capital-oriented partnerships will be considered section 736(b) payments and, to the extent they represent the retiring partner's share of traditional and nontraditional unrealized receivables and substantially appreciated inventory, will be analyzed under section 751(b).

Finally, the effect of new Code section 197 must be considered where the partnership owns intangible assets, including good will. Where a section 754 election is in effect, increased deductions for amortization with respect to intangibles owned by the partnership may be available. In addition, in cases where a payment for a withdrawing partner's share of partnership good will is not immediately deductible, that section may at least provide amortization deductions with respect to such payment.

C. Illustrative Example

This section illustrates the effect of these revisions upon the analysis of the sale and liquidation of A's interest in the ABC Partnership, which has the following balance sheet.

<u>Asset</u>	ABC Partnership		<u>Gain</u>
	<u>Basis</u>	<u>FMV</u>	
Cash	6000	6000	--
Inventory	270	300	30
Machine	0	150	150
Accounts			
Receivable	0	150	150
Capital Asset	30	300	270
Good Will	0	300	300
Total	6300	7200	900
Partners' Equity			
A	2100	2400	300
B	2100	2400	300
C	2100	2400	300
Total	6300	7200	900

1. *Sale of A's Partnership Interest.*—The tax consequences of the sale to B and C of A's interest would be only slightly different under the amendments made by OBRA 1993. The partnership's inventory was substantially appreciated even under the two-pronged test of prior law and remains so under the single 120%-of-basis test prescribed by OBRA 1993. As under prior law, A would still have \$110 of ordinary income under section 751(a) and \$190 of capital gain under section 741.¹²³ The basis of the partnership's property would not change unless a section 754 election were in effect. As under prior law, the failure to make a section 754 election can result in B and C being overtaxed.¹²⁴ If such an election were in effect, the partnership would increase the basis of its assets under section 743(b), as under prior law.¹²⁵ In such a case, B and C may now be able to amortize their increased basis in A's share of the partnership's good will under section 197 as added by OBRA 1993, subject to the limitations discussed above.¹²⁶ This fact provides an additional incentive for the partnership to make a section 754 election. As under prior law, such an election will not affect the taxation of the selling partner.

2. *Liquidation of A's Partnership Interest*

a. *Effects if Capital Is Not a Material Income-Producing Factor.*—If capital is not a material income-producing factor for the ABC Partnership, payments for A's \$100 share of unstated good will and \$50 share of the traditional unrealized receivables (the accounts receivable) continue as under prior law to be section 736(a) payments, resulting in ordinary income to A and providing a deduction for B and C. However, the \$50 payment for A's share of nontraditional unrealized receivables (the depreciation recapture inherent in the machine) is now a section 736(b) payment, making the total amount of such payments \$2,250. Under section 751(b), A is considered to have received \$100 for her share of the partnership's substantially appreciated inventory, and \$50 for her share of the machine, generating \$60 of ordinary income under section 751(b). She will also realize a capital gain of \$90 under sections 736(b) and 731, for a total of \$210 of ordinary income and \$90 of capital gain.¹²⁷ For A, therefore, these results are the same as under prior

123. See *supra* text accompanying notes 6-17.

124. See *supra* text accompanying notes 22-26.

125. See *supra* text accompanying notes 27-39.

126. See *supra* text accompanying notes 98-121.

127. Under § 751(b), A is deemed to have received from the partnership inventory having a value of \$100 and basis of \$90 and a share of the machine having a value of \$50 and a basis of zero and to have sold these items back to the partnership for \$150 in cash, resulting in \$60 of ordinary income. The deemed distribution reduces the basis of her partnership

law; she has \$100 excess ordinary income and \$100 too little capital gain when compared with the theoretically correct result.

