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Partnership Distributions: Whatever Happened to Nonrecognition?

BY CHRISTOPHER H. HANNA*

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INTRODUCTION

In developing the Internal Revenue Code of 1954, Congress went to great lengths to provide general nonrecognition treatment for partners and partnerships on partnership distributions of money or other property. There were only a few exceptions to the general rule of nonrecognition. In the last ten years, however, Congress has enacted several extremely important exceptions to the general rule of nonrecognition on partnership distributions so that today the exceptions very nearly swallow the general rule. Furthermore, with the increasing popularity of limited liability companies (which the Internal Revenue Service has ruled will be taxed as a partnership¹) and the creation of registered limited liability partner-

¹ See, e.g., Rev. Rul. 93-53, 1993-26 I.R.B. 7 (classifying a Florida limited liability company as a partnership); Rev. Rul. 93-50, 1993-25 I.R.B. 13 (classifying a West Virginia limited liability company as a partnership); Rev. Rul. 93-49, 1993-25 I.R.B. 11 (deciding that an Illinois limited liability company may be taxed as a partnership or an association depending on the provisions of the limited liability company agreement); Rev. Rul. 93-38, 1993-21 I.R.B. 4 (deciding that a Delaware limited liability company may be

ships,² the partnership distribution provisions have taken on added significance.

This Article analyzes the exceptions to the general rule of nonrecognition for partnership distributions beginning in Part I with an historical

taxed as a partnership or an association depending on the provisions of the limited liability company agreement); Rev. Rul. 93-30, 1993-16 I.R.B. 4 (classifying a Nevada limited liability company as a partnership); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (classifying a Colorado limited liability company as a partnership); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (classifying a Virginia limited liability company as a partnership); Rev. Rul. 88-76, 1988-2 C.B. 360 (classifying a Wyoming limited liability company as a partnership).

The following state statutes authorize the formation of limited liability companies ("LLC"): ALA. CODE §§ 10-12-1 to -61 (Supp. 1993); ARIZ. REV. STAT. ANN. §§ 29-601 to -857 (West Supp. 1993); COLO. REV. STAT. §§ 7-80-101 to -913 (Supp. 1992); 1993 CT. ALS 267, Pub. Act No. 93-267; DEL. CODE ANN. tit. 6, §§ 18-101 to -1106 (Supp. 1992); FLA. STAT. ANN. §§ 608.401-471 (West 1993); GA. CODE ANN. §§ 14-11-100 to -1109 (Michie Supp. 1993) (effective Mar. 1, 1994); IDAHO CODE §§ 53-601 to -672 (Supp. 1993); ILL. ANN. STAT. ch. 805, para. 180/1-1 to /60-1 (Smith-Hurd Supp. 1993) (effective Jan. 1, 1994); IND. CODE ANN. §§ 23-16-10.1-1 to -10.1-4 (Burns Supp. 1992); (relating only to foreign limited liability companies); IOWA CODE ANN. §§ 490A.100-.1601 (West Supp. 1993); KAN. STAT. ANN. §§ 17-7601 to -7651; LA. REV. STAT. ANN. §§ 1301-69 (West Supp. 1993); MD. [CORPS. & ASS'NS] CODE ANN. §§ 4A-101 to -1103 (1992); MINN. STAT. ANN. §§ 322B.01-.955 (West Supp. 1993); MO. ANN. STAT. §§ 359.700-.832 (Vernon Supp. 1993) (effective Jan. 1, 1994); MONT. CODE ANN. §§ 35-8-101 to -1307; 1993 Neb. Laws 121; NEV. REV. STAT. §§ 86.010-.571; 1993 N.H. Laws 313; 1993 N.J. Laws Ch. 210; N.M. STAT. ANN. §§ 53-19-1 to -74 (Michie Supp. 1993); N.D. CENT. CODE §§ 10-32-01 to -155 (Supp. 1993); OKLA. STAT. ANN. tit. 18, §§ 2000-60 (West Supp. 1992-1993); R.I. GEN. LAWS. §§ 7-16-1 to 7-16-75 (1992); S.D. CODIFIED LAWS ANN. §§ 47.34-1 to -59 (Supp. 1993); TEX. REV. CIV. STAT. ANN. art. 1528n (West 1993); UTAH CODE ANN. §§ 48-26-102 to -157 (Supp. 1993); VA. CODE ANN. §§ 13.1-1000 to -1073 (Michie 1993); W. VA. CODE §§ 31-1A-1 to -69 (Supp. 1993); and WYO. STAT. §§ 17-15-101 to -136 (1993). In addition, Mississippi has enacted legislation recognizing limited liability companies formed in other states. 1993 Miss. Laws 530.

The following eleven states are considering LLC legislation: California, S.B. 469 (authorizes the creation of limited liability companies); Hawaii, H.B. 1777, 17th Leg., 1st Sess.; Maine, H.B. 1123, 116th Leg., 1st Sess.; Michigan, 1993 MI. ALS 23, H.B. 4023, 86th Leg.; New York, A.B. 8676, 215th General Assembly, 1st Sess.; North Carolina, 1993 N.C. ALS 354, 140th Assembly, H.B. 923; Ohio, S.B. 74, 120th General Assembly; Oregon, 1993 ORE. ALS 173, S.B. 285 67th Leg.; Pennsylvania, H.B. 1719 176th General Assembly; Tennessee, H.B. 952 (Tennessee Limited Liability Company Act); and Washington, H.B. 1235, 53d Leg.

² Texas was the first state that provided for a registered limited liability partnership. See TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (West Supp. 1993) (providing for limited liability); *id.* § 45-A (establishing the procedure for registration). For a discussion of the registered limited liability partnership, see R. Dennis Anderson et al., *Registered Limited Liability Partnerships*, State Bar of Texas—Bulletin of the Business Law Section, Sept. 1991, at 1.

overview of the Internal Revenue Code of 1954.³ The next two parts of the Article discuss the distribution provisions that result in gain or loss to a partner under current law. Part II discusses distributions that result in gain or loss to a distributee partner,⁴ while Part III addresses distributions that result in gain or loss to a non-distributee partner.⁵ In Part IV, the Article focuses on distributions that are recharacterized as other types of transactions that may result in gain or loss to a partner.⁶ Part V critiques the distribution provisions as they exist today.⁷ The Article concludes that Congress should repeal several distribution provisions while retaining much of the general structure of the distribution provisions in subchapter K.⁸

Some terminology needs to be addressed. Unless otherwise stated, the following terms will be used as defined in this paragraph. The term "liquidating distribution" means a distribution of money or other property that is made in liquidation of a partner's interest.⁹ "Current distribution" means a distribution of money or other property that is not a liquidating distribution.¹⁰ An "advance" or "draw" against a partner's distributive share of partnership income is not treated as a distribution until the last day of the partnership taxable year.¹¹ The terms "cash" and "money" are

³ See *infra* notes 13-101 and accompanying text.

⁴ See *infra* notes 102-60 and accompanying text.

⁵ See *infra* notes 161-223 and accompanying text.

⁶ See *infra* notes 224-98 and accompanying text.

⁷ See *infra* notes 299-349 and accompanying text.

⁸ For articles advocating more radical changes to the distribution provisions in subchapter K, see, for example, William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Noël B. Cunningham, *Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991) (commenting on the specifics of Professor Andrew's article and generally endorsing his suggestions for improving the law regarding partnership distributions); Mark P. Gergen, *Reform Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173 (1991). But see John P. Steines, *Unneeded Reform*, 47 TAX L. REV. 239 (1991) (disagreeing with Professor Gergen's thesis that the current law allows too many abuses regarding partnership distributions and criticizing Professor Gergen's specific recommendations as being too complicated).

⁹ Treas. Reg. § 1.761-1(d) (as amended in 1972) ("[L]iquidation of a partner's interest means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.").

¹⁰ *Id.* "Current distributions" are sometimes referred to as "operating distributions" or "nonliquidating distributions."

¹¹ Treas. Reg. § 1.731-1(a)(1)(ii) (1960). It is sometimes difficult to distinguish an advance (or draw) from a distribution. The leading commentators suggest that Regulation § 1.731-1(a)(1)(ii) "is probably limited to cases in which the distributee is obligated to restore or return the distribution to the extent it exceeds his distributive share of

used interchangeably in this Article as are the terms "carryover basis" and "transferred basis."¹² Only minimal coverage will be given to the adjusted basis of distributed property, its character and holding period, and any basis adjustments to both the partner and the partnership upon a partnership distribution.

I. HISTORICAL BACKGROUND OF THE INTERNAL REVENUE CODE OF 1954 REGARDING PARTNERSHIP DISTRIBUTION PROVISIONS

Prior to the Internal Revenue Code of 1954 (the "1954 Code"),¹³ some confusion existed with respect to the appropriate tax treatment of partnership distributions as well as other partnership provisions.¹⁴ One of Congress' objectives in developing the 1954 Code was to clarify the

partnership income." WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 19.03[2] (2d ed. 1990); see, e.g., *White v. Commissioner*, 991 F.2d 657 (10th Cir. 1993); *Seay v. Commissioner*, 63 T.C.M. (CCH) 2911 (1992); Rev. Rul. 92-97, 1992-2 C.B. 124; Rev. Rul. 81-242, 1981-2 C.B. 147; Rev. Rul. 81-241, 1981-2 C.B. 146.

¹² "Carryover basis" is a term that is rarely used in the Code. It is, however, a term that is still commonly used among tax practitioners instead of "transferred basis." "Transferred basis" is defined in § 7701(a)(43):

The term "transferred basis property" means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

I.R.C. § 7701(a)(43) (1988).

¹³ Pub. L. No. 83-591, 68A Stat. 3 (1954).

¹⁴ As many commentators have noted, much of the law relating to partnerships was found not in the statute but rather in regulations, rulings, and court decisions which were often incomplete and frequently contradictory. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4091 [hereinafter H.R. REP. NO. 1337]; see S. REP. NO. 1622, 83d Cong., 2d Sess. 89 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4721 [hereinafter S. REP. NO. 1622]; *General Revenue Revision: Hearings Before the Committee on Ways and Means, House of Representatives*, 83d Cong., 1st Sess. 1368, 1369 (1953) [hereinafter 1953 *Revenue Hearings*] (statement of Mark H. Johnson, Esq. on behalf of the American Bar Association); Jacob Rabkin & Mark H. Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909, 920-33 (1942); J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 112 (1954) [hereinafter Jackson, *A Proposed Revision*]; J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1183-84 (1954) [hereinafter Jackson, *The Internal Revenue Code of 1954*]; Mark H. Johnson, *Taxation of Partnerships*, 1952 A.B.A. SEC. OF TAX'N 46, 56 (Report of the Committee on Taxation of Partnerships) [hereinafter *Partnership Report from the Thirteenth Annual ABA Meeting*].

partnership tax provisions, including those relating to partnership distributions. Undertaking "the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws,"¹⁵ the Ways and Means Committee of the House of Representatives ("Ways and Means Committee") conducted hearings in June, July, and August of 1953 on a number of different tax topics, including one related to the taxation of partnerships. Consequently, a number of taxpayers gave statements and sent in letters to the Ways and Means Committee regarding the taxation of partnerships.¹⁶

A. American Bar Association

The most substantive statement at the Ways and Means Committee hearings was presented by the American Bar Association Section of Taxation (the "ABA Tax Section").¹⁷ The ABA Tax Section's recommendations stemmed in large part from the original comments of the ABA Tax Section Partnership Committee, which were released in September, 1949, at the Tenth Annual Meeting of the ABA Tax Section.¹⁸

¹⁵ H.R. REP. NO. 1337, *supra* note 14, at 4091.

