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Transference of Partnership Interests under the Internal Revenue Code of 1954*

Jerry Simon†

The tax problems involved in the transference of a partnership interest present themselves in a number of situations. Quite often they arise in the case of the "collapsible partnership," one whose assets consist, in large measure, of uncollected receivables, appreciated inventory or of other items which, in the normal passage of time, produce ordinary income. It is the purpose of this paper to discuss attempts, both statutory and judicial, to prevent such prospective ordinary income from being realized at capital gains rates. Since such a realization is most likely to occur in connection with the transference of a partnership interest either by sale, or death or retirement of a partner, the first three sections of this material concern themselves with those subjects. A concluding section deals with the interrelation of the three situations and attempts to evaluate the new sections of the 1954 Internal Revenue Code dealing with the transference problem. It should be stressed, however, that any discussion of the new provisions is to a considerable extent necessarily limited to conjecture, since regulations explaining and implementing them were not available until recently and to date have been published only in proposed form.

**Sale of a Partnership Interest — Old Law**

Prior to the 1954 revision of the Internal Revenue Code there was little, if any, consistency in the tax treatment accorded gains and losses attributable to sales of partnership interests. Any attempt to develop a pattern of rules from the decisions on this subject serves only to illustrate the need for congressional action in this area. The following resumé, however brief, should substantiate this contention.¹

*This paper was written in partial fulfillment of the requirements for the LL.M. degree at Yale Law School, 1955.
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1. Under the Code, regulations, and cases as they existed before the new law, the rules governing sale or exchange of a partnership interest were applied to two distinctly different kinds of situations: (1) the case in which a partner sells his interest in the partnership to an outsider, and (2) the retirement of a partner.
Under the 1939 Code, gain or loss realized on the sale of a partnership interest was computed by subtracting from the amount received, the transferor’s basis for the interest sold plus his share of undistributed partnership income which had already been taxed. Although there were no specific provisions in the 1939 Code concerning the treatment of liabilities, it was generally assumed that the rule of Crane v. Commissioner would apply to the sale of a partnership interest in that the amount of the liabilities assumed by the transferee would be added to his basis for the interest acquired, the seller adding this same amount (representing, in his case, obligations from which he was released) to the sum actually received for the interest for purposes of computing gain or loss.

While the method used in computing gain or loss was fairly well settled, the treatment of the sum derived thereby, the taxable gain or loss, was not nearly so clear.

The theory generally applied by the courts recognized a partnership as a separate entity and an interest therein as a capital asset, the sale or exchange of which gave rise to a capital gain or loss. The Bureau of Internal Revenue, however, took the posi-

(1) In the latter instance the transaction was treated as a sale to the partnership of the retiring partner’s interest.) Since the new Code provides special rules applicable to the retirement of a partner, pre-revision cases involving problems peculiar to retirement will not be discussed here, but rather in the section dealing with retirement of a partner.

2. Although the purchase price generally took the form of cash, it could be in stock as well. Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945); T. B. Noble, 12 B.T.A. 1419 (1928).

3. This would generally be the original cost of the interest plus the basis of any property contributed to the partnership at the time of contribution. U.S. Treas. Reg. 111, § 29.113(a) (13)-1 (1943).

4. This recognized that part of the price received by the transferee represented payment for partnership income, still held by the partnership, on which the transferor had already paid income tax. Hence, money received for this income was not taxed again. (This was accomplished by adding the amount in question to the transferee’s basis, thus reducing his gain by that amount.) Undistributed partnership income not yet taxed was taxed to the transferor at ordinary income rates. Karsch Standard Paving Co. v. Commissioner, 190 F.2d 330 (10th Cir. 1951); cert. denied, 342 U.S. 860 (1951); LeSage v. Commissioner, 173 F.2d 826 (5th Cir. 1949); Standard Paving Co., 13 T.C. 425 (1949); cf. Meyer v. United States, 213 F.2d 278 (7th Cir. 1954).

5. 331 U.S. 1 (1946).


tion that in the case of a partnership whose assets consisted chiefly of accounts receivable, this rule should not apply, and that portion of the price paid for an interest in such a partnership attributable to receivables should be treated as *ordinary* income. Similar treatment was given to that part of the purchase price which represented payment for installment obligations. Capital gains treatment was allowed under the partnership entity idea, however, in cases of legal and medical partnerships even though the assets of the firms involved consisted chiefly of uncollected accounts.

This question, whether a partnership interest was a capital asset or simply an interest in a group of assets, some capital, some not, was never clearly settled. One case favoring the partnership entity approach even criticized the division of assets of a single proprietorship into capital and non-capital items when the interest was sold as a whole. This fragmentation procedure, however, was cited with approval by the Supreme Court in language not necessarily restricted in its application to single proprietorship situations.

In some instances, the form of the transaction had more to do with the tax results than acceptance or non-acceptance of the partnership entity idea. One Tax Court opinion, while recognizing the entity approach, held that partners had not sold their partnership interests as such, but had disposed instead of the partnership's assets and that tax treatment was dependent upon

8. G.C.M. 26379, 1950-51 *Cum. Bull.* 58 (1950). There were several cases rejecting the entity theory: Randolph Products Co. v. Manning, 176 F.2d 190 (3d Cir. 1949); Commissioner v. Whitney, 169 F.2d 562 (2d Cir. 1948), *cert. denied*, 335 U.S. 892 (1948); Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945); Doyle v. Commissioner, 102 F.2d 86 (4th Cir. 1939); Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937); City Bank Farmers Trust Co. v. United States, 47 F. Supp. 98 (Ct. Cl. 1942); Paul W. Trousdale, 16 T.C. 1056 (1951); McAfee, 9 T.C. 720 (1947).


12. Judge Stephens, in his opinion in Hatch’s Estate v. Commissioner, 198 F.2d 26 (9th Cir. 1952), indicated disapproval of Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), which had divided assets into capital and non-capital where a single proprietorship was sold as a unit.

13. Watson v. Commissioner, 345 U.S. 544 (1953); *cf.* Meyer v. United States, 213 F.2d 278 (7th Cir. 1954), which distinguished the *Watson* decision on the ground that it was concerned only with whether or not unmatured crops were real property.
the character of the individual items sold. In other situations, losses were treated as ordinary losses on the ground that the mere forfeiture of capital invested in a partnership could not be considered a sale or exchange.

In those cases recognizing a partnership interest as a capital asset, the holding period for determining whether the gain or loss was long or short term began at the time the partnership interest was acquired (regardless of when the individual assets it represented came into the partnership). Similarly, the basis of the individual partner for his interest and that of the partnership for its assets were considered two separate and distinct things, the partnership's basis for its assets being unaffected by a change in membership unless the change converted the partnership into a single proprietorship or was accompanied by a termination and reorganization of the partnership.