For B and C, however, there is a difference in result when compared with pre-OBRA 1993 law. They can still immediately deduct \$150 under section 736(a), representing A's share of unstated good will and traditional unrealized receivables (the accounts receivable), but not the \$50 payment for A's share of the machine. Because the partnership is deemed under section 751(b) to have purchased A's share of the machine at its \$50 fair market value, it will obtain a \$50 basis increase therein. B and C will ultimately have ordinary income of \$60 and capital gain of \$240 each. As under prior law, they each have \$50 less ordinary income and \$50 more capital gain than the theoretically correct result would prescribe.¹²⁸ As to B and C, therefore, post-OBRA 1993 law is less generous in terms of timing, but not in terms of overall characterization of gain and loss. By continuing prior law's treatment of payments for A's share of unstated good will under section 736(a), present law still permits B and C to shift \$100 of ordinary income to A and away from themselves.

b. *Effects if Capital Is a Material Income-Producing Factor.*—If capital is a material income-producing factor for the ABC Partnership, all payments for A's share of partnership property, including unstated good will and traditional unrealized receivables, are section 736(b) payments. Of these payments, a total of \$200 (representing A's \$100 share of traditional and nontraditional unrealized receivables and her \$100 share of substantially appreciated inventory) is subject to section 751(b), resulting in ordinary income to A of \$110. The remaining \$2,200 is treated as a liquidating

interest from \$2,100 to \$2,010, so that the remaining \$2,100 of § 736(b) payments will generate \$90 of capital gain under § 731.

128. As noted above, the partnership has obtained deductions from ordinary income of \$150 under § 736(a). On the sale of its assets, the partnership would realize ordinary income of \$270 (\$100 from the machine, \$150 from the accounts receivable, and \$20 from the inventory), leaving net partnership ordinary income of \$120, or \$60 per partner. Each partner's basis in his partnership interest would increase by \$60, to \$2,160. If no § 754 election were in effect, the partnership would realize a capital gain of \$570 (\$300 from the good will and \$270 from the capital asset), or \$285 per partner, increasing each partner's basis in his partnership interest to \$2,445. In liquidation, each partner would receive cash of \$2,400 and would thus realize a capital loss of \$45. In total, each partner will have \$60 of ordinary income and a net \$240 of capital gain (consisting of a \$285 capital gain and a \$45 capital loss).

If a § 754 election were in effect, the partnership would have recognized \$90 less capital gain on the sale of its assets (\$240 per partner) and the partners would have recognized no further gain or loss on the liquidating distribution. As indicated supra note 65, since the partnership has effectively deducted the cost of A's share of good will, it should not be entitled to obtain any basis in the partnership's good will. Administrative or legislative clarification of this point may be necessary.

distribution, giving rise to capital gain of \$190. Thus, as in the case where she sold her partnership interest, A is taxed on the theoretically correct amounts of gain where the partnership liquidates her interest.¹²⁹

Because the entire \$2,400 payment to A is within section 736(b), no deduction is available to the remaining partners. Thus, similar results obtain for B and C as if they had directly purchased A's interest, but with one significant difference. Where B and C purchased A's interest, the basis of the partnership's assets did not change at all in the absence of a section 754 election.¹³⁰ Here, where A's interest is liquidated under section 736, the partnership is treated under section 751(b) as purchasing A's \$200 share of the partnership's inventory, machine, and accounts receivable and will therefore adjust the basis of these assets even if it has not made a section 754 election. Such adjustments are especially favorable for the remaining partners because they increase the basis of the partnership's ordinary income assets, thus relieving them of excess ordinary income.¹³¹ Thus, if a capital-oriented partnership will not make a section 754 election, the partners may prefer to structure the transaction as a liquidation of the partner's interest by the partnership, rather than as a purchase of the partner's interest by the other partners. Doing so will not affect the tax treatment of the retiring partner, but may place the remaining partners in a better position than if they had purchased the interest of the retiring partner.¹³²

129. Under § 751(b), A is deemed to receive \$100 of inventory having a basis of \$90, \$50 of accounts receivable having a basis of zero, and \$50 of the machine also having a basis of zero. She thus has a basis of \$90 in the properties deemed distributed and reduces the basis of her interest in the partnership from \$2,100 to \$2,010. A has \$110 of ordinary income on the deemed sale by her of these § 751 properties to the partnership for \$200 of cash, and the partnership will increase its basis in such properties by a net amount of \$110 (\$10 for the inventory, \$50 each for the accounts receivable and the machine). The remaining \$2,200 amount of the § 736(b) payments to A will give rise to capital gain of \$190 under §§ 736(b) and 731 (\$2,200 cash distributed minus \$2,010 basis in A's partnership interest).