¹⁶ See 1953 Revenue Hearings, *supra* note 14, at 1363 (statement of F. N. Bard); *id.* at 1368 (statement of Mark H. Johnson); *id.* at 1386 (statement of Randolph Paul on behalf of Howard F. Knipp); *id.* at 1387 (letter from L. Blaine Liljenquist on behalf of Western States Meat Packers Association, Inc.); *id.* at 1388 (letter from Thomas Jefferson Miley on behalf of Commerce and Industry Association of New York, Inc.); *id.* at 1389 (statement by Addison B. Clohosey on behalf of Research Institute of America); *id.* at 1390 (statement of W. W. Findley on behalf of the West Side Lumber Association and the Citizens of the State of Arkansas); *id.* at 1391 (statement of the American Institute of Accountants).

¹⁷ The Committee on Taxation of Partnerships (the "Partnership Committee") of the ABA Tax Section had, beginning in 1947, worked more than five years in formulating its recommendations for an overall statute covering the income taxation of partnerships. See 1953 Revenue Hearings, *supra* note 14, at 1368 (statement of Mark H. Johnson, Esq.); Mark H. Johnson, *Taxation of Partnerships*, 1949 A.B.A. SEC. OF TAX'N 89, 92 (Report of the Committee on Taxation of Partnerships) [hereinafter *Partnership Report from the Tenth Annual ABA Meeting*]. Apparently, the Partnership Committee was created, in large part, as a response to the publication of Rabkin and Johnson's seminal article on the taxation of partnerships in the *Harvard Law Review* in 1942, *supra* note 14. See ARTHUR B. WILLIS, *HANDBOOK OF PARTNERSHIP TAXATION* at v (1957).

¹⁸ These recommendations were the subject of a symposium at the Tenth Annual Meeting in St. Louis. The *Outline of the American Bar Association Symposium on Taxation of Partnerships* is reproduced in Paul Little, *Federal Income Taxation of Partnerships* 399 app. II (1952).

The original comments in 1949 identified eight major tax issues, one of which was partnership distributions. The Partnership Committee separated distributions into two categories: (1) current distributions by partnerships and (2) distributions in the winding up of the partnership business or the retirement of a partner. *Partnership Report From the Tenth Annual ABA Meeting*, *supra* note 17, at 92. The Partnership Committee proposed the adoption of a section that it had numbered as 193. *Id.* at 90. Under proposed § 193(a), the distributee partner would recognize gross income to the extent that the amount distributed exceeded the distributee's basis in his partnership interest at the close of the partnership's taxable year. *Id.* Part or all of this gross income could be treated as capital gain under proposed § 193(d) if the income were attributable to the value of property retained by the partnership or to the value of property previously distributed to another partner. *Id.* at 96. The Partnership Committee stated that recognition of gross income would arise in one of two situations: (1) the partner "purchased his partnership interest for less than his capital on the books," or (2) the partner "receive[d] credit for appreciated property which [was] either retained by the partnership or distributed to another partner." *Id.* at 95.

If the amount distributed were property other than money, then under proposed § 193(b) the amount distributed would be equal to the basis of the property to the partnership immediately prior to the distribution. The distributee would take the property with a carryover basis. *Id.* at 90. The Partnership Committee had considered several other approaches before adopting the carryover basis approach. One alternative approach was to treat the distribution of either appreciated or depreciated property as resulting in the recognition of gain or loss to the non-distributee partners. Another alternative was to adjust the bases of the remaining partnership property. The Partnership Committee rejected both of these alternative approaches because of their artificiality and complexity. *Id.*

As to the partnership and the non-distributee partners, under proposed § 193(c) no gain or loss would be recognized by them. If property were contributed to the partnership and then distributed to another partner, however, the contributing partner would recognize gain or loss "in accordance with regulations prescribed by the Commissioner . . . in such manner as to reflect any difference between the basis of [the] property and the amount credited to the account of the contributing partner." *Id.* For example, assume A contributed property with a basis of \$2 and a value of \$10 to a partnership. The partnership then distributed the property to partner B. At the time of the distribution to B, A would have \$8 of gain, representing the difference between the basis and the amount credited to A's account on contribution. *Id.* at 96.

The ABA's proposed § 193(c) was not enacted by Congress as part of the 1954 Code. In fact, Congress left proposed § 193(c) untouched for exactly forty years, finally enacting it in 1989 (in a slightly modified form) as section 704(c)(1)(B) of the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642(a), 103 Stat. 2106, 2379-81 (1989). See *infra* text accompanying notes 165-223, for a discussion of section 704(c)(1)(B).

In the case of distributions to a partner in the course of the winding up of the partnership business or the partner's retirement from the partnership, the Partnership Committee provided a separate set of rules in its proposed § 194. *Partnership Report from the Tenth Annual ABA Meeting*, *supra* note 17, at 90-91. This proposed approach was, in essence, a substituted basis approach as opposed to a carryover basis approach. In

The Partnership Committee essentially based the statute that it presented in its revised set of recommendations (as well as in its original 1949 recommendations) upon the then-present (pre-1954) concepts contained in the Code.¹⁹ In the case of current distributions, the Partner-

proposed § 194(a) the Partnership Committee provided that if the distributee received money in excess of his basis in the partnership, the excess would be included in the distributee's gross income. *Id.* at 91. Conversely, if the distributee received money that was less than his basis in the partnership, the excess basis would be deductible as a loss. *Id.* This recognition of gain or loss could occur "if the partner originally acquired his interest for more or less than his capital account" or if the partner was being redeemed out at a bargain or at a premium. *Id.* at 96. The distributee partner could also recognize a loss if under proposed § 194(a) he received property in addition to money, but only if the fair market value of the property was less than one-half of the amount of loss realized on the distribution. *Id.* at 91.

The Partnership Committee also made a recommendation in its proposed subsections (c) and (d) to section 194 that appears to be the forerunner of section 751(b) (involving disproportionate distributions). For a discussion of section 751(b), see *infra* text accompanying notes 140-46, 162-64. Regarding subsection (c), the Partnership Committee stated that "if a distribution to the taxpayer partner takes into account either unrealized appreciation or depreciation in the value of property retained by the partnership or distributed to another partner, he should realize his proportionate share of such appreciation or depreciation." *Partnership Report from the Tenth Annual ABA Meeting*, *supra* note 17, at 96. In addition, if the partnership would have realized capital gain or loss on the sale of such property, then the partner's gain or loss should also be capital. As a result, the provision was apparently both a recognition as well as a characterization provision. The Partnership Committee stated that "[t]his provision is somewhat analogous to the proposed section 193(d) [a characterization provision], except that here either gain or loss may be recognized." *Id.*

The Partnership Committee gave an example of section 194(c)'s application. Assume ABC Partnership has three equal partners, A, B, and C. The partnership has \$100 cash plus property with a basis of \$20 and a value of \$50. Each partner has a \$40 basis in his partnership interest. Partner A retires and receives \$50 cash from the partnership. He has \$10 of gain that is considered to be from the sale of the property retained by the partnership. In addition, the partnership increases its basis in the property from \$20 to \$30. *Id.*

The Partnership Committee also included a provision which covered the converse situation in its proposed section 194(d). If the partnership distributed appreciated or depreciated property to a partner, the remaining partners would take into account any gain or loss realized by them with respect to the distributed property. If, for example, partner A received the property worth \$50 instead of \$50 cash on retirement, partner A would recognize no gain but partners B and C would each recognize \$10 of gain. As a result, partners B and C would each increase their basis in their partnership interest by \$10. *Id.* at 96-97.

¹⁹ This Article only discusses some of the major provisions of the ABA recommendation regarding partnership distributions. For more thorough coverage, see *1953 Revenue Hearings*, *supra* note 14, at 1368-86 (statement of Mark H. Johnson and the appendix thereto); *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at

ship Committee's revised recommendation stated simply: "No gain or loss shall be recognized to the partnership or the partners upon the distribution."²⁰ The distributee partner would take the property with a carryover basis from the partnership.²¹ These two provisions had the advantages of certainty and simplicity. There would no longer be a difference in the amount of gain or loss realized depending upon whether the partnership or the partners sold the property.²²

The Partnership Committee also recommended rules to govern the distributions of property to a partner in the course of winding up the

46-66.

²⁰ *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at 50 (proposed section 191(a)). Apparently, pre-1954 law provided for nonrecognition of gain or loss on a distribution of property even though no provision in the Internal Revenue Code of 1939 (the "1939 Code") specifically so stated. See Rabkin & Johnson, *supra* note 14, at 922 n.31; Mark H. Johnson, *Property Distributions by Partnerships*, 4 TAX L. REV. 118, 120 (1948).

²¹ *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at 50-51 (proposed section 191(b)). Under pre-1954 law, the basis of property distributed by a partnership to a partner "[was] such part of the basis in his hands of his partnership interest as [was] properly allocable to such property." Internal Revenue Code, Pub. L. No. 76-1, § 113(a)(13), 53 Stat. 1, 43 (1939) (Section 113(a)(13) of the 1939 Code). The Service interpreted this to mean that when property was distributed in kind pro rata to the partners, the basis of the distributed property equalled the portion of the distributee's basis in his partnership interest that the value of the distributed property bore to the value of all partnership assets immediately prior to the distribution. Gen. Couns. Mem. 20251, 1938-2 C.B. 169, 169-70. Many commentators questioned the reasonableness of the Service's position. See, e.g., Rabkin & Johnson, *supra* note 14, at 923; Jackson, *The Internal Revenue Code of 1954*, *supra* note 14, at 1212-13; 1953 Revenue Hearings, *supra* note 14, at 1382 app. (statement of Mark W. Johnson); Johnson, *supra* note 20, at 119 ("Under the present statute [section 113(a)(13)], there are two possible approaches. One is sensible, and the other represents the Bureau's position [G.C.M. 20251].").