SALE OF A PARTNERSHIP INTEREST — NEW LAW

Under the new Code, gain or loss on the sale of a partnership interest is determined in much the same manner as it was under the old rules. The transferor partner is first charged ordinary income rates on his share of untaxed partnership income. Then his basis for his interest, including his share of any undistributed partnership income, is subtracted from the amount received. At this point the problem of determining the tax treatment to be given the resulting recognized gain or loss again presents itself.

Section 741 of the new Code sets out the general rule by providing that the sale or exchange of a partnership interest is to be treated as the sale or exchange of a capital asset. Exceptions to this capital asset treatment are found in section 751 which
provides that money received for (1) “Unrealized Receivables”\(^{22}\) and (2) “Substantially Appreciated Inventory”\(^{23}\) be treated as if obtained in exchange for assets not of a capital nature. Application of these provisions may be demonstrated as follows:

Assume under the following fact situation that C sells his interest (for which he has a cost basis of $3,000) to D for $6,000.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES AND CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adj. Basis</td>
<td>Fair Market to Ptshp. Value</td>
</tr>
<tr>
<td>Cash</td>
<td>$6,000</td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td></td>
</tr>
</tbody>
</table>

C’s gain on the transaction is $6,000 (amount received) less $3,000 (basis for interest), or $3,000. $2,000 of this amount is considered to have been given for C’s share of “unrealized receivables” for which C’s share of the partnership basis is zero,\(^{24}\) so this absorbs $2,000 of the gain as ordinary income. The remaining $1,000 is capital gain.

If the partnership has debts, however, the problem is not so simple. Assume in the above situation, for example, that the partnership has a $3,000 note payable outstanding. This reduces the capital accounts of the partners $1,000 each, so that A, B, and C now have account balances of $5,000 each, instead of the $6,000 shown. Again we have a sale by C to D of C’s interest, D paying C the amount of the latter’s capital account ($5,000) and assuming C’s share of partnership liabilities. Under section 752

\(^{22}\) Defined in id. § 751(c) as “any rights (contractual or otherwise) to payments 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.” If these items have been included in income of the partnership previously (if the partnership is on an accrual basis) they are not treated as “unrealized receivables.”

\(^{23}\) Defined in id. § 751(d) as “inventory items” of the partnership (further defined in § 751(d) (2) whose fair market value exceeds “(A) 120 percent of the adjusted basis to the partnership of such property, and (B) 10 percent of the fair market value of all partnership property, other than money.”

\(^{24}\) According to the House, Senate and Conference Committee reports on the new law, gain realized on ordinary income items represented by the interest is obtained by subtracting from their fair market value the partnership’s basis for them. (This would, of course, be limited to the transferor’s share of these items and his share of the partnership’s bases for them.)
of the new Code, C is treated as having received, in addition to the $5,000, the amount of any liabilities from which he is released in the transaction. That same section provides, however, for an addition to a partner's basis for his interest when he assumes partnership liabilities (as C did when the note was made). These two additions, one (of $1,000) to C's basis when he assumed the liabilities and the other (of $1,000) to the amount he received for his interest cancel each other out.  

Hence the gain recognized is $6,000 received for the interest ($5,000 plus release from $1,000 in liabilities) less $4,000 (C's original basis, $3,000, plus the $1,000 increase made when he assumed the liabilities) or $2,000. Characterization of the gain as capital or ordinary now becomes a problem.

The Senate Reports on the new Code indicates that money received for a partnership interest is to be applied first to ordinary income items and the balance treated as payment for capital assets. In our illustration this would mean that the accounts receivable (for which C's share of the partnership basis is zero) were purchased for $2,000 (their fair market value) and the balance of the purchase price paid for that part of the interest made up of capital items. Since the $2,000 gain is absorbed here

25. This "cancelling out" process will occur in every such instance, the basis being increased when the liabilities are assumed, and decreased when they are discharged. This is a codification of the rule of Crane v. Commissioner, 331 U.S. 1 (1946), as applied to partnership interests.

26. The following example of the application of § 751 is given in S. Rep. No. 1022, 83d Cong., 2d Sess. 403 (1954): Assume that C buys B's interest in a personal service partnership, AB, for $15,000 when the balance sheet of the firm is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted basis</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Advances for</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Clients</td>
<td>$7,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>0</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Adjusted basis</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>A, Capital</td>
<td>$9,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>B, Capital</td>
<td>$9,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

The example states that "under the provisions of section 751(a), B realizes $3,000 in ordinary income attributable to his partnership interest in 'unrealized receivables.'" This illustration lacks clarity in that the bases of A and B for their interests given in the "Adjusted Basis" column at the right of the balance sheet happen to be exactly equal to their respective shares of the partnership bases for its assets less their shares of partnership liabilities. This coincidence will not occur in all cases. In this connection, see note 37 infra. For further support of this idea that payment for a partnership interest is applied first to ordinary income items, see Proposed Rule Making, 20 Fed. Reg. 5876, § 751-1(e), example (1) (1955).
as ordinary income, no capital gain would be recognized, even though there has been appreciation of the capital items represented by the interest and this appreciation is reflected in the purchase price.\textsuperscript{27} This method of applying the amount received to ordinary income items to the extent of their fair market value before recognizing capital gain in effect uses liabilities as an offset to capital gain but not to ordinary income. This same problem is encountered in those instances in which an interest is sold for less than its fair market value even though no liabilities are involved.

If gain recognized on the sale of an interest exceeds the amount by which the ordinary income items in the interest have appreciated over their bases, the same rule, that gain recognized over the appreciation of ordinary income items is capital gain, would seem to apply. In other words, had the amount given for C's interest been $7,000 (plus assumption of his share of the liabilities) C would have realized $2,000 ordinary income and $2,000 capital gain, even though the capital assets represented by the interest had not appreciated $2,000 in value. (D's basis for the interest acquired would be $7,000, the amount paid, plus $1,000, liabilities assumed, or $8,000.)

Had C received only $2,000 for his interest (plus release from liabilities) presumably the $1,000 loss would be a capital loss, but this is not too clear since discussions of the new partnership provisions found in the House, Senate and Conference Committee Reports discuss only those situations in which gains occur. Assume that a one-half interest in a partnership having two assets— one capital (land), basis $3,000, value $6,000 and one not (substantially appreciated inventory), basis $3,000, value $6,000 — is sold at a $2,000 loss. Would this be a capital loss, ordinary loss or two losses, one capital, one ordinary? A definitive answer cannot be made at this time. This, like many other problems in this area, will have to be worked out as the situations arise.