130. See *supra* text accompanying notes 21-22.

131. See *infra* note 132.

132. If the ABC Partnership were a capital-oriented partnership and did not make a § 754 election its balance sheet before and after the liquidation of A's interest would be as follows.

Asset	Pre-Liquidation		Post-Liquidation	
	Basis	FMV	Basis	FMV
Cash	6000	6000	3600	3600
Inventory	270	300	280	300
Machine	0	150	50	150
Accounts Receivable	0	150	50	150
Capital Asset	30	300	30	300
Goodwill	0	300	0	300
Total	6300	7200	4010	4800

If the partnership has made a section 754 election, it will increase the basis of its capital asset and its good will by a total of \$190 to reflect the capital gain recognized by A under sections 736(b) and 731. The resulting increase in the basis of the partnership's good will may be amortizable under section 197 as added by OBRA 1993, subject to the limitations discussed above.¹³³

IV. COMMENTS AND CONCLUSION

The sale of a partner's interest will not have radically different consequences after the enactment of OBRA 1993 when contrasted with prior law. With respect to such transactions, particular attention must be paid to the newly-expanded definition of substantially appreciated inventory under section 751(d) and to the possibility that purchasing partners may be able to obtain amortization deductions under newly-enacted section 197 for the seller's share of the partnership's good will and other intangible assets where a section 754 election has been made.

Partners' Equity	Pre-Liquidation		Post-Liquidation	
	<u>Basis</u>	<u>FMV</u>	<u>Basis</u>	<u>FMV</u>
A	2100	2400	0	0
B	2100	2400	2100	2400
C	2100	2400	2100	2400
Total	6300	7200	4200	4800

As the table illustrates, the partnership will increase the basis of its inventory, machine, and accounts receivable by a total of \$110 as a result of § 751(b). Thus, even if no § 754 election is in effect, the partnership will only recognize ordinary income of \$220 if it sold its inventory, machine, and accounts receivable, which corresponds to the theoretically correct result of \$110 per partner. Without a § 754 election B and C will still be taxed on \$570 (\$285 per partner) of the capital gain inherent in the partnership's good will and capital asset, which includes \$190 of capital gain (\$95 per partner) already taxed to A under §§ 736(b) and 731. Accordingly, each partner will increase the basis of his partnership interest by \$395, to \$2,495. On the receipt of \$2,400 in a liquidating distribution, each will claim a capital loss of \$95. For B and C, therefore, this yields \$110 of ordinary income and a net \$190 of capital gain (capital gain of \$285 and capital loss of \$95 on liquidation of the partnership). This does pose timing problems for them, but eliminates the characterization problems resulting where they purchased A's interest and the partnership did not make a § 754 election; there, each had a total of \$165 of ordinary income and \$135 of capital gain. See *supra* text accompanying notes 22-26.

If the partnership made a § 754 election, it also would increase the basis of its capital asset and good will by an aggregate amount of \$190, to reflect the capital gain recognized to A under §§ 736(b) and 731. In that case, each partner would recognize \$110 of ordinary income and \$190 of capital gain on the sale of the partnership's assets with no further gain or loss on liquidation of the partnership.

133. See *supra* text accompanying notes 101-21.

With regard to liquidations of a partner's interest, however, the rules have changed much more substantially. Under the amendments made by OBRA 1993, section 736 now contains two distinct sets of rules, one for partnerships for which capital is not a material income-producing factor, and one for partnerships for which it is such a factor.