Pre-1954 law led to easy tax manipulation by partnerships. For example, assume AB Partnership, with A and B being equal partners. The AB Partnership has three assets: (1) Blackacre, which has a basis and value of \$100,000, (2) Whiteacre, which has a basis of \$10,000 and a value of \$100,000, and (3) cash of \$100,000. Each partner's basis in his partnership interest is \$105,000. The AB Partnership distributes Blackacre to A and Whiteacre to B as current distributions. Under pre-1954 law, each partner's basis for his distributed property would be \$70,000 (two-thirds of \$105,000). If, for example, B were to sell Whiteacre for its value of \$100,000, B would only recognize gain of \$30,000. If the AB Partnership had instead sold Whiteacre, the partnership would have had a gain of \$90,000. As a result, a partnership could increase the basis of its assets that have greatly appreciated in value by disposing of them by way of current distributions. Jackson, *A Proposed Revision*, *supra* note 14, at 134.

²² See Rabkin & Johnson, *supra* note 14, at 922-23, for an example of how pre-1954 law created a difference in the amount of gain realized depending upon whether the partnership or the partners sold the property. See also the example at *supra* note 21.

partnership activity, the distributee's retirement from the partnership, or the reduction of the distributee's interest in the aggregate partnership property.²³ Generally, gain or loss *would be recognized* in two situations. First, the distributee partner would recognize gain to the extent that the amount realized, after excluding the value of any distribution of property other than money, exceeded the basis of his interest in the aggregate partnership property.²⁴ In other words, gain would be recognized to the extent that money alone exceeded the partner's basis in his partnership interest.²⁵ Second, the partner would recognize loss if the distribution consisted entirely of money, to the extent that the partner's basis in the partnership interest exceeded the amount of money received.²⁶ If the distribution included property other than money, loss would be recognized only if the loss exceeded an amount equal to twice the value of the distributed property other than money.²⁷ In addition, in the case of a retirement or reduction of interest of the distributee partner, the remaining partners would be forced to recognize gain or loss if the bases of the remaining partnership assets could not be properly adjusted.²⁸ Generally, the basis of any distributed property in liquidation of a partner's interest would be a substituted basis.²⁹

The Partnership Committee believed that "the problems arising from a disproportionate liquidating distribution"³⁰ deserved special consideration. Consequently, it recommended the following provision:

²³ *Partnership Report from the Thirteenth Annual ABA Meeting, supra* note 14, at 51-53 (proposed section 194).

²⁴ *Id.* at 51-52 (proposed section 194(a)(1)).

²⁵ This proposal was quite a change from the Partnership Committee's original recommendation that gross income be recognized if the amount distributed, including property other than money, exceeded the partner's basis in his partnership interest at the end of the partnership's taxable year. *See supra* note 18. Congress would make this same change in 1954.

²⁶ *Partnership Report from the Thirteenth Annual ABA Meeting, supra* note 14, at 52 (proposed section 194(a)(2)).

²⁷ *Id.*

²⁸ *Id.* at 52-53 (proposed section 194(c)(1)). The remaining partners were allowed an adjustment to the bases of property retained by the partnership "to reflect the cost [to them] of acquiring the distributee partner's interest in the partnership properties retained by the partnership." *Id.* at 53. An elective rule was available to avoid making this adjustment to partnership property in proposed section 194(c)(2). If elected, the adjustment was made to the remaining partners' bases in their partnership interests as opposed to adjusting the partnership's bases in its assets. *Id.*

²⁹ *Id.* at 52 (proposed section 194(b)).

³⁰ 1953 *Revenue Hearings, supra* note 14, at 1378 app. (statement of Mark H. Johnson). *See infra* text accompanying notes 140-46, 162-64, for a discussion of disproportionate liquidating distributions.

In the case of a retirement of a partner or the reduction of his interest, that partner shall be treated as first having realized his distributive share of the ordinary income or loss and the capital gain or loss which would have been realized by the partnership on a sale for value of all its properties, except those received by him as part of his distribution, and then as having received his distribution as on the winding up of the partnership.³¹

Apparently, this provision was designed to prevent the conversion of ordinary income into capital gain through the use of collapsible partnerships.³² At the partner's election, the ordinary income component could be included in gross income over three years in order to alleviate the hardship of including it all at once.³³ The Partnership Committee gave no example as to the operation of this provision.

B. American Law Institute

At about the same time that the ABA Tax Section was working on its recommendations for the overhaul of the taxation of partners and partnerships, the American Law Institute (the "ALI") was working on a monumental income tax project that included substantial changes to the taxation of partners and partnerships.³⁴ In fact, the ALI used the

³¹ *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at 52 (proposed section 194(a)(3)(B)).

³² *1953 Revenue Hearings*, *supra* note 14, at 1385 app. (statement of Mark H. Johnson).

³³ *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at 52 (proposed section 194(a)(3)(B)).

³⁴ The ALI began work on its income tax project in 1948 with work in the partnership area beginning in 1949. See *1953 Revenue Hearings*, *supra* note 14, at 1370 ("The tax section committee has cooperated very closely . . . with the monumental income tax project of the American Law Institute.") (statement of Mark H. Johnson); WILLIS, *supra* note 17, at v; Arthur B. Willis, *Report of the Committee on Taxation of Partnerships*, A.B.A. SEC. TAX'N 98-101 (1954) [hereinafter *Partnership Report from the Fifteenth Annual ABA Meeting*]; *The Internal Revenue Code of 1954: Hearings Before the Committee on Finance, United States Senate on H.R. 8300, An Act to Revise the Internal Revenue Laws of the United States*, 83d Cong., 2d Sess. 459-80 (1954) [hereinafter *Hearings Before the Committee on Finance for H.R. 8300*]. Only some of the major provisions of the ALI Draft regarding partnership distributions are discussed in this Article. For more thorough coverage, see Jackson, *A Proposed Revision*, *supra* note 14, at 109 and Stanley S. Surrey & William C. Warren, *The Income Tax Project of the American Law Institute: Partnerships, Corporations, Sale of a Corporate Business, Trusts and Estates, Foreign Income and Foreign Taxpayers*, 66 HARV. L. REV. 1161, 1165-76

Partnership Committee of the ABA Tax Section's 1949 original recommendations as its starting point in its study of partnerships.³⁵ Like the ABA Tax Section, the ALI categorized distributions into two categories. Regarding the tax treatment of the first category, current distributions, the ALI considered two completely different approaches: a substituted basis approach and a carryover basis approach. Under the substituted basis approach, "[t]he basis of any currently distributed property in the hands of the distributee would be equal to his own basis for his interest in that property, plus a substituted basis equal to the basis of his interest in the properties (including money) currently distributed to the other distributees, less his interest in any cash received by him."³⁶ The ALI rejected this approach, however, in favor of a carryover basis approach.³⁷

Under the carryover basis approach, the distributee partner would take the property with a carryover basis from the partnership with no gain or loss being recognized on the current distribution.³⁸ This was the same approach that the Partnership Committee of the ABA Tax Section had adopted in its recommendation.³⁹ As a result, under the ALI Draft, no gain or loss would be recognized by the partnership or the partners on a current distribution of property.⁴⁰

In the case of a distribution of property to a partner in the course of winding up the partnership activity, the distributee's retirement from the partnership, or the reduction of the distributee's interest in the aggregate

(1953).

³⁵ *Partnership Report from the Thirteenth Annual ABA Meeting*, *supra* note 14, at 55.

³⁶ Jackson, *A Proposed Revision*, *supra* note 14, at 134.

³⁷ *See id.* at 176-77 app. (proposed section X754 adopted a carryover basis approach). As to liquidating distributions, however, the ALI adopted the substituted basis approach. *See infra* text accompanying notes 41-51.

³⁸ *See* Jackson, *A Proposed Revision*, *supra* note 14, at 176-77 app. (proposed section X754); *see id.* at 136 (discussing proposed section X754).

³⁹ That the ALI and ABA adopted the same carryover basis approach should have come as no surprise since Mark H. Johnson was both actively involved in the creation of the ALI draft (in addition to being a special consultant to the ALI) and served as chairman of the Partnership Committee of the ABA Tax Section that was involved in overhauling the tax treatment of partnerships. *See 1953 Revenue Hearings*, *supra* note 14, at 1370 (statement of Mark H. Johnson).

⁴⁰ Jackson, *A Proposed Revision*, *supra* note 14, at 176 app. (proposed section X754(a)). Under proposed section X759(e)(1) of the ALI Draft, however, gain could be recognized by a partner if the partnership made an election under section X759(a) (relating to contributions of property) or section X759(b) (relating to the retirement of a partner or the reduction or transfer of his interest) and the distribution would otherwise result in the partner's basis in his partnership interest being negative. *Id.* at 181-84 app.

partnership property, the ALI adopted an entity, or substituted basis, approach resulting in the recognition of gain or loss in several situations.⁴¹ The ALI adopted the entity approach in light of two overriding policy concerns.⁴² First, gain should not be recognized if it is attributable to the value of property other than money distributed.⁴³ Second, ordinary income should not be easily convertible into capital gain.⁴⁴

Under the ALI Draft, gain would be recognized by the distributee only when the distributee partner received money or the non-distributee partners assumed the distributee partner's share of partnership obligations in excess of the distributee's basis in his partnership interest.⁴⁵ Loss would be recognized only if the distributee received an amount of money that was less than the distributee's basis in his partnership interest or the realized loss exceeded twice the value of property other than money received.⁴⁶ In addition, in the case of a retirement or reduction of interest of the distributee partner, the remaining partners would be forced to recognize gain or loss if the basis of the remaining partnership assets could not be properly adjusted.⁴⁷

The ALI was particularly concerned that adoption of the entity approach for distributions of property to a partner in the course of winding up the partnership activity, the distributee's retirement from the partnership, or the reduction of the distributee's interest in the aggregate partnership property would permit the shifting of basis from capital assets with a high basis to ordinary income assets with a low basis.⁴⁸ Consequently, these "disproportionate liquidating distributions" could lead to the conversion of ordinary income into capital gain or the conversion of a capital loss into an ordinary loss. Therefore, the ALI included a provision generally providing that if "the partnership's non-capital assets have significantly changed in value" (either upward or downward), the distributee will be treated "as he would have been treated if the partner-

⁴¹ *Id.* at 179-80 (proposed section X757).

⁴² Surrey & Warren, *supra* note 34, at 1172.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See Jackson, *A Proposed Revision*, *supra* note 14, at 179 app. (proposed section X757(a)(1)).

⁴⁶ *Id.* (proposed section X757(a)(2)).

⁴⁷ *Id.* (proposed section X757(c)(3)). For example, assume ABC Partnership has three equal partners, A, B, and C. The partnership has two assets: asset X with a basis of zero and value of \$90, and cash of \$180. A retires receiving asset X. The remaining partners would have a \$60 gain that must be recognized because no property subject to a basis adjustment remains. Therefore, B and C will each recognize a gain of \$30. See *id.* at 164.