\textsuperscript{27} It is conceivable, in the case of a partnership with proportionately large liabilities that when that portion of the purchase price equal to the fair market value of non-capital items is diverted, the remainder will be less than that portion of the transferor's basis attributable to his interest in capital assets. Presumably, in such a situation the taxable ordinary income would be limited to the amount of the overall gain on the transaction. It should be remembered, however, that § 731, which governs the recognition of gain, makes special provision for ordinary income items provided for in §§ 736 and 751. In this connection, see Proposed Rule Making, 20 Fed. Reg. 5876, § 751-1(e), example (1), which contemplates ordinary income and a capital loss in the same transaction.
The new Code retains the pre-revision idea that two sets of bases exist in connection with any partnership: (1) the partnership's basis for each of its assets, used in computing gain or loss realized by the partnership when it sells or exchanges the asset, and (2) each partner's basis for his interest in the partnership, used in computing gain or loss realized by the partner on the sale or exchange of his interest (or gain or loss to his estate if the interest passes by means of his death).

An individual partner's basis for his interest and his share of the partnership's bases for its assets (hereafter referred to collectively as the "partnership basis") may be, and often are, equal. However, there are some instances in which these two differ. For example, there is the case in which property appreciates after purchase by the partnership and a partner acquires his interest by purchase with a sum recognizing this appreciation.

The new Code contains provisions which seem intended, by means of certain adjustments to the partnership basis, to keep these two sets of bases more nearly equal than they were under the old rules. How effectively this is accomplished can best be seen by examining the provisions themselves and their application to practical situations. Discussion here will be limited, however, to those phases of basis adjustment incidental to the sale of a partnership interest.

Under section 754 of the new Code, a partnership may, for taxable years beginning after December 31, 1954, elect to undergo basis adjustment in the event of: (1) a distribution of partnership property, (2) the transfer of a partnership interest. We are here concerned only with the latter. This election, unless revoked, applies so as to increase or decrease partnership basis in all distributions and transfers made by the partnership thereafter.

28. Generally its cost, or its adjusted basis to its contributor prior to contribution. INT. REV. CODE OF 1954, § 723.

29. Cost if the interest is purchased, fair market value if it is inherited, and money and the adjusted basis of property contributed if it is acquired through contribution. Id. §§ 722, 742.

30. The transferee may obtain the benefit of such an adjustment if the property involved is distributed within two years, or may be required to make it under certain circumstances even after two years has elapsed. Id. § 732(d).

31. Under id. § 743(b) of the House version of the new Code, the election was irrevocable. This was changed by the Senate to permit revocation if good business reasons were shown.
The amount of the adjustment is determined under a formula found in section 743(b) of the new act. This states that partnership basis is increased by "the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property." This section further provides that if the transferee's proportionate share of the partnership basis exceeds his basis for his interest, partnership basis is reduced by the amount of the excess. This increase or decrease with respect to the partnership basis takes effect as concerns the transferee partner only. The application of this formula is illustrated below.

Suppose that C sells his interest in the partnership to D for $6,000 in this situation:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES AND CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Partner's Share of Basis</td>
</tr>
<tr>
<td>Basis</td>
<td>F.M.V.</td>
</tr>
<tr>
<td>Cash</td>
<td>$6,000</td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

The partnership basis will be increased by $6,000 (D's basis for his interest) less $3,000 (D's proportionate share, one-third of the total partnership basis, $9,000) or $3,000.

The rule for allocation of adjustments to basis is found in section 755, which states that the adjustment should be apportioned among the bases of the appreciated partnership assets so as to reduce the difference between these bases and the fair market value of the assets. This provision divides partnership assets into two categories: (1) capital assets, and (2) "other property," and states that adjustments are to be applied to the

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32. Under the House version of the bill (id. § 743) the adjustment was to apply to all partners, not just the transferee.

33. Since ordinarily partnership basis is shared by partners in proportion to their capital interests (and would here be divided into three equal parts), this illustration, modeled after a Conference Committee example discussed in note 37 infra presupposes prior basis adjustments (at least two of them).

34. Cost, if acquired by purchase; fair market value, if by inheritance; basis of donated property, if by contribution; plus the partner's share of the partnership liabilities. Id. §§ 722, 742, 752.

35. A partner's proportionate share of the partnership basis is determined in accordance with his share of partnership capital which in this case would be ⅓. Id. § 743(b).
bases of those items which are of the same type as those involved in the exchange whose appreciation (or depreciation) in value gave rise to the adjustment. If no items "of a like character" are owned by the partnership, basis allocable to such items is held in abeyance until property of this type is acquired.  

Applying this to our illustration, we find that the $3,000 adjustment should be allocated $1,000 to the basis of land and $2,000 to the basis of receivables, since these proportions best reflect the comparative appreciation of the items which gave rise to the adjustment. (This allocation, according to proportionate appreciation, is consistent with examples in the conference committee reports).

It should be noted that the amount of the adjustment does not depend on the transferor's basis for his interest. It would have been the same if D had purchased the interest of A or B. D now has a "special basis" of $2,000 for receivables and $1,000 for land which will be used in computing his share of the gain or loss if either or both of these things are sold. What becomes of this adjustment to partnership basis if D sells his interest is not too clear. Since there is no provision for eliminating the

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36. Similarly, in a case involving a decrease in basis, property of the proper type has its basis reduced to zero, and any "left over" basis adjustment is applied to the basis of similar property when it is later acquired. Actually, these "left over" basis problems do not generally occur in sale or exchange situations since the appreciated property which gave rise to the adjustment remains in the hands of the partnership.


Assume that A dies; profits are shared equally:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted</th>
<th>Market</th>
<th>Liabilities and Capital</th>
<th>Adjusted</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>basis</td>
<td>value</td>
<td>Liability</td>
<td>basis</td>
<td>value</td>
</tr>
<tr>
<td>Cash</td>
<td>$ 5,000</td>
<td>$ 5,000</td>
<td>Liability</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Prop. X (inventory)</td>
<td>20,000</td>
<td>21,000</td>
<td>A, Capital</td>
<td>12,000</td>
<td>22,000</td>
</tr>
<tr>
<td>Prop. Y (dep. asset)</td>
<td>20,000</td>
<td>40,000</td>
<td>B, Capital</td>
<td>15,000</td>
<td>22,000</td>
</tr>
<tr>
<td>Acc. Rec.</td>
<td>10,000</td>
<td>10,000</td>
<td>C, Capital</td>
<td>18,000</td>
<td>22,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
<td><strong>Total</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
</tr>
</tbody>
</table>

By means of calculations similar to those already demonstrated, this example finds that A's successor has the benefit of a $7,000 basis adjustment. It is not clear what the column titled "Adjusted basis" on the liabilities and capital side is intended to include. If the items, $12,000, $15,000, and $18,000, are intended to represent the partners' bases for their interests (less their share of partnership liabilities) then the assumption is that each partner's share of the partnership basis is ⅔ of $55,000, and the illustration is useful only for identical fact situations. If the figures represent each partner's share of the partnership basis, the illustration still is not clear. The difference in partners' shares seem to presuppose prior basis adjustments and there is no indication as to what A's successor is going
“special basis” and none for dividing it among the other partners when the partner who obtained it relinquishes his interest, the probability is that it passes to whoever acquires the interest of the transferee partner when he sells.