Partnerships for which capital is not a material income-producing factor (i.e., services-oriented partnerships) will be affected by the OBRA amendments. Such partnerships must be aware of the expanded definition of substantially appreciated inventory under section 751(d). However, with regard to payments in liquidation of a partner's interest, such partnerships can rely upon the rules of prior law in modified form. Specifically, they can continue to treat payments for a retiring general partner's share of unstated good will and traditional unrealized receivables as section 736(a) payments, generally resulting in ordinary income to the retiring partner and an immediate deduction or its equivalent for the remaining partners. In contrast with prior law, payments for a retiring partner's share of nontraditional unrealized receivables, such as depreciation recapture, will now be section 736(b) payments, causing the retiring partner to realize ordinary income under section 751(b), but depriving the partnership of an immediate deduction with respect to such payments. Whether or not it has made a section 754 election, the partnership will adjust the basis of its nontraditional unrealized receivables to reflect the amount paid to the retiring partner.¹³⁴

However, the OBRA 1993 amendments will have their greatest effect upon partnerships for which capital is a material income-producing factor. Like their services-oriented counterparts, these partnerships are subject to the newly-expanded definition of substantially appreciated inventory and must also treat payments for a retiring partner's share of nontraditional unrealized receivables as section 736(b) payments. However, the changes wrought by OBRA 1993 upon capital-oriented partnerships are even more far-reaching. Indeed, with regard to such partnerships, this legislation effectively repeals section 736(a). For such partnerships, all liquidating payments for a retiring partner's share of partnership property including unstated good will, traditional and nontraditional unrealized receivables, will be analyzed under sections 736(b) and 751(b).

Under this regime, the retiring partner will be taxed on the liquidation of her interest just as if she had sold her interest to her fellow partners. For the remaining partners, the consequences of such a liquidation are less favorable than under prior law, since they can no longer immediately deduct

134. This assumes that the retiring partner is a general partner. See IRC § 736(b)(3)(B), enacted by OBRA 1993, *supra* note 1, § 13262(a), 107 Stat. at 541. All payments to retiring limited partners, even if made by a services-oriented partnership, are governed by the rules applicable to capital-oriented partnerships, discussed below.

payments under section 736(a) or shift additional ordinary income to the retiring partner via payments for unstated good will. Even so, however, it may still be better for partners in capital-oriented partnerships to have the partnership liquidate the retiring partner's interest than to purchase such interest themselves. This is so because the section 736 liquidation route implicates section 751(b), under which the partnership will automatically increase the basis for its unrealized receivables and substantially appreciated inventory to reflect its payment for the retiring partner's interest in such assets, even when no section 754 election is in effect. By contrast, if the retiring partner's interest were purchased by her fellow partners, no adjustments would be made to the basis of any partnership property in the absence of such an election.

In enacting the amendments described above, Congress was concerned, in part, with the mismeasurement of income that could result from the immediate deduction of items under section 736(a), even though income therefrom might not be realized until well into the future. In this respect, its amendment of section 751(c) to preclude all partnerships from immediately deducting payments for nontraditional unrealized receivables seems appropriate. A correlative exception to this rule, under which partnerships may continue to deduct payments for traditional unrealized receivables under section 736(a), also seems justified, since the opportunity for deferral with respect to such items is limited.¹³⁵ What is surprising however, is that Congress also amended section 736 to allow this correlative exception to apply only to services-oriented partnerships. Thus, unlike their services-oriented counterparts, capital-oriented partnerships can no longer deduct payments for a retiring partner's share of traditional unrealized receivables. Since Congress apparently believed that traditional unrealized receivables did not pose the same potential for deferral as nontraditional unrealized receivables, it is difficult to understand why it singled out capital-oriented partnerships in this respect, at least in the absence of evidence that such partnerships have greater opportunities for deferral or mismeasurement of income with respect to such items. Yet the legislative history cites no such evidence and offers no stated basis for treating services-oriented partnerships less favorably than capital-oriented partnerships. Indeed, one wonders from the legislative history whether Congress realized that it was creating this specific distinction between the two types of partnerships. In this respect, Congress's amendments are overly broad because they unjustifiably preclude capital-oriented partnerships from deducting payments for a retiring partner's traditional