⁴⁸ See Surrey & Warren, *supra* note 34, at 1172-73.

ship had sold all its assets, i.e., as having received his distributive share of the potential partnership gains and losses."⁴⁹ The ALI thought that the prevention of tax avoidance in this area outweighed the policy rationale for nonrecognition on partnership distributions.⁵⁰ Because of the complexity of the special rule for disproportionate liquidating distributions, however, the ALI limited its application to partners having a ten percent or greater interest in the aggregate partnership property (with attribution rules applying).⁵¹

C. House Ways and Means Committee

The House subsequently enacted a bill in which it tried to provide, among other things, "a simple and uniform method" with respect to partnership distributions.⁵² In House Bill 8300,⁵³ which was introduced on March 9, 1954,⁵⁴ the House took into account many of the recommendations made by the ABA Tax Section and the ALI.⁵⁵ The House Bill, however, also included a number of provisions that were completely at odds with the recommendations of the ABA Tax Section and the ALI.⁵⁶

The House version, like the ABA Tax Section's recommendations and the ALI Draft, would have avoided the complexities of pre-1954 law which required that a portion of the distributee's basis in his partnership interest be assigned to the distributed property.⁵⁷ Under the House version, property distributed by a partnership to a partner would generally take a carryover or transferred basis in the hands of the partner.⁵⁸ The money or other property distributed would reduce the distributee partner's

⁴⁹ Jackson, *A Proposed Revision*, *supra* note 14, at 169; *see id.* at 180, 187-89 app. (proposed sections X757(e) and X761).

⁵⁰ *Id.* at 167.

⁵¹ *Id.* at 188 app. (proposed section X761(a)(3)); *see id.* at 168.

⁵² H.R. REP. NO. 1337, *supra* note 14, at 4094. The "rules [were] applicable whether the distribution [was] out of income or partnership capital, and whether the distribution [was] pro rata to all the partners or [had] the effect of changing the respective partnership interests." *Id.*

⁵³ H.R. 8300, 83d Cong., 2d Sess. (1954).

⁵⁴ *See id.* at 4025.

⁵⁵ *See Partnership Report from the Fifteenth Annual ABA Meeting*, *supra* note 34, at 98-101.

⁵⁶ *Id.*

⁵⁷ H.R. REP. NO. 1337, *supra* note 14, at 4094. *See supra* note 21 and accompanying text (providing a brief discussion of pre-1954 law).

⁵⁸ H.R. REP. NO. 1337, *supra* note 14, at 4094.

basis in the partnership.⁵⁹ An exception was made when the basis of the distributed property exceeded its value at the time of distribution. In such a situation, the basis of the property to the distributee would be its fair market value.⁶⁰

The distribution of money or other property did not result in gain or loss to the partnership. A distributee partner, however, could recognize gain or loss in two situations. First, gain would be recognized if money *or the basis of other property* received by a partner exceeded the partner's basis in the partnership.⁶¹ This recognition of gain could occur in either a current or liquidating distribution.⁶² Second, a capital loss would be recognized in a liquidating distribution to the extent that the basis of the partner's interest in the partnership exceeded the fair market value of the property distributed.⁶³

The House Bill also provided a third situation in which a partner could recognize gain or loss on a distribution. In this situation, a distributee partner would recognize ordinary income or loss to the extent that money or other property distributed was attributable to the distributee's share of unrealized receivables or fees of the partnership,⁶⁴ substantially appreciated or depreciated inventory, or stock in trade.⁶⁵ This situation, however, would *not* apply to a distribution in kind of the above described items.⁶⁶

The partnership provisions of House Bill 8300 were met with mixed reactions from the ABA Tax Section and the ALI.⁶⁷ The Partnership Committee of the ABA Tax Section prepared a report in which it

⁵⁹ *Id.*

⁶⁰ *Id.* at 4095.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ "Unrealized receivables or fees" was defined as any rights to income which have not been included in gross income under the partnership's method of accounting. *Id.* at 4097. It primarily applied to cash method partnerships that acquired a contractual or legal right to income for goods or services. *Id.*

⁶⁵ "Substantially appreciated or depreciated inventory or stock in trade" was defined as any noncapital assets, "the value of which exceeds by more than 20 percent the basis of such inventory and exceeds by more than 10 percent the basis of all partnership property other than money." *Id.*

⁶⁶ *See id.*

⁶⁷ *See, e.g., Partnership Report from the Fifteenth Annual ABA Meeting, supra* note 34, at 98; *Hearings Before the Committee on Finance for H.R. 8300, supra* note 34, at 459.

analyzed and critiqued the partnership provisions of House Bill 8300. In addition, the Partnership Committee compared the provisions in House Bill 8300 to those presented by the ABA Tax Section in its statement before the Ways and Means Committee and the ALI Draft.⁶⁸ While the Partnership Committee recognized that the "draftsmen of the House Bill attempted to reproduce the ABA and ALI Draft in a simplified form,"⁶⁹ the ABA Tax Section and the ALI both thought that the draftsmen were unsuccessful.

In the hearings before the Senate Finance Committee in April of 1954, Thomas N. Tarleau, Esq., chairman of the ABA Tax Section, presented the Partnership Committee's report on House Bill 8300. The report had strongly negative reactions to provisions in House Bill 8300 regarding partnership distributions.⁷⁰ The Partnership Committee stated that under the bill, a partner would recognize gain on a distribution of property if the basis of the property exceeded the partner's basis in his partnership interest.⁷¹ The Partnership Committee thought that this was an inappropriate result.⁷²

⁶⁸ *Hearings Before the Committee on Finance for H.R. 8300*, *supra* note 34, at 459-80.

⁶⁹ *Id.* at 459.

⁷⁰ *See id.* at 469-72, 475-77 (statement of Thomas N. Tarleau) (providing a concise summary of the criticisms).

⁷¹ *Id.* at 469. This provision was substantially the same provision that the Partnership Committee had recommended in its original 1949 recommendations. *See supra* note 18.

⁷² The Committee gave three reasons why this result was inappropriate. First, the ABA Tax Section and the ALI went to great lengths to provide for nonrecognition of property going into a partnership (contributions) and property coming out of a partnership (distributions). The Partnership Committee stated:

A fundamental premise of the ABA and ALI Draft was that there should be no taxable gain or recognizable loss upon the distribution of property to a partner, except in the case where the distribution of cash exceeds the basis of the partnership interest. The House Bill violates this concept, and it is believed that this a matter of extreme importance. So long as the distribution is in property other than cash, it is contrary to the general taxing theories of the Code to recognize gain or loss. If gain or loss is not recognized on the contribution, logically there should be no gain or loss upon the distribution. The [sic] greatest of flexibility in forming and dissolving partnerships should be encouraged, and the recognition of gain or loss upon distributions of property operates in the opposite direction.

Hearings Before the Finance Committee on H.R. 8300, *supra* note 34, at 469.

The Partnership Committee also disagreed with the House Bill 8300's use of adjusted basis of the distributed property as opposed to fair market value in determining the gain

The Partnership Committee also commented on the use of the fair market value of the property in determining the amount distributed when the fair market value was less than the adjusted basis of the distributed property.⁷³ The Partnership Committee stated that making a fair market value determination would unnecessarily create administrative problems.⁷⁴ Additionally, even though the use of fair market value was an exception, the Committee believed that fair market value would actually be less than adjusted basis a "sufficient number of times to be burdensome to both the Treasury Department and the taxpayers."⁷⁵ The Partnership Committee also noted that different tax results would arise depending upon whether the partnership distributed property in kind or sold the property and distributed the proceeds.⁷⁶

Finally, the Partnership Committee harshly criticized the additional result of having a partner recognize gain or loss on disproportionate liquidating distributions.⁷⁷ The major flaw with the proposed section was its inapplicability to distributions in kind of unrealized receivables or fees, appreciated inventory, or stock in trade.⁷⁸ This, according to the Partnership Committee, would lead to "a splendid opportunity for tax avoidance!"⁷⁹

D. Senate Finance Committee

In an attempt to eliminate the provisions of House Bill 8300 that the Partnership Committee found to be ineffective, unwise, or simply

or loss to the distributee. *Id.* at 469-70. Finally, the Partnership Committee rejected proposed section 734 of the House bill which allowed adjustments to the bases of remaining partnership property stating that it did not adequately achieve its objective of equating the partnership's bases in its assets with the partners' bases in their partnership interests. *Id.* at 470.

⁷³ *Id.* at 471 (statement of Thomas N. Tarleau).

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.* at 471-72.

⁷⁷ *Id.* at 475-77.

⁷⁸ *Id.* at 475.

⁷⁹ *Id.* at 476. The Partnership Committee Report gave the following example. Assume ABC is a partnership with three equal partners, A, B, and C. It has three assets: \$90 of cash, a ranch with an adjusted basis and fair market value of \$90, and cattle with an adjusted basis of zero and a fair market value of \$90. A, B, and C each have a \$60 basis in their partnership interests. The cattle are distributed to A in retirement of his partnership interest. The cattle are appreciated inventory, but proposed section 751 is inapplicable because the cattle are distributed in kind to A. A has a \$60 capital loss on liquidation of his interest and would recognize \$90 of ordinary income if he were to sell the cattle. *Id.*

objectionable, the Partnership Committee met with the legal draftsmen of the Treasury Department and the Joint Committee on Internal Revenue Taxation. As a result of these meetings, as well as the objections of numerous taxpayers, the Senate Finance Committee adopted an approach very different from that adopted by the Ways and Means Committee.⁸⁰ Under the Senate approach, the two general situations in which gain or loss would be recognized under the House's version were greatly limited.⁸¹ The Senate Finance Committee stated:

It has been pointed out that the assigning to the distributee of the partnership's basis for property distributed in liquidation of his interest and the recognition of gain or loss on the difference between this basis and the basis for his interest [as in the House version] in many cases would result in the taxation of gains where there were no real gains and the recognition of losses where there were no real losses.⁸²

As a result, gain would be recognized to a distributee only when *money* distributed by the partnership exceeded the partner's basis in the partnership interest.⁸³ Loss would be recognized in the case of a liquidating distribution only if money, inventory items, or unrealized receivables were distributed and their basis to the partnership was less than the partner's basis in the partnership interest.⁸⁴ As in the House version, the distribution of money or other property would not result in gain or loss to the partnership.⁸⁵ The Senate stated that "[t]hese rules, combined with the nonrecognition of gain or loss upon contribution of

⁸⁰ See S. REP. NO. 1622, 83d Cong., 2d Sess. 95 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621.