It is submitted that this method of computing basis adjustment does not as effectively balance the partnership’s basis with those of the individual partners as would that contained in the Senate version of the bill, before it was “simplified” by the Conference Committee, which computed the adjustment by subtracting from the transferee’s basis for his interest that of the transferor. (If the transferor’s basis was greater, a decrease would result.) Consistently applied, this would result in the transferee’s basis for his interest and his share of the partnership basis being equal.

If we assume that the “special basis” of the transferee is “passed on” to his successor, the following comparison between the two methods of computation may be made. In our illustration D’s part of the partnership basis would be $7,000 under the Code as it now stands, $1,000 more than his basis for his interest, whereas under the Senate bill, the two figures would be the same. Carried further, the figures would remain static under the Senate bill if D sold the partnership interest to E and E to F (both sales for $6,000) whereas under the present arrangement, F’s basis for his interest would be $6,000, but his share of the partnership basis would be over $10,000. Similar to “tack” his special basis onto. Which will it be: $18,333 (1/6 of $55,000), $12,000, $15,333 (1/3 of liabilities plus $12,000)?

Section 1.743-1 of the Proposed Rule Making, 20 Fed. Reg. 5873 (1955), contains a similar example which uses a different method of computing the adjustment. The new partner’s proportionate share of the partnership’s adjusted basis is determined by dividing the total partnership basis (less the basis for partnership liabilities) by a fraction composed of the transferor’s basis for his partnership interest or his share of the partnership’s basis (the example is not clear which) over the total partnership basis (less the basis for partnership liabilities). No matter which of the two possibilities cited above is used as the numerator of the fraction, this computation has the effect of making the basis adjustment dependent on the transferor partner’s basis for his partnership interest and seems to be in conflict with both the Conference Committee Report and § 743(b). It does, however, produce the result intended by the Senate version of the bill discussed above.

38. Eliminating the adjustment would seem to be especially unwise in the event that it had served to decrease basis as this would allow the partnership a tax advantage for no apparent reason.

39. This idea of retaining that part of the partnership basis held by a predecessor is used in § 743(b) in connection with honoring § 704(c)(2) agreements for basis adjustment purposes.

40. This computation assumes that C’s basis for his interest is equal to his share of the partnership basis which would be the case if the partnership had consistently adjusted its basis after each transfer of a partnership interest.
distortions occur in situations in which the partnership basis is decreased under the method of computation set out in the Code.

Other problems arise in those situations in which the amount paid for a partnership interest is more or less than its fair market value.

If the payment exceeds the fair market value of the interest, the excess is considered good will and thus capital gain; hence the discussion above is applicable. Whether, under section 755, adjustment attributable to good will is to be allocated to the basis of a good will account set up especially for this purpose, or simply used to increase the bases of items "of a like character" (capital assets) is open to question.

If the sale price exceeds the transferee's proportionate share of the partnership basis but is less than the fair market value of the interest sold, another allocation problem arises. Should the basis adjustment be allocated to capital assets and "other property" in proportion to their appreciation, or should some other test be used? The decision concerning the character of the gain in such a situation, as pointed out previously, would probably control basis allocation to some extent, but not entirely so, as the gain realized in the sale of the interest and the basis adjustment would not necessarily be the same.

**Retirement of a Partner — Old Law**

A casual examination of pre-revision cases concerning retirement from a partnership reveals that this area is no less confused than were the cases dealing with the sale of a partnership interest prior to the 1954 Code. The following summary of retirement cases under the 1939 Code should serve to illustrate this point.

Many partnership agreements provide that upon retirement of a partner, the partnership (as composed after the withdrawal) is to make certain payments to the retired partner who, in turn, relinquishes his interest in the partnership. The amount of the payments under such a plan is often a specified portion of partnership profits for a certain period after the withdrawal of the retiring partner.

Under the 1939 Code, retirement under such a plan was usually treated as a sale to the partnership of the interest of the retiring partner which, under the entity idea, produced a capital
gain or loss. There were cases, however, holding that such payments were not intended as part of the purchase price but were instead the result of a mutual insurance arrangement whereby the partner withdrawing continued to share in partnership profits for a specified period after he left the firm. In these cases, the remaining members of the partnership were not taxed on the payments since they were considered ordinary income of the retiring partner. In cases in which a purchase was found, however, the remaining partners were refused deductions for amounts paid to their former associate, such payments being considered additional contributions to capital. In determining which transactions received which tax treatment the courts used no consistent criteria. Emphasis was placed, in many instances, upon the wording of the partnership agreements; these, of course, varied with each individual case.

In those cases in which a partner surrendered his firm interest in connection with a distribution to him of partnership property, tax treatment was not quite so unpredictable. No gain or loss was recognized on a property distribution. The distributee's basis for his partnership interest was allocated to the items he received in proportion to their fair market values and he was allowed to "tack" onto his holding period for each of these items that of the partnership.

If both cash and property were distributed, gain was recognized to the extent that the cash exceeded the distributee's basis for his partnership interest. The basis for his interest was reduced by the amount of cash received before being allocated to the property involved in the distribution whether or not any gain was recognized. The character of the gain recognized in a distribution involving cash was dependent upon whether or not

42. Whitworth v. Commissioner, 204 F.2d 779 (7th Cir. 1953); Carol F. Hall, 19 T.C. 445 (1952); see cases cited note 74 infra.
44. INT. REV. CODE OF 1939, ¶ 113(a) (13) (2); I.T. 2010, III-1 CUM. BULL. 46 (1924).
46. INT. REV. CODE OF 1939, ¶ 113(2) (13) (2); I.T. 2010, III-1 CUM. BULL. 46 (1924).
47. See note 46 supra.
the court making the determination applied the entity theory (under which a partnership interest is a capital asset), the cash being, in effect, the purchase price for part of the partnership interest.