135. In general, a current deduction is permitted for items that do not have a useful life substantially beyond the taxable year. See *Zaninovich v. Commissioner*, 616 F.2d 429, 431-32 (9th Cir. 1980), rev'g 69 T.C. 605 (1978); Regs. § 1.263(a)-2(a) (stating that property having a useful life substantially beyond the taxable year is a capital expenditure).

unrealized receivables, even though the opportunity for abuse in such cases is minimal.

By contrast, Congress clearly was aware that it was creating a distinction between capital-oriented partnerships and services-oriented partnerships with regard to payments for a retiring partner's share of good will. In addressing this issue as part of the amendments to section 736, Congress echoed the criticisms of commentators concerning the potentially abusive treatment of good will under prior law.¹³⁶ Given its concern with the issue of deferral and the possibility of manipulation, however, the question is not why Congress altered the treatment of good will with respect to capital-oriented partnerships, but rather, why it did not also do so with respect to services-oriented partnerships. By thus creating an exception for services-oriented partnerships, Congress has left open to such partnerships the possibility of manipulation that existed under prior law. Its stated justification for doing so—that “general partners in service partnerships do not ordinarily value good will in liquidating partners”¹³⁷—is unpersuasive. If such partnerships indeed do not ordinarily value good will in liquidating partners, then it is unnecessary to provide them with a special rule on the subject. Nothing inherent in the nature of services-oriented partnerships precludes them from engaging in the sorts of abuses with which Congress was concerned.¹³⁸ The elective treatment of good will is at odds with the extensive efforts under other portions of subchapter K to prevent partners from allocating items to

136. See, e.g., Lynch, *supra* note 75, at 473-75 (noting, for example, that partners could, under prior law, structure payments for good will so as to take advantage of differences in tax rates and the partners' respective tax situations in order to maximize tax savings for all partners). Staff of Senate Comm. on the Budget, *supra* note 79, at 425-26; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013; see also *supra* text accompanying notes 94-97.

137. Staff of Senate Comm. on the Budget, *supra* note 79, at 426; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

138. Several cases involving the proper characterization of payments for good will to a departing partner have involved services-oriented partnerships. See, e.g., *Tolmach v. Commissioner*, T.C. Memo 1991-538 (CCH) 1991, where in connection with the expulsion of a partner from a law firm, a referee found the value of the partnership to be over \$11,000,000 of which \$8,750,000 was attributable to good will, and therefore the payment to the partner was held to be within § 736(a) because the partnership agreement did not provide for a payment with respect to good will. Cf. *Schilbach v. Commissioner*, T.C. Memo 1991-556 (CCH) 1991 (holding that seller of medical practice received payment for practice good will which was taxable as capital gain); Rev. Rul. 70-45, 1970-1 C.B. 17 (holding that a taxpayer who admits partners to his professional practice may be considered to have transferred a portion of his share of the practice's good will, entitling him to capital gain treatment).

maximize tax benefits among themselves and is thus difficult to justify from a policy perspective.¹³⁹

Finally, Congress's action is puzzling in light of its concurrent enactment in OBRA 1993 of new section 197 of the Code, under which good will is not currently deductible, but is treated as an intangible asset that is amortizable ratably over a fifteen-year period. In the absence of more compelling justifications, Congress should have abrogated prior law's treatment of payments representing a partner's share of good will for services-oriented partnerships as well as capital-oriented partnerships. Doing so would have better harmonized the rules applying to all partnerships.