As to some of the actual objections, see *Hearings Before the Committee on Finance for H.R. 8300*, *supra* note 34, at 325 (statement of Thomas N. Tarleau on behalf of the American Bar Association); *id.* pt. 1, at 495 (statement of Charles C. MacLean, Jr. on behalf of the Association of the Bar, City of New York); *id.* pt. 3, at 1308 (statement of J. S. Seidman on behalf of the American Institute of Accountants); *id.* pt. 3, at 1531 (statement of Ralph M. Andrews on behalf of the New York State Bar Association); *id.* pt. 4, at 2195 (statement of Robert H. Caffee on behalf of the Smaller Manufacturers Council of Pittsburgh).

⁸¹ S. REP. NO. 1622, *supra* note 14, at 4727-29.

⁸² *Id.* at 4728.

⁸³ *Id.* at 4729.

⁸⁴ *Id.*

⁸⁵ *Id.* at 4727.

property to a partnership, will remove deterrents to property being moved in and out of partnerships as business reasons dictate."⁸⁶

The basis of property distributed would continue to be a carryover basis in the hands of the distributee in the case of current distributions. The basis of the property distributed, however, could not exceed the partner's basis in his partnership interest.⁸⁷ In the case of liquidating distributions, the distributee would substitute his basis in the partnership interest for the partnership basis of the property distributed. However, the basis to the distributee of inventory items and unrealized receivables would be limited to the basis they had to the partnership. This approach was designed to prevent the conversion of ordinary income into capital gains.⁸⁸

The Senate included a third situation in which gain or loss would be recognized that was very similar to the third situation under the House version. The Senate version, however, expanded on the House version. Certain distributions to a partner would be treated as a sale or exchange of property between the partnership and the partner, thereby potentially creating gain or loss to both the partner and the partnership. Unlike the House version, the Senate version also applied to distributions in kind of inventory items or unrealized receivables.⁸⁹

E. The Internal Revenue Code of 1954

The Senate version was adopted substantially intact in the Conference Agreement and became part of the 1954 Code.⁹⁰ As a result, new sections 731, 732, 733, 735, and 751 eliminated much of the uncertainty surrounding partnership distributions.⁹¹ Section 731(a) provides that

⁸⁶ *Id.* at 4729.

⁸⁷ *Id.* at 4728.

⁸⁸ *Id.*

⁸⁹ *Id.* at 4732-33.

⁹⁰ Several minor changes were made to the Senate's version of the provisions relating to partnership distributions. See H.R. CONF. REP. NO. 2543, 83d Cong., 2d Sess. 58-65 (1954), reprinted in 1954 U.S.C.C.A.N. 5314-26.

⁹¹ Section 736 was also enacted as part of the 1954 Code and generated quite a controversy during its enactment. See *Hearings Before the Committee on Finance for H.R. 8300*, *supra* note 34, at 331 (statement of Thomas N. Tarleau); *id.* pt. 1, at 497 (statement of Charles C. MacLean, Jr.); *id.* pt. 2, at 1134 (statement of William R. Spofford); *id.* pt. 3, at 1323 (statement of J.S. Seidman); *id.* pt. 3, at 1449-51 (statement of John W. Downs); *id.* pt. 3, at 1462-69 (statement of Robert I. Winslow); *id.* pt. 3, at 1559 (statement of Ralph M. Andrews); *id.* pt. 3, at 1720 (statement of the Illinois State Chamber of Commerce); *id.* pt. 4, at 1964-65 (statement of the Chamber of Commerce of the United States); *id.* pt. 4, at 2197 (statement of Robert H. Caffee); *id.* pt. 4, at 2222

normally a partner will not recognize gain or loss in the case of a distribution by a partnership to a partner,⁹² and section 731(b) states that no gain or loss will be recognized by a partnership on a distribution of property, including money.⁹³ In the same two situations in which the Senate's version required recognition,⁹⁴ however, gain or loss would be recognized by a distributee partner. First, gain will be recognized "to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution."⁹⁵ Second, loss will be recognized upon a distribution in liquidation of a partner's interest where no property other than money, inventory items, or unrealized receivables is distributed to such partner.⁹⁶ The loss will be recognized to the extent of the excess of the adjusted basis of such partner's interest over the sum of any money distributed plus the basis to the distributee of any unrealized receivables and inventory items. Any gain or loss recognized is considered gain or loss from the sale or exchange of the distributee partner's partnership interest, i.e., capital gain or capital loss.⁹⁷

The third situation in which a partner could recognize gain or loss on a distribution is where the distribution is disproportionate under section 751(b).⁹⁸ Moreover, not only is it possible that a partner may have gain or loss recognition under this third situation, but the partnership may also be forced to recognize gain or loss.⁹⁹ This provision, which is almost identical to the provision contained in the Senate version of its bill,¹⁰⁰ contrasts with the general rule under section 731(b) that a partnership will

(communication of the Cleveland Chamber of Commerce); *id.* pt. 4, at 2282 (communication of the Minnesota Society of Certified Public Accountants); *id.* pt. 4, at 2393 (communication of Ernst & Ernst).

Section 736 involves payments in liquidation of the interest of a retiring partner or deceased partner's successor in interest and is not discussed directly in this Article. However, if the payments under section 736 are classified as being made in exchange for the interest of the partner in partnership property, the payments are treated as a distribution. I.R.C. § 736(b) (1989). As a result, the distribution rules discussed in this Article are applicable.

⁹² I.R.C. § 731(a) (1989).

⁹³ I.R.C. § 731(b) (1989).

⁹⁴ See *supra* text accompanying notes 80-86.

⁹⁵ I.R.C. § 731(a)(1) (1989).

⁹⁶ I.R.C. § 731(a)(2) (1989).

⁹⁷ I.R.C. § 731(a) (1989); Treas. Reg. § 1.731-1(a)(3) (1960).

⁹⁸ I.R.C. § 751(b) (1989).

⁹⁹ *Id.*

¹⁰⁰ See *supra* text accompanying notes 88-89.

not recognize gain or loss on a distribution of money or other property to a partner.¹⁰¹

Congress, the ABA Tax Section, and the ALI went to great lengths to achieve nonrecognition status for partnership distributions. When the House Ways and Means Committee provided for additional situations in which gain or loss could be recognized, it was quickly met with strong opposition from the ABA Tax Section, the ALI, and, eventually, the Senate Finance Committee. As a result, Congress provided for only three situations in which a partner could recognize gain or loss on a partnership distribution. In only one of the situations, under section 751(b), could a *non-distributee* partner recognize gain or loss on a partnership distribution. Consequently, tax practitioners had few provisions to be concerned about in determining whether a partnership distribution resulted in recognition of gain or loss to either a distributee partner or a non-distributee partner.

II. PARTNERSHIP DISTRIBUTIONS THAT RESULT IN GAIN OR LOSS TO THE DISTRIBUTEE PARTNER

A. Section 731(a)(1)

As stated previously, section 731(a)(1) is the first exception to the general rule of nonrecognition in the case of a distribution of money or other property. It has remained unchanged since its enactment in 1954. This exception requires recognition of capital gain to the extent that any money distributed exceeds the distributee partner's basis in his partnership interest.¹⁰² Section 731(a)(1) applies to both current and liquidating distributions, and, when applicable, results only in the recognition of gain, not loss.

The rationale behind this exception is fairly straightforward. The money represents something other than previously taxed earnings or a return of capital.¹⁰³ In addition, money cannot have a basis different than its face amount. Once a partner's basis in his partnership interest reaches zero, any money distributed must result in gain to the recipient

¹⁰¹ I.R.C. § 731(b) (1989). *But see* § 731(c) (providing that sections 736, 737 and 751 will override section 731).

¹⁰² *See* Treas. Reg. § 1.731-1(a)(3) (1960) (stating that any gain recognized under section 731(a) is capital gain).

¹⁰³ *See, e.g.,* H.R. REP. NO. 432, 98th Cong., 2d Sess. 1216 (1984) ("This tax-free treatment is based, in part, on the theory that a partner is entitled to withdraw his investment in a partnership before recognizing gain on the investment.").

partner so that the partner can take a basis in the money equal to its face amount.¹⁰⁴ In order to achieve maximum deferral and nonrecognition in a distribution of property other than money, the property can take a basis of zero and thereby defer any potential gain.¹⁰⁵

It should be noted that a distribution of money can be in a form different than an *actual* distribution of money. For example, a reduction of a partner's share of partnership liabilities is treated as a distribution of money.¹⁰⁶ This reduction can occur in a number of situations, including partnership satisfaction of a liability, partner assumption of a partnership liability,¹⁰⁷ partnership abandonment of encumbered property,¹⁰⁸ partnership reconveyance of encumbered property (or foreclosure),¹⁰⁹ or the condemnation of encumbered property.¹¹⁰ A decrease in a partner's individual liabilities by reason of an assumption by the partnership of such individual liabilities is also treated as a distribution of money to the partner.¹¹¹

It is somewhat unusual for a partner to recognize gain under section 731(a)(1) on a current distribution. There are several situations, however, in which section 731(a)(1) may apply to a current distribution. First, if a

¹⁰⁴ At least with respect to current distributions, this approach avoids the problem of a partner having a negative basis in his partnership interest. In the case of liquidating distributions, negative basis would not seem to be an option. See, e.g., ALAN GUNN, PARTNERSHIP TAXATION 93 (1991). As to the difficulty of utilizing negative basis, see *infra* text accompanying notes 302-03.

¹⁰⁵ I.R.C. § 732(a)-(c) (1989). Section 735 preserves the characterization of any gain or loss with respect to certain types of property.

¹⁰⁶ I.R.C. § 752(b) (1989); Treas. Reg. § 1.752-1(c) (1991).

¹⁰⁷ The Treasury has promulgated regulations under section 752 defining what constitutes assumption of a liability. The definition under section 752 is virtually identical to that under section 704(b). A person is considered to assume a liability only to the extent that "(1) the assuming person is personally obligated to pay the liability; and (2) if a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability, and no other partner (or person that is related to another partner) would bear the economic risk of loss for the liability immediately after the assumption." Treas. Reg. § 1.752-1(d) (1991); cf. Treas. Reg. § 1.704-1(b)(2)(iv)(c) (as amended in 1992).

¹⁰⁸ See, e.g., *Middleton v. Commissioner*, 77 T.C. 310, 319 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982); *O'Brien v. Commissioner*, 77 T.C. 113, 116-17 (1981).

¹⁰⁹ See, e.g., *Freeland v. Commissioner*, 74 T.C. 970, 975-76 (1980).

¹¹⁰ See, e.g., Rev. Rul. 81-242, 1981-2 C.B. 147.

¹¹¹ I.R.C. § 752(b) (1989); Treas. Reg. § 1.752-1(c) (1991). A partnership's taking of property subject to a liability is treated as an assumption of the liability by the partnership up to the fair market value of the property at the time of contribution. I.R.C. § 752(c) (1989); Treas. Reg. § 1.752-1(e) (1991).

partner has a low adjusted basis in his partnership interest, then section 731(a)(1) may apply. This basis may be the result of a contribution by the partner of property with a low or zero basis. Second, if the partnership distributes money before including it in income, section 731(a)(1) may apply.¹¹² This situation may occur if, for example, the partnership has received money for giving an option, which has not yet been exercised, and the partnership distributes the money to the partners.¹¹³

There are several ways of avoiding section 731(a)(1) with respect to a current distribution. Probably the easiest and most obvious way is to have the distribution treated as an advance or draw against the partner's distributive share of income, because this will not be treated as a distribution until the last day of the partnership's taxable year.¹¹⁴ As a result, the partner will get the benefit of any increase in the adjusted basis of his partnership interest under section 705(a)(1).¹¹⁵ A second way to avoid section 731(a)(1) with respect to a current distribution is to have the distribution treated as a loan from the partnership to the partner under section 707(a)(1). When the partner has sufficient basis, the loan is canceled, and the loan proceeds will be treated as a distribution *at that time*.¹¹⁶

¹¹² See, e.g., CURTIS J. BERGER & PETER J. WIEDENBECK, CASES AND MATERIALS ON PARTNERSHIP TAXATION § 9.01 (1989); MCKEE, *supra* note 11, at ¶ 19.03[1]; ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION § 132.05 (4th ed. 1989).

¹¹³ See, e.g., *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727, 731 (1975).

¹¹⁴ Treas. Reg. § 1.731-1(a)(1)(ii) (1960).

¹¹⁵ The leading commentators in this area suggest that Treas. Reg. § 1.731-1(a)(1)(ii) is "probably limited to cases in which the distributee is obligated to restore or return the distribution to the extent it exceeds his distributive share of partnership income." MCKEE ET AL., *supra* note 11, at ¶ 19.03[2]; see, e.g., *White v. Commissioner*, 991 F.2d 657 (10th Cir. 1993); *Seay v. Commissioner*, 63 T.C.M. (CCH) 2911 (1992); Rev. Rul. 92-97, 1992-2 C.B. 124; Rev. Rul. 81-242, 1981-2 C.B. 147; Rev. Rul. 81-241, 1981-2 C.B. 146.

¹¹⁶ Treas. Reg. § 1.731-1(c)(2) (1960). But see Rev. Rul. 73-301, 1973-2 C.B. 215 (finding that cash withdrawals of a partner that created a deficit in the partner's capital account did not constitute loans because "no unconditional and legally enforceable obligation" existed requiring the partner to repay the money—the loans were treated as partnership distributions); *Mangham v. Commissioner*, 40 T.C.M. (CCH) 788, 799 (1980) (finding that advances were not loans); Rev. Rul. 57-318, 1957-2 C.B. 362 (finding cancellation of a deficit to be a distribution and thus treating the cancellation as a capital gain).

If the partnership *acquires* indebtedness of a partner and then distributes that debt to the partner, the Service has ruled that the property distribution rules of subchapter K will apply, and the partner will recognize capital gain or loss to the extent that the fair market value of the debt differs from its basis under section 732. Rev. Rul. 93-7, 1993-4 I.R.B. 5. In the ruling, the Service analogized the distribution to a partner of indebtedness of that partner to a distribution of money because there is no mechanism for preserving gain or loss in the extinguished indebtedness. Gain or loss must be recognized at the time

B. Section 731(a)(2)

Section 731(a)(2) is the second exception to the general rule of nonrecognition for partnership distributions. This exception, which occurs much less frequently than the first exception under section 731(a)(1),¹¹⁷ applies in the case of liquidating distributions where the distributee receives solely money, unrealized receivables,¹¹⁸ or inventory items,¹¹⁹ or any combination of the three. If the distribution is a current distribution or if the partner receives property other than money, unrealized receivables, or inventory items, section 731(a)(2) does not apply.¹²⁰

of distribution or it will be lost forever. *Id.* The Service in Rev. Rul. 93-7 appears to be attacking a variation of the May Company transaction in which a partnership acquires debt of a partner and then distributes the debt to the partner as opposed to the original May Company transaction where the partnership acquired stock of a corporate partner and then distributed the stock to the partner. See *infra* text accompanying notes 280-98 for a description of the May Company transaction and the Service's response to it. See, e.g., Christian M. McBurney & George L. Middleton, *Tax Consequences of a Distribution of Debt to a Debtor-Partner*, 78 J. TAX'N 210 (1993).

¹¹⁷ See, e.g., BERGER & WIEDENBECK, *supra* note 112, § 9.01; AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS, ADOPTED BY THE AMERICAN LAW INSTITUTE AT PHILADELPHIA, PENNSYLVANIA, May 20, 1982, 33 (1984).

¹¹⁸ "Unrealized receivable," as defined in section 751(c), generally 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. I.R.C. § 751(c) (1993). For purposes of sections 731, 741, and 751, unrealized receivables also includes items such as stock in a DISC, section 1245 property, stock in certain foreign corporations, section 1250 property, and franchises, trademarks, or tradenames. *Id.*

¹¹⁹ Section 751(d)(2) defines inventory item as

(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 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).

I.R.C. § 751(d)(2) (1989).

¹²⁰ This provision seems to lead to some possible "game playing" by a partner. For example, if a partner were to receive even \$1 worth of property other than money, unrealized receivables, or inventory items in a liquidating distribution, then no loss could

The amount of loss recognized by the partner under section 731(a)(2) is the excess of the adjusted basis in his partnership interest over the sum of any money distributed plus the basis to the distributee of any unrealized receivables or inventory items distributed.¹²¹ When applicable, section 731(a)(2) provides for the recognition of loss, not gain.¹²²

The rationale for this second exception is not as apparent as the exception under section 731(a)(1) but is just as valid. If a partner receives only money in liquidation of his partnership interest and the partner's adjusted basis in his partnership interest is greater than the money received, any excess basis must be recognized as a loss because money must take a basis equal to its face amount. The loss that is recognized is a capital loss.¹²³

If the partner receives a combination of money, unrealized receivables, and inventory items, the partner may again recognize a loss depending on his adjusted basis in the partnership interest. This rule is designed to prevent a partner from converting a capital loss into an ordinary loss. For example, assume that a partner has an adjusted basis in her partnership interest of \$100. She receives, in liquidation of her partnership interest, \$20 cash plus an inventory item which has an adjusted basis to the partnership of zero and a fair market value of \$80. Under sections 732(b) and (c)(1), she will take the inventory item with a basis of zero.¹²⁴ As a result, she will recognize an \$80 capital loss. If she were to immediately sell the inventory item for \$80, she would have \$80 of ordinary income.¹²⁵ If she were not forced to recognize a capital loss of \$80 on the liquidating distribution, then she would take the inventory item with an exchanged basis of \$80. If she then later sold the inventory item within the five-year period, any resulting gain or loss would be ordinary.¹²⁶ For example, if she sold it for \$80, she would

be recognized under section 731(a)(2). The \$1 worth of other property would absorb the remaining basis of the partner's partnership interest under sections 732(b) and (c). See *infra* text accompanying notes 127-39.

¹²¹ Sections 732(b) and (c)(1) determine the adjusted bases of unrealized receivables or inventory items that are distributed in liquidation of a partner's interest.

¹²² I.R.C. § 731(a)(2) (1989).

¹²³ I.R.C. § 731(a) (1989); Treas. Reg. § 1.731-1(a)(3) (1960).

¹²⁴ This is based on the assumption that sections 704(c)(1)(B), 737, and 751(b) do not apply.

¹²⁵ Section 735(a)(2) states that "[g]ain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751(d)(2)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be." I.R.C. § 735(a)(2) (1989).

¹²⁶ *Id.*

have no gain or loss and, in essence, would be offsetting an \$80 capital loss against \$80 of ordinary income. If she sold the inventory item for \$90, she would only have \$10 of ordinary income (representing the appreciation during the time in which she personally held the inventory item) and would still, in essence, be offsetting an \$80 capital loss against \$80 of ordinary income. If, instead, the partnership had sold the inventory item rather than distributing it, the gain would have been ordinary and would have been allocated to the partners.

Section 731(a)(2) is not without its flaws. Read literally, section 731(a)(2) *only* applies if the distributee receives money, unrealized receivables, or inventory items, or a combination thereof.¹²⁷ If any other property is distributed to the partner, section 731(a)(2) is inapplicable.¹²⁸ Almost immediately after the enactment of section 731(a)(2), the leading commentators of the day wrote:

It should be noted that under a literal interpretation of this rule [section 731(a)(2)] a bag of peanuts could receive a million dollar basis, if a partner with a very high basis for his partnership interest merely received that property in liquidation. However, in a situation involving *de minimis* property, the million dollar loss would probably be recognized.¹²⁹

By including small amounts of property in the distribution other than money, unrealized receivables, or inventory items, a partner could conceivably make section 731(a)(2) inapplicable and thus convert a capital loss into an ordinary loss. Assume that ABC is a partnership with three equal partners, A, B, and C.¹³⁰ The partnership's assets consist mainly of cash, stocks, and bonds. A is retiring from the partnership. She has a basis in her partnership interest of \$500,000. On liquidation of her interest, she will receive \$200,000 cash plus a typewriter worth \$500.¹³¹ If A did not receive the typewriter, she would have a capital loss of \$300,000.¹³² By also receiving the typewriter, however, A does not

¹²⁷ In fact, Treas. Reg. § 1.731-1(a)(2)(ii) specifically states that "[i]f the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized." Treas. Reg. § 1.731-1(a)(2)(ii) (1969) (emphasis added).

¹²⁸ *Id.*

¹²⁹ Jackson, *The Internal Revenue Code of 1954*, *supra* note 14, at 1228 n.87.

¹³⁰ This example is a slightly modified version of an example given in GUNN, *supra* note 104, at 94-95.

¹³¹ Any section 1245 recapture with respect to the typewriter has been ignored.

¹³² The capital loss limitations of section 1211 would apply.

recognize any loss and takes the typewriter with a basis of \$300,000. If she uses the typewriter in her business, she will be able to take depreciation deductions. Furthermore, if she subsequently sells the typewriter at a loss, the loss will be a section 1231 loss that will most likely result in an ordinary loss. A has thus converted a capital loss into an ordinary loss.¹³³ Such a result is rare, however, since any other property distributed would generally be a capital asset. As a result, the distributee partner would only accomplish deferring the recognition of the capital loss.¹³⁴

If a *de minimis* amount of property other than money, unrealized receivables, or inventory items is distributed in order to avoid recognition of loss under section 731(a)(2), the distributee should recognize the loss at the time of the distribution.¹³⁵ Although no court has specifically addressed this issue,¹³⁶ the ABA Tax Section and the ALI would have allowed recognition of a loss in a liquidating distribution that included property other than money only if the loss exceeded an amount equal to twice the value of the distributed property.¹³⁷ This approach would have avoided the possible *de minimis* problem of section 731(a)(2) but would have created a valuation problem as the distributed property would have had to be valued at the time of distribution.¹³⁸ However, the valuation problem may not be as much trouble as it appears since under the capital

¹³³ If A had held the typewriter solely for personal use, then A would have converted a deductible capital loss into a nondeductible personal loss.

¹³⁴ See, e.g., WILLIS, *supra* note 17, at 287-89; MCKEE ET AL., *supra* note 11, ¶ 19.05; WILLIS ET AL., *supra* note 112, § 132.04; CARTER G. BISHOP & JENNIFER J. S. BROOKS, *FEDERAL PARTNERSHIP TAXATION* 420 (1990).

It would be possible for the distributee partner to convert a deductible capital loss into a nondeductible personal loss. See *supra* note 133.

¹³⁵ See, e.g., WILLIS, *supra* note 17, at 287-89; GUNN, *supra* note 104, at 94-95; MCKEE ET AL., *supra* note 11, ¶ 19.05; WILLIS ET AL., *supra* note 112, § 132.04.

¹³⁶ GUNN, *supra* note 104, at 94. In *Neubecker v. Commissioner*, the petitioner, one of three partners in a law firm, withdrew along with one of the other partners to form a new two-partner law firm. At the time of withdrawal, the petitioner had a capital account balance of \$2,425.57. The petitioner received the following, totalling \$415, on dissolution: one typewriter (worth \$100), one secretary chair (worth \$50), two file cabinets (worth \$100), miscellaneous books and pamphlets (worth \$100), one waiting room chair (worth \$50), and office supplies (worth \$15). In addition, the petitioner retained certain clients of the first partnership. The petitioner reported a capital loss of \$2,425.57 under section 731(a)(2). The Tax Court disallowed the loss for a number of reasons including the fact that section 731(a)(2) had no application because the petitioner had received property other than money, unrealized receivables, or inventory items. *Neubecker v. Commissioner*, 65 T.C. 577, 584 (1975).

¹³⁷ See *supra* text accompanying notes 26-29, 46.

¹³⁸ See WILLIS, *supra* note 17, at 289 n.15.

account maintenance rules of section 704(b), any property that is distributed must be valued at the time of distribution.¹³⁹

C. Section 751(b)

Section 751(b) was probably the most controversial provision enacted by Congress in 1954 under Subchapter K. Designed to prevent the conversion of potential ordinary income into capital gain through distributions of property,¹⁴⁰ the section can apply in either of two situations, each situation being the converse of the other. In addition, section 751(b) applies to both current and liquidating distributions.¹⁴¹

The first situation to which section 751(b) is applicable is described in section 751(b)(1)(A): "To the extent a partner receives in a distribution" unrealized receivables or inventory items that have substantially appreciated in value ("substantially appreciated inventory items") "in exchange for all or part of his interest in other partnership property (including money)," then the transaction will "be considered as a sale or exchange of such property between the distributee and the partnership."¹⁴² Consequently, a distribution of unrealized receivables or substantially appreciated inventory items can result in gain or loss to a partner, and to the partnership, even though the partner has a high basis in his partnership interest.

To illustrate, assume that AB Partnership with two equal partners, A and B, has two assets, a capital asset with an adjusted basis of \$5,000 and a fair market value (and book value) of \$15,000 and inventory with an adjusted basis of \$3,000 and a fair market value (and book value) of

¹³⁹ Treas. Reg. § 1.704-1(b)(2)(iv)(e) (as amended in 1992).

¹⁴⁰ S. REP. NO. 1622, *supra* note 14, at 4731.

¹⁴¹ Treas. Reg. § 1.751-1(b)(1)(i) (as amended in 1971). Although section 751(b) applies to current as well as liquidating distributions, its application to liquidating distributions is limited. Generally, payments in liquidation of a partner's interest are categorized as either section 736(a) or section 736(b) payments. Section 736(a) payments are treated as either a distributive share or as a guaranteed payment depending upon whether the payments are determined with regard to the income of the partnership. I.R.C. § 736(a) (1991). Section 736(b) payments are treated as partnership distributions. I.R.C. § 736(b)(1) (1991). Section 751(b) only applies to the section 736(b) payments.

Section 736(b) payments do not include amounts paid for unrealized receivables or goodwill of the partnership except to the extent that the partnership agreement provides for a payment with respect to goodwill. I.R.C. § 736(b) (1993). However, this rule only applies if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership. *Id.*

¹⁴² I.R.C. § 751(b)(1)(A) (1991); Treas. Reg. § 1.751-1(b)(2) (as amended in 1971).

\$15,000. The partnership distributes \$5,000 of inventory to A, who has an adjusted basis in her partnership interest of \$4,000 and a capital account of \$15,000. The inventory is a substantially appreciated inventory item.¹⁴³ A has received a substantially appreciated inventory item in exchange for part of A's interest in other partnership property. A is treated as exchanging \$1,500 of capital asset with an adjusted basis of \$500 for \$1,500 of inventory. A will recognize \$1,000 of capital gain as a result of the deemed exchange under section 751(b).¹⁴⁴

The second situation, described in section 751(b)(1)(B), is simply the converse of the first situation. Thus, "[t]o the extent a partner receives in a distribution partnership property (including money) *other than*" unrealized receivables or substantially appreciated inventory items in exchange for all or part of his interest in unrealized receivables or substantially appreciated inventory items, the transaction will "be considered as a sale or exchange of such property between the distributee and the partnership."¹⁴⁵ As with the first situation to which section 751(b) applies, a distribution of property other than unrealized receivables or substantially appreciated inventory items can result in gain or loss to a partner, and to the partnership, even though the partner has a high basis in his partnership interest.

To illustrate, assume that AB Partnership with two equal partners, A and B, has two assets, a capital asset with an adjusted basis of \$5,000 and a fair market value (and book value) of \$15,000 and inventory with an adjusted basis of \$3,000 and a fair market value (and book value) of \$15,000. The partnership distributes \$5,000 of the capital asset to A, who has an adjusted basis in her partnership interest of \$4,000 and a capital account of \$15,000. The inventory item is a substantially appreciated inventory item. A has received other partnership property in exchange for part of her interest in a substantially appreciated inventory item. A is treated as exchanging \$1,500 of the inventory with an adjusted basis of \$300 for \$1,500 of the capital asset. A will recognize \$1,200 of ordinary income as a result of the deemed exchange under section 751(b).¹⁴⁶

¹⁴³ A partnership's inventory items are considered to be substantially appreciated "if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property." I.R.C. § 751(d)(1)(A) (1993). Inventory property is excluded from this computation if a principal purpose for acquiring such property was to avoid the provisions of section 751 relating to inventory items. I.R.C. § 751(d)(1)(B).

¹⁴⁴ See Treas. Reg. § 1.751-1(g) (as amended in 1971) for numerous examples illustrating section 751(b).

¹⁴⁵ I.R.C. § 751(b)(1)(B) (1991) (emphasis added); Treas. Reg. § 1.751-1(b)(3) (as amended in 1971).

¹⁴⁶ For the tax consequences to the partnership and non-distributee partners, see *infra*

*D. Section 737**1. Introduction*

Congress enacted section 737 in response to the loophole created by the enactment of section 704(c)(1)(B) as part of the Revenue Reconciliation Act of 1989.¹⁴⁷ Under section 704(c)(1)(B), if a partner contributes appreciated property to a partnership and the property is subsequently distributed to another partner within five years of the date of contribution, the contributing partner is treated as recognizing gain as if the property had been sold at its fair market value at the time of contribution.¹⁴⁸ However, the partnership's distribution of other property to the contributing partner will not trigger gain with respect to the contributed property even if the value of the property distributed exceeds the contributing partner's basis in his partnership interest. Section 737 was enacted in order to eliminate this loophole.

For example, assume that A wants to dispose of appreciated property to B without immediately recognizing gain via the use of a "mixing bowl" transaction. A mixing bowl transaction is simply a method for a "selling partner" to dispose of appreciated property through a partnership and defer any gain.¹⁴⁹ A contributes property worth \$500,000 with an adjusted basis of \$200,000 to the partnership, and B contributes property worth \$490,000 for a 49% interest in the partnership. B also sets up a related taxpayer that contributes property worth \$10,000 to the partnership in exchange for a 1% interest in the partnership. The partnership may consider making special allocations of income with respect to the contributed properties, that is, cross-allocations of income. If the partnership were to distribute A's contributed property to B within five years of contribution, the built-in gain would be triggered and allocated entirely to A under section 704(c)(1)(B). If, however, the partnership distributes the property contributed by B, and its related taxpayer, to A in liquidation of A's interest, section 704(c)(1)(B) will not be triggered. The built-in gain cannot be allocated to A if A is no longer a partner in the partnership.¹⁵⁰ Therefore, A will defer recognition of \$300,000 of gain.

text accompanying notes 162-64.

¹⁴⁷ See *infra* notes 165-223 and accompanying text.

¹⁴⁸ I.R.C. § 704(c)(1)(B) (1991).

¹⁴⁹ For a thorough description of the mixing bowl transaction, see Christian M. McBurney, *Mixing-Bowl Transactions and the Partnership Disguised Sale Regulations*, 70 TAXES 123 (1992).

¹⁵⁰ See, e.g., MCKEE ET AL., *supra* note 11, ¶ 10.04[4] (Supp. 1992).

2. *New Section 737*

Congress enacted section 737 as part of the Energy Policy Act of 1992, which was signed into law by President Bush on October 24, 1992.¹⁵¹ Section 737(a) reads:

In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of—

- (1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or
- (2) the net precontribution gain of the partner.

Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be determined by reference to the proportionate character of the net precontribution gain.¹⁵²

The term "net precontribution gain" is defined as the net gain, if any, that the distributee partner would have recognized under section 704(c)(1)(B) had the partnership distributed to another partner all property that the distributee partner had contributed to the partnership within five years of the distribution and that the partnership had held immediately before the distribution.¹⁵³ Any gain resulting under section 737(a) increases both the partner's adjusted basis in his partnership interest and the partnership's basis in the contributed property.¹⁵⁴

Congress provided for three exceptions to section 737(a). First, if any portion of the property distributed consists of property that the distributee partner had contributed, then such property is not taken into account under section 737(a) and, in addition, is not taken into account in determining the amount of the net precontribution gain under section

¹⁵¹ Pub. L. No. 102-486, 106 Stat. 2776 (1992). Section 737 applies to partnership distributions on or after June 25, 1992. The Service has stated that section 737 should not apply to property contributed to a partnership before October 4, 1989, which is the effective date of section 704(c)(1)(B). Before October 4, 1989, net precontribution gain would always be zero. See Juliann Avakian-Martin, *Official Outlines IRS Thinking on Forthcoming Partnership Regs.*, 59 TAX NOTES 852 (1993).

¹⁵² I.R.C. § 737(a) (West Supp. 1993).

¹⁵³ I.R.C. § 737(b).

¹⁵⁴ I.R.C. § 737(c).

737(b).¹⁵⁵ Second, section 737 does not apply to the extent that section 751(b) applies to a transaction.¹⁵⁶ Finally, section 737 does not apply to a constructive termination of the partnership under section 708(b)(1)(B).¹⁵⁷

To illustrate the application of section 737, assume that A and B form a partnership. A contributes appreciated property X with a basis of zero and a fair market value of \$100, and B contributes property Y with a basis and a fair market value of \$100. If the partnership distributes property Y to A when property Y's fair market value is still \$100, within five years of the time of contribution, A will recognize gain equal to the amount of his precontribution gain of \$100. In addition, A will increase the adjusted basis of his partnership interest by \$100, and property X's basis will be increased by \$100.

More sophisticated transactions are also caught within the web of section 737. For example, assume that A contributes appreciated property X with a basis of zero and a fair market value of \$100. B contributes appreciated property Y with a basis of \$20 and a fair market value of \$100. A also contributes Z stock. Instead of distributing property Y to A, the partnership contributes property Y to Z corporation. The partnership then distributes the Z stock to A. Under section 737, A must include in income the precontribution gain of \$100 with respect to property X to the extent that the value of the Z stock, taking into account property Y, exceeds A's basis in his partnership interest.¹⁵⁸

Although section 737 is fairly far-reaching, tax planners have devised methods to avoid its application to mixing bowl transactions. One method is to have the contributing partner obtain a share of partnership liabilities under section 752 so as to increase that partner's basis in the partnership. This means, however, that the contributing partner will have to remain a partner in the partnership.¹⁵⁹ A second way to avoid section 737 is to have the partnership incrementally redeem out the contributing partner as opposed to redeeming out the partner in a single transaction.¹⁶⁰ This method will also accomplish deferral of gain.

¹⁵⁵ I.R.C. § 737(d)(1).

¹⁵⁶ I.R.C. § 737(d)(2).

¹⁵⁷ H.R. CONF. REP. NO. 1018, 102d Cong., 2d Sess. 429 (1992).

¹⁵⁸ *Id.* Gain recognition only appears to be required to the extent that the value of the Z stock is attributable to property Y, which was contributed to Z corporation after the Z stock was contributed to the partnership. *Id.*

¹⁵⁹ See Lee A. Sheppard, *A Look at the Partnership Provisions of H.R. 11*, 57 TAX NOTES 15, 16 (1992).

¹⁶⁰ *Id.*; see also Avakian-Martin, *supra* note 151, at 852 (contributing property to the partnership to increase outside basis will be generally acceptable in avoiding section 737; however, contributing built-in loss property to lower net pre-contribution gain immediately before a distribution may be attacked as abusive).

III. PARTNERSHIP DISTRIBUTIONS THAT RESULT IN GAIN OR LOSS TO A NON-DISTRIBUTEES PARTNER

Congress has provided for several situations in which a distribution to a partner will result in gain or loss to a non-distributees partner.¹⁶¹ In other words, a partner who does not receive a distribution of money or other property may be forced to recognize gain or loss on a distribution to another partner. This can obviously lead to some unexpected results for those who are unfamiliar with these provisions.

A. Section 751(b)

Previously discussed under Part II,¹⁶² section 751(b) is included a second time because it can result in gain or loss to a non-distributees partner as well as a distributees partner. For example, assume that AB Partnership with two equal partners, A and B, has two assets, a capital asset with an adjusted basis of \$5,000 and a fair market value (and book value) of \$15,000 and inventory with an adjusted basis of \$3,000 and a fair market value (and book value) of \$15,000. The partnership distributes \$5,000 of the capital asset to A, who has an adjusted basis in her partnership interest of \$4,000 and a capital account of \$15,000. The inventory is substantially appreciated. By receiving the capital asset, A has received other partnership property in exchange for part of her interest in the substantially appreciated inventory item. A is treated as exchanging \$1,500 of the inventory asset with an adjusted basis of \$300 for \$1,500 of the capital asset. A will recognize \$1,200 of ordinary income as a result of the deemed exchange under section 751(b). The partnership, in turn, is treated as exchanging \$1,500 of capital asset with an adjusted basis of \$500 for \$1,500 of inventory and will recognize \$1,000 of capital gain. This gain is allocated to B, the non-distributees partner.¹⁶³

In the above example, a distribution of property to A resulted not only in gain to A but also gain to B, a non-distributees partner. This is the unexpected consequence of section 751(b). Because of the broad reach of section 751(b),¹⁶⁴ tax planners and taxpayers need to be concerned with the potentially adverse tax consequences to a non-distributees partner as

¹⁶¹ See *supra* notes 140-46 and accompanying text.

¹⁶² See *supra* part II.C.

¹⁶³ Treas. Reg. § 1.751-1(b)(3)(ii)-(iii).

¹⁶⁴ See *infra* text accompanying notes 309-10.

well as a distributee partner with respect to almost all partnership distributions.

B. Section 704(c)

Section 704(c), which was enacted as part of the Internal Revenue Code of 1954,¹⁶⁵ has been amended several times since its enactment¹⁶⁶ but has never applied to a *distribution* of property. For example, assume that A contributes land with an adjusted basis of \$20 and a fair market value of \$100 in exchange for an interest in the partnership. If the partnership subsequently sold the land for \$100, the \$80 of gain resulting from the sale would be allocated entirely to A under the prior version of section 704(c)(1). But what if the partnership distributed the land to another partner in the partnership? This would not trigger the \$80 of built-in gain under former section 704(c). Deciding that this nonrecognition result led to abuse, Congress amended section 704(c) in 1989.¹⁶⁷

1. *House Ways and Means Committee*

In 1989, the House Ways and Means Committee proposed that section 704(c) be amended to treat sales and distributions of partnership property in a consistent manner.¹⁶⁸ Otherwise, partners could easily avoid triggering section 704(c) recognition by simply distributing the contributed property rather than selling it.¹⁶⁹ In the above example, if the partnership distributed the land to a noncontributing partner when its fair market value was \$100, the built-in gain of \$80 would be triggered and allocated entirely to A under the amended version of section 704(c). This would also result in an adjustment to the basis of the property of \$80. Therefore, the partnership's adjusted basis in the property would be increased to \$100 on the distribution. The character of the gain would be the same as if the partnership had sold the property for its fair market value.

¹⁶⁵ Internal Revenue Code of 1954, Pub. L. No. 83-591, § 704(c), 68A Stat. 3, 240 (1954).

¹⁶⁶ Section 704(c) was amended slightly by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1906(b)(13)(A), 90 Stat. 1520, 1834 (1976) (substituting "Secretary" for "Secretary or his delegate"), and was amended again by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 71(a), 98 Stat. 494, 589 (1984). Prior to the 1984 Act, section 704(c) were merely elective. The 1984 amendment, however, made section 704(c) mandatory.

¹⁶⁷ Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642, 103 Stat. 2106, 2379-81 (1989).

¹⁶⁸ H.R. REP. NO. 247, 101st Cong., 1st Sess. 1356 (1989).

¹⁶⁹ *Id.*

If the property had a fair market value of \$150 at the time of distribution, then, again, only the built-in gain of \$80 would be triggered and allocated to A.¹⁷⁰ If the property's fair market value were only \$60 at the time of distribution, then the ceiling rule would apply to trigger only \$40 of gain.¹⁷¹ If the contributed property were distributed to the contributing partner, then no gain or loss would be triggered on the built-in gain. This proposal was essentially identical to that proposed by the ABA Partnership Committee in its report from the Tenth Annual ABA Meeting in 1949.¹⁷²

2. Senate Finance Committee

The Senate Finance Committee proposed a provision very similar to that of the House Ways and Means Committee.¹⁷³ The Senate version, however, contained two major differences.¹⁷⁴ First, section 704(c) would only apply to distributions of contributed property made within three years following the time when the property was contributed.¹⁷⁵ Second, section 704(c) provided

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 1356-57. The ceiling rule basically states that the amount of precontribution gain or loss that can be allocated with respect to contributed property is limited to the realized gain or loss that resulted from the sale or disposition of the property. The rule also limits the amount of depreciation with respect to property with precontribution gain. See Treas. Reg. § 1.704-1(c)(2)(i) (as amended in 1992); Treas. Reg. § 1.704-1(c)(2)(i) Ex. 1; Treas. Reg. § 1.704-1(b)(5) Ex. 14, 18; see also, e.g., R. Donald Turlington, *Section 704(c) and Partnership Book-Tax Disparities—The Ceiling Rule and the Art of Tax Avoidance*, 46 N.Y.U. ANNUAL INST. ON FED. TAX'N 26-1, 26-3 (1988) ("The ceiling rule provides that a partner contributing cash to a partnership (a 'cash contributing partner') may not be allocated income, gain, loss, or deduction for tax purposes attributable to property contributed by another partner in excess of a 'ceiling' amount equal to the partnership's total income, gain, loss, or deduction attributable to such property computed by treating the partnership as an entity separate and distinct from the partners."); John P. Steines, *Partnership Allocations of Built-in Gain or Loss*, 45 TAX L. REV. 615, 642 (1990) ("Thus, the most basic statement of the ceiling rule is that, where it applies, it prevents a partner from obtaining a cost basis equal to his economic investment in the portion of assets nominally contributed by, but economically purchased from, the other partners.").

On December 23, 1992, the Treasury issued new proposed regulations under section 704(c). PS-164-84, 1993-5 I.R.B. 34, 57 Fed. Reg. 61345 (1992). The proposed regulations retain the ceiling rule under the traditional method in addition to providing two other methods for making allocations under section 704(c). *Id.*; see, e.g., Blake D. Rubin & Seth Green, *The Proposed Regulations on Partnership Allocations with Respect to Contributed Property*, 59 TAX NOTES 257 (1993).

¹⁷² See *supra* note 18.

¹⁷³ See S. PRT. NO. 56, 101st Cong., 1st Sess. 195-98 (1989).

¹⁷⁴ *Id.* at 196-98.

¹⁷⁵ *Id.* at 196.

for an exception to its application if the contributed property was distributed to a partner and property of a like kind was distributed to the contributing partner within a limited time period.¹⁷⁶ The Senate failed to explain why it proposed a three-year time limit instead of the indefinite time period proposed by the House Ways and Means Committee.¹⁷⁷ The Senate Finance Committee did justify the inclusion of the like kind exception, however, on the ground that a transaction that would be treated as a like kind exchange if it occurred outside of the partnership should be treated in a similar manner if done through a partnership.¹⁷⁸

3. Conference Committee

The Conference Committee followed the Senate's