**Retirement of a Partner — New Law**

In a special section applicable to retirement from a partnership, the new Internal Revenue Code sets out the general rule that payments by the partnership for the interest of a retired partner are to be treated as distributions by the partnership, and hence any gain or loss recognized on such payments is a capital gain or loss. This same section provides, however, that payments for "unrealized receivables" and good will are not to be included in the payments for the interest but are to be treated as the retired partner's distributive share of partnership income if determined "with regard to the income of the partnership" or as a "guaranteed payment" if not so determined, either of which is ordinary income to the retired partner. Another exception to the general rule is found in section 751-(b)(1)(B), which provides that money paid to the retired partner for "substantially appreciated inventory" is to be treated as if received in a sale or exchange of a non-capital item, the gain realized on the inventory being ordinary income. If the retiring partner is released from his share of partnership liabilities, the amount of such liabilities is added to the sum received in distribution and serves to offset the increase in his basis made upon acquisition of the debts.

The remaining partners are not taxed on 736(a) type payments (for receivable and inventory items). If considered the retired partner's distributive share of partnership income, they are obviously not taxable to anyone else. If considered "guaranteed payments," they are deductible as partnership business.

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49. Id. § 731(a)(2).
50. As defined id. § 751(c); see note 22 supra.
51. Under id. § 736(b)(2)(B) this does not include good will provided for in the partnership agreement.
52. Id. § 738(a)(1). Under some of the pre-revision cases, payments to a retired partner were considered as a distributive share of partnership income even though based on partnership income for a period before the retirement. Whether or not this idea is carried over under the new Code is of no practical significance since, under § 736(a), the payment will be ordinary income whether or not it is based on income.
53. Defined in id. § 751(d); see note 23 supra.
54. Id. § 752(b).
55. Id. § 752(a).
expenses.\textsuperscript{56} If the option provided in section 754 is in effect, the partnership may increase its basis for its remaining property in the amount of any gain recognized on a distribution to a retired partner.\textsuperscript{57} Allocation of this adjustment is made in accordance with rules set out in section 755.

An argument might be made by a partnership which had made payments to a retired partner for his share of the partnership’s “substantially appreciated inventory” that it be allowed a basis adjustment under 743(b) to the extent that the amounts so paid exceeded the retired partner’s proportionate share of the partnership basis for such inventory. This contention would be based on the idea that payments for inventory are the only part of the entire transaction taxed under the rules governing sale of a partnership interest and, since this phase of the transaction is considered a sale under section 751(b), it should be viewed in the same light with reference to section 743(b). Failing in this, it would seem that the partnership could use its cost for the retiring partner’s part of the inventory as its basis for that part of its inventory.\textsuperscript{58}

The foregoing discussion may be illustrated as follows: Assume in this situation that C retires, giving up his interest in the partnership for which he had a cost basis of $4,000, and receives annual payments for the next two years of $4,000 each.

<table>
<thead>
<tr>
<th>PARTNERSHIP’S FAIR MARKET</th>
<th>ASSETS</th>
<th>LIABILITIES AND CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Basis</td>
<td>Value</td>
</tr>
<tr>
<td></td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>3,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>0</td>
<td>6,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$12,000</td>
<td>$24,000</td>
</tr>
</tbody>
</table>

The fair market value of C’s share of the partnership’s unrealized receivables, $2,000, is considered payment for those items and is, under section 736(a), ordinary income. C receives

\begin{itemize}
\item \textsuperscript{56} Id. §§ 707(c), 162(a).
\item \textsuperscript{57} Id. § 734(b) (1) (A).
\item \textsuperscript{58} This possibility arises due to the fact that under § 751(b) the partnership, as such, is buying its own assets from a former partner. Whether or not a cost basis is possible in such a case is not clear.
\end{itemize}
$2,000 as payment for his share of the inventory of the partnership which is, under the test provided in section 751(d), "substantially appreciated." C's share of the partnership basis for these items is $1,000 and the gain, $1,000, is ordinary income under section 751(b). The amount given for C's share of the partnership's capital assets, $4,000 (one-third of $12,000, the sum of the fair market value of land and cash owned by the partnership) is treated as if received in a distribution.

Determination of C's basis for his interest in partnership capital assets is troublesome. His original cost basis for his partnership interest was $4,000. However, in determining the gain recognized under section 751(b) on that portion of the payments attributable to "substantially appreciated inventory" C used as his basis for those items his share of the partnership basis for them. Although there is no specific provision requiring it, it would seem only reasonable that C reduce his original basis by that amount — the amount used to offset payments for inventory — for purposes of determining gain on the "distribution" under section 731. Assuming that this is the case, C's basis, $3,000 (his original basis reduced by the $1,000 already used to offset ordinary income under 751(b)) is exceeded by the cash distributed to him, $4,000, by $1,000, and this amount is capital gain under section 731(a)(1).

Each of the two annual $4,000 annual payments received by C will consist of a return of capital of $2,000, a capital gain of $500 (one-half the total $1,000 capital gain) and $1,500 in ordinary income (one-half the total $3,000 ordinary income).

Since the $2,000 paid for C's share of partnership receivables is a "guaranteed payment," it may be deducted as a partnership business expense. The partnership may also elect to adjust (increase) its basis for land $1,000 under section 734(b)(1)(A). It might attempt to secure an increase of $1,000 in its basis for inventory either through the application of section 743(b) or

59. This is in conformity with illustrations in the Senate and Conference Committee Reports. See notes 26 supra and 61 infra.

60. This section, which provides, in part, for an adjustment of the partnership bases for undistributed property in the amount of gain or loss realized by a distributee partner under § 731(a), will apply here only to capital items since gain or loss in non-capital assets is not determined under § 731 but under § 736(a) or § 751(b). Section 734 also provides for increasing or decreasing the bases of property retained by the partnership if the bases of distributed property vary before and after distribution. See § 734(b)(1)(B), 734(b)(2)(B).
as part of its cost basis for inventory acquired from the withdrawing partner.

The application of these new rules to a situation involving a partnership with liabilities in its balance sheet involves calculations similar to those used when interest in such a partnership is sold. Assume, for example, that in the preceding illustration the partnership has a $6,000 note outstanding, that the capital accounts of the three partners are $6,000 each, and that C retires under an arrangement whereby he is to receive two annual payments of $3,000 each and be released from his share of the partnership debts. The ordinary income recognized on the receivable and inventory items would be computed as before, by designating that portion of the sum received by C which is equal to the fair market value of such items as payment for them.

Since the addition to C's basis made upon acquisition by the partnership of liabilities is offset by a constructive increase in the amount received by him in distribution, these two adjustments serve to cancel each other out. Assuming, as was done in the earlier example, that C's basis for his interest is reduced by $1,000, the amount used to offset ordinary income under section 751(b), the basis is now $4,000 (the original basis) plus $2,000 (C's share of partnership liabilities) less $1,000 (used to compute gain on inventory) or $5,000.

The fair market value of C's portion of partnership capital assets is still $4,000, but since $4,000 of the payments, totaling $6,000, has already been allocated to the purchase of receivables and inventory, only $2,000 remains for treatment as a distribution. To this is added $2,000 (representing liabilities from which C was released) and total receipts by him, real and constructive, are $4,000. Since the basis for the interest is $5,000, it becomes apparent that here, as in the case of a sale of a partnership interest, a technical application of the rules can produce both ordinary income and a capital loss in the same transaction, and for the same reason; for in both situations payments are applied first to the extent of the fair market value of ordinary income items before gain or loss on capital items is determined. It is suggested that here, as in the sale or exchange situation, courts will, when faced with situations similar to the one illustrated above, reduce the amount of ordinary income recognized to the point at which no gain or loss is recognized on capital items.
Another problem in connection with the use of liabilities as an offset to the appreciation of capital items becomes apparent when an attempt is made to determine the amount of "good will" taxable as ordinary income under section 736(a). Is good will the amount paid in excess of the retiring partner's capital account, or must the payment to him exceed the fair market value of the assets represented by his interest? In other words, if C had received payments totaling $8,000 in the last illustration, would the $2,000 in excess of his capital account be good will, or would it be used to offset the unrealistic capital loss created by charging liabilities solely against the appreciation of capital assets? Available information provides no answer to this problem.61

The following hypothetical situation62 illustrates the application of the provisions of the new Code governing property distributions in liquidation of a retiring partner's interest.

Assume that in the following situation C relinquishes his

<table>
<thead>
<tr>
<th>Assets</th>
<th>Fair Market value</th>
<th>Liabilities</th>
<th>Fair Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$13,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Accounts</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivable</td>
<td>0</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>20,000</td>
<td>23,000</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$33,000</td>
<td>$66,000</td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td>$33,000</td>
<td></td>
</tr>
</tbody>
</table>

Partner A retires from the partnership in accordance with an agreement whereby he is to receive $10,000 a year for three years, a total of $30,000 for his partnership interest. The value of A's capital interest in the partnership for purposes of § 736(b) is $12,000 (1/3 of $36,000, the sum of $13,000 cash and $23,000, the fair market value of fixed assets). The accounts receivable (unrealized receivership) are not included in A's capital interest in the partnership under § 730(b). Since the basis of A's interest is $11,000 ($10,000, the basis of his capital investment, plus $1,000, his share of partnership liabilities), he will realize a $1,000 capital gain on the sale of his interest in partnership property. The balance to be received by him, $18,000, constitutes payments under § 736(a) and is taxable to A as ordinary income.

This illustration is subject to criticism on two counts: (1) It assumes, as do all of the Senate and House Reports examples, that each partner's basis for his interest is equal to his share of the partnership's basis for its assets less his share of partnership liabilities. (2) It deals with liabilities in an unusual fashion. It either assumes that C is not released from his share of partnership liabilities, or it fails to comply with § 752(b) which treats release from liabilities as equivalent to a distribution.


Partnership ABC is a personal service partnership and its balance sheet is as follows:

partnership interest (for which he has a basis of $7,000) in exchange for all of the cattle belonging to the partnership.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership</td>
<td>Fair Market</td>
</tr>
<tr>
<td>Basis</td>
<td>Value</td>
</tr>
<tr>
<td>Cash</td>
<td>$15,000</td>
</tr>
<tr>
<td>Ranch</td>
<td>6,000</td>
</tr>
<tr>
<td>Cattle</td>
<td>0</td>
</tr>
<tr>
<td>Totals</td>
<td>$21,000</td>
</tr>
</tbody>
</table>

Of the $12,000 received by C (value of the cattle), $4,000 is treated as a distribution of his part of the partnership inventory. No gain is recognized at this time, C's basis for this portion of the cattle being zero.\(^63\) If sold within five years, this portion of the inventory produces ordinary income.\(^64\) The other $8,000 (in cattle) received by C is treated under section 751(b)(1)(A) as if obtained in exchange for C's interest in the other partnership assets, which has a fair market value of $8,000, and a basis of $7,000. C realizes a $1,000 capital gain, having received property (cattle) valued at $8,000 for an interest in partnership assets with a basis of $7,000. His basis for this portion of the cattle would be $8,000, its cost (the fair market value of the property given in exchange for it).

The partnership has, in effect, exchanged its part of the inventory (valued at $8,000) for $8,000 in capital assets. Since the partnership has no basis for these inventory items, the entire gain, under section 751(b)(1)(B), is ordinary income. It would seem that the partnership had a cost basis for that part of its capital assets acquired from C of $8,000 (the value of the inventory items given in exchange).\(^65\)

Assume now that the cash held by the partnership is $12,000 (instead of $15,000) and that the ranch, now valued at $12,000 with a basis to the partnership of $9,000, is given to C upon retirement.

In this instance C realizes $4,000 ordinary income on the exchange of his part of the inventory (for which he has no

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\(^63\) Int. Rev. Code of 1954, § 732, permits C to allocate his basis for his partnership interest to substantially appreciated inventory acquired through distribution, to the extent of the partnership's basis for the inventory (in this case zero).

\(^64\) Id. § 735(a)(2).

\(^65\) See note 58 supra.
basis) under 751(b) (1) (B). That portion of the ranch represented by the other $8,000 is considered a distribution and under section 731 no gain is recognized. C's basis for the ranch would probably be computed as follows: A cost basis of $4,000 would be allowed for the part received in exchange for inventory plus C's partnership basis, $7,000, which would be allocated to property (the ranch) received in distribution under section 732-(c) (2). This would give C a basis of $11,000 for the ranch.

The partnership would have a $4,000 cost basis for that part of the inventory which it acquired from C, and would realize a $2,000 capital gain on that portion of the ranch (two-thirds) given in exchange for C's interest in cash and inventory.

It should be noted that had C received a ranch valued at $15,000 in the last illustration, the $3,000 in excess of the value of his partnership interest would probably be considered payment for good will and treated as ordinary income under 736(a).

**DEATH OF A PARTNER — OLD LAW**

In those situations involving the death of a member of a partnership, problems of several types are encountered. Under the Code and cases prior to the new law, treatment of the various tax aspects of these problems was, for the most part, so inconsistent as to make any attempt at predicting the outcome in a given instance a hazardous undertaking.

One of the more litigated (and confused) questions in this area involved the determination of the period covered by the deceased partner's final income tax return. In those situations in which a partner used a different taxable year from that used by the partnership his death near the end of his taxable year, but only halfway through the partnership year, created a problem. Assume, for example, that the partner's taxable year ran from January 1st to December 31st while the partnership filed its returns on a July 1st to June 30th basis. If the partner died on December 20th, it is obvious that his share of partnership income reported in the partnership return of the previous June would be included in his final return. However, should his share of partnership income for the period between July 1st and December 20th also be included? This question was answered in the affirmative by the Supreme Court in *Guaranty Trust Co. v.*
Commissioner\textsuperscript{66} which held that, as to the deceased partner, the partnership year had ended abruptly at the time of his demise. This rule caused a "bunching" of income earned by the partnership in two different (partnership) years in the decedent's final return resulting in higher rates and the possible elimination of usable losses.\textsuperscript{67} While this decision was followed by the Court of Appeals for the Second Circuit,\textsuperscript{68} decisions in the third, fifth, and eighth circuits managed, by means of minor factual differences, to distinguish the Guaranty decision, holding that the deceased partner's share of income for the fractional part of the partnership year occurring prior to his death was to be included in his estate's return, and limiting the partnership income in the decedent's final return to that reported in the partnership return last preceding his death.\textsuperscript{69} However, even if the partner had been considerate enough to depart this world on the last day of the partnership's fiscal year, his heirs were still faced with other problems when they attempted to liquidate his interest.

A lump sum distribution of the value of the deceased partner's interest generally created no problem, nor did a distribution in kind of the decedent's share of partnership assets. This amount, the value of decedent's interest, was included in his gross estate\textsuperscript{70} and no gain or loss was recognized.\textsuperscript{71} The estate's basis for property received in such a distribution was its fair market value.\textsuperscript{72}

However, in those situations in which there existed a partnership agreement providing for payments to the estate out of partnership profits, the results were less clear. Here, as in the case of a retiring partner, the payments were said to represent

\textsuperscript{66} 303 U.S. 493 (1938).
\textsuperscript{67} For a detailed discussion of this problem, see Weyher & Flom, \textit{Death and Income Taxes— The Demise of a Partner}, 52 \textit{COLUM. L. REV.} 635 (1952).
\textsuperscript{68} Commissioner v. Estate of Waldman, 196 F.2d 83 (2d Cir. 1952) following an earlier case, Darcey v. Commissioner, 66 F.2d 531 (2d Cir. 1933), \textit{cert. denied}, 290 U.S. 705 (1934); see Grant v. Buser, 125 F. Supp. 93 (S.D. Ohio 1954).
\textsuperscript{69} Commissioner v. Mnookin's Estate, 184 F.2d 89 (8th Cir. 1950); Girard Trust Co. v. United States, 182 F.2d 921 (3d Cir. 1950); Henderson's Estate v. Commissioner, 155 F.2d 310 (5th Cir. 1946); see Northern Trust Co. v. Jarecki, 123 F. Supp. 623 (N.D. Ill. 1954).
\textsuperscript{70} Int. Rev. Code of 1939, § 811(k), added by 58 \textit{STAT.} 71 (1944) (now \textit{INT. REV. CODE OF 1954, § 2031(b)}).
\textsuperscript{71} If the distribution included payment for the decedent's share of partnership receivables, this amount \textit{might} have been "income in respect of a decedent." See note 78 \textit{infra}.
\textsuperscript{72} Int. Rev. Code of 1939, § 113(a)(5), as amended, 67 \textit{STAT.} 616 (1953) (now \textit{INT. REV. CODE OF 1954, § 1014}).
the purchase price for the decedent's interest in some instances and, in others, his share of post death partnership profits paid by the surviving partners under a mutual insurance plan. Treatment of the surviving partners was also similar to that found in the retirement situation. If the payments were considered a "purchase price," they were contributions to capital by the surviving partners and not deductible, whereas if the label "income" was placed on them, they were not taxed to the remaining partners. In either case the value of the right to receive the payments was included in the gross estate of the decedent. The estate paid income tax on "purchase price" payments only to the extent that they exceeded the value placed on the right to receive them for estate tax purposes. In the case of "income type payments, however, the estate was taxed on the entire amount of each payment.

A further complication was found in the application of section 126 of the 1939 Code which provided that income "in respect of a decedent" is taxable to its recipients, but allowed a credit for estate tax already paid on the right to receive such income. This provision applied to reduce the double tax on "income" payments, and at the same time to bring certain portions of "purchase price" payments within the scope of both taxes.

73. Edwards v. Commissioner, 102 F.2d 757 (10th Cir. 1939); Pope v. Commissioner, 39 F.2d 420 (1st Cir. 1930); Hill v. Commissioner, 38 F.2d 165 (1st Cir. 1930), cert. denied, 281 U.S. 761 (1930); Benedict v. Price, 38 F.2d 309 (E.D.N.Y. 1929); Raymond S. Wilkins, 7 T.C. 519 (1946), affirmed, 161 F.2d 830 (1st Cir. 1947); H. Lewis Brown, 1 T.C. 760 (1943), affirmed, 141 F.2d 307 (2d Cir. 1944); Estate of Bavier C. Miller, 38 B.T.A. 487 (1938); W. Frank Carter, 36 B.T.A. 60 (1937); Arthur C. Hilmer, 27 B.T.A. 1165 (1933); Lester G. Hathaway, 16 B.T.A. 1318 (1929).


76. Estate of Bavier C. Miller, 38 B.T.A. 487 (1938); City Bank Farmers Trust Co., Executor, 29 B.T.A. 100 (1933); Bavier C. Miller Trust, P-H B.T.A. Mem. Dec. ¶ 62256 (1940); see Estate of George R. Nutter, 46 B.T.A. 35 (1942).

77. Bull v. United States, 295 U.S. 247 (1935); but see McClennen v. Commissioner, 131 F.2d 165 (1st Cir. 1942); see Gussie K. Barth, 35 B.T.A. 546 (1937).

78 U.S. Treas. Reg. 118, § 39.126(2)-1 (1939). This regulation gives an illustration involving payments for the interest of a deceased partner, dividing them into payments for tangible assets on which no gain is recognized and those for an "interest in the previously earned proportion of the unfinished partnership business transactions" which were ordinary income. This would seem to indicate that
DEATH OF A PARTNER — NEW LAW

By providing that "the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year," the new Code repudiates Guaranty Trust Co. v. Commissioner and thus eliminates one of the more troublesome pre-revision problems. That this provision is intended to prevent the "bunching" of income is not open to doubt in light of the following excerpt from the Senate Report:

"The application of these provisions in the case of the death of a partner may be summarized as follows: The partnership taxable year will continue to its normal conclusion both for the remaining partners and with respect to the decedent partner. The last return of the decedent partner will include only his share of partnership income for the partnership taxable year ending with or within the last taxable year of the decedent partner. The income of the succeeding partnership taxable year which is attributable to the interest of the decedent in the partnership will be includible in the return of his estate or successor at interest. In general, the same rule applies, except as modified by the partnership agreement, where the interest of the decedent partner in the partnership is liquidated in connection with his death."

Section 736 of the 1954 Code, discussed earlier in connection with retirement from a partnership, also applies to payments made to the heir or estate of a deceased partner. As in the retirement situation, this provision, when read in conjunction with section 751, divides such payments into three categories: (1) those attributable to "unrealized receivables" and good will (except as provided for in the partnership agreement, (2) those

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79. INT. REV. CODE OF 1954, § 706(c) (2) (A) (ii).
81. Since INT. REV. CODE OF 1954, § 736, addresses itself to "payments" made to the heir or estate of a deceased partner, presumably a distribution in kind is still covered by § 731, although no gain would be recognized either on the receipt or sale of the property because the estate takes as its basis the fair market value of the interest at time of the partner's death under § 1014, and this basis is allocated to the various assets received in distribution under § 732.
given in payment for "substantially appreciated inventory," and (3) those made for the balance of the partnership interest.

The value of the right to receive all payments is includible in the gross estate of the decedent.82 That portion of the payments designated by section 736(a) as a "distributive share" or "guaranteed payment" is clearly taxable to the heir or estate receiving it as ordinary income. However, since such payments are specifically designated "income in respect of a decedent" by section 753, credit will be given for the estate tax paid on the right to receive them.83 Payments to an heir or estate subject to treatment as sale proceeds (751(b)) or a distribution (731) will presumably be accorded the same tax treatment given "purchase price" payments under the old law, i.e., subjected to income tax only in those cases in which they exceed the value placed on the right to receive them for estate tax purposes.

As in the retirement situation, the surviving partners will not be taxed on 736(a) payments and should be entitled to a new basis for that portion of the "substantially appreciated inventory" formerly belonging to the decedent either as a cost basis, or through a basis adjustment under section 743(b). The basis adjustment available to the partnership under section 734 in the retirement situation will probably not be allowed here since that adjustment was dependent upon recognition of a gain to the distributee under section 731 which will not occur here.84

82. Id. § 2031; cases cited note 75 supra.
83. INT. REV. CODE OF 1954, § 691(c).
84. See note 81 supra. This assumes, as was done in the retirement situation, that in computing gain or loss on "distributions" under § 731, that portion of the partner's basis for his interest allocated to receivables and good will (§ 736) and appreciated inventory (§ 751) will be deducted from the basis for the partnership interest used. If this were not the case, computations under § 731 might frequently result in capital losses, since the deceased partner's estate has as its basis for his share of receivables and inventory their fair market value, and since the estate's basis for items received in distribution (fair market value) is equal to the value of the items (or payments) received, the inclusion of its bases for the receivables, goodwill, and inventory items mentioned above in a § 731 computation would result in a capital loss in the amount of these bases.

It should also be noted that § 734(b)(1)(B) provides that in distributions in kind, the partnership may adjust its bases for remaining property by the difference between the bases of distributed items in the hands of the partnership before distribution and that of the distributee for the items after distribution. In light of the deceased partner's "stepped up" basis, would this be applicable in the case of payments received in distribution under §§ 736 and 731? It could be argued that although cash is distributed (and it has a universal basis), it represents property which has appreciated in value.
OTHER PROBLEMS

There are several problems too general in nature for discussion under one of the preceding sections which should be pointed out at this time.

Section 736 singles out payments attributable to good will for special (ordinary income) treatment in death or retirement situations. Such treatment is applied only to good will not provided for in the partnership agreement. In view of the language found in some of the pre-revision cases indicating a reluctance on the part of the courts to admit the existence of good will in the case of a personal service partnership, it may be impossible for such firms to secure capital gains treatment for good will even if provision is made in the partnership agreement.

Another foreseeable problem in connection with good will springs from the difference in its treatment under section 736 from that accorded it under section 751. Assume, for example, that A holds an interest in a partnership whose sole assets are unappreciated capital items worth $15,000 (a building, basis $5,000, value $5,000, and land, basis $10,000, value $10,000) and has a cost basis for this partnership interest of $15,000. If A retires and receives $20,000 from his former associates, his $5,000 gain is attributable to good will and is ordinary income under section 736, whereas if he sells his interest to an outsider, the $5,000 increment is capital gain since it is not attributable to receivables or appreciated inventory. On the other hand, the remaining partners get tax benefit under the retirement plan (they pay no tax on the $5,000) but if a sale takes place the best they can hope for is an adjustment to partnership basis. Whether or not it is possible for a partner to "sell" his interest to his associates and thus bring a transaction equivalent to retirement within the province of section 751 remains to be seen.

It seems certain that in the process of litigation there must be a narrowing of the definition of "unrealized receivables" provided in section 751. Literally applied, this can be used to include items obviously not within the scope of congressional

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86. W. Frank Carter, 36 B.T.A. 60 (1937); John G. Madden, 5 COH Tax Ct. Mem. 559 (1946); see Nigel L. Campbell, 1 B.T.A. 441 (1925).
intent. Certain fringe items, such as suppliers' service contracts and attorneys' contingent fee contracts may or may not fall within the new definition.

It should be pointed out also that the optional or elective character of basis adjustments provided for under the new provisions may prove troublesome in some instances.87

CONCLUSION

Although the new provisions dealing with partnership interests have eliminated many of the problems existing under the old law, there are still many unanswered questions and several seeming inconsistencies. The two main weaknesses in the new sections are: (1) failure to provide a system which would effectively equalize partners' and partnership bases, and (2) the difference in formulae used in the characterization of gain in sale and retirement situations. It is hoped that these, as well as the several lesser problems left unsolved by the new provisions, will be eliminated by the issuance of definitive regulations or, if still needed, by further legislative action.

87. See Phillips, Some Aspects of Taxation of Partners and Partnerships Under the New Internal Revenue Code, 34 Neb. L. Rev. 25, 44 (1954). This article points out the possibility of the partner losing benefits of § 743(b) because the partnership has not elected to use these adjustments.