Congress believed that its amendments would reduce the confusion of prior law concerning whether a transaction is a sale or a liquidation of the partner's interest "by eliminating a primary difference between sales and liquidations."¹⁴⁰ As this article has demonstrated, however, the legislation does not entirely eliminate differences between these transaction forms. It is true that under these amendments, the retiring partner in a capital-oriented partnership will now be taxed in the same way whether her interest is sold or liquidated by the partnership. However, the remaining partners in such a case may still be better off by structuring the transaction as a liquidation of the retiring partner's interest. Thus, one can imagine future cases in which such partners contend, as they had an incentive to do under prior law, that a transaction seemingly structured as a purchase by them of a departing partner's interest was actually a retirement of that partner's interest by the partnership.¹⁴¹

These considerations are even more pronounced in the case of services-oriented partnerships. As to them, Congress allowed the rules of prior law to continue to apply with regard to payments for a retiring partner's share of unstated good will and traditional unrealized receivables, leaving intact the significant tax differences that depend upon the characterization of a transaction as a sale or instead as a liquidation of a partner's interest. Accordingly, for services-oriented partnerships, the new legislation does little to minimize the respective stakes that existed under prior law.

139. See, e.g., IRC § 704(b) (requiring that allocations of partnership items have economic effect in order to be given tax effect); IRC § 751(b) (precluding shifting of ordinary income and capital gain among partners through disproportionate distributions). See generally Lynch, *supra* note 75, at 473-83.

140. Staff of Senate Comm. on the Budget, *supra* note 79, at 425; H.R. Rep. No. 111, *supra* note 79, at 782, reprinted in 1993 U.S.C.C.A.N. at 1013.

141. Similarly, the Service may in certain cases assert that a transaction reported as a liquidation of a partner's interest was in fact a purchase of the partner's interest by her fellow partners, thus denying the partnership the benefits of the automatic basis adjustments resulting from the application of § 751(b).

In addition to thus perpetuating certain differences that resulted under prior law between sales and liquidations of partnership interests, Congress added to the statutory scheme elements of uncertainty and complexity that did not previously exist. For example, in amending section 751(d)(1), defining substantially appreciated inventory, it added a facts-and-circumstances oriented, tax-avoidance “purpose” test that reduces the certainty of the more mechanical test of prior law. Even more significantly, because section 736 now prescribes different rules for capital-oriented partnerships and for services-oriented partnerships, it is now necessary to determine whether capital is or is not a material income-producing factor for a partnership. That inquiry was previously irrelevant, and hence unnecessary, under section 736. Given the greater flexibility available under section 736 to partnerships in which capital is not a material income-producing factor, one can expect many partnerships to characterize themselves as services oriented, rather than capital oriented. Moreover, the application of section 197 in connection with sales and liquidations of partnership interests, and particularly the scope of the anti-churning rules, will need administrative clarification. Thus, it is not evident that Congress’s actions have significantly reduced confusion or complexity in this area.

Congress could have created more harmony within the statutory scheme and curbed a significant area of potential abuse by allowing all partnerships to continue to treat payments for a retiring partner’s share of traditional receivables as section 736(a) payments, while at the same time requiring all partnerships to treat payments for the partner’s share of unstated good will and nontraditional unrealized receivables as a section 736(b) payments. Instead, OBRA 1993 precludes capital oriented partnerships from deducting payments for a partner’s share of traditional unrealized receivables, where the possibility for abuse seems minimal. At the same time, by continuing the treatment of prior law for good will payments in the context of services-oriented partnerships, the legislation fails to address the more potentially abusive area that existed under prior law.

It has been contended that a single rule should govern the withdrawal of a partner from a partnership, whether by sale or liquidation of that partner’s interest.¹⁴² Given its stated intentions as reflected in the relevant legislative history, Congress may have had as its ultimate goal the elimination of all differences in tax consequences between sales and liquidation of a partner’s interest. Nevertheless, the amendments effected by OBRA 1993 do not in fact equalize the tax consequences of sales and liquidations of partnerships. Rather, they perpetuate an area of potential abuse that existed under prior law and create additional and unjustifiable uncertainties.

142. See Lynch, *supra* note 75, at 483-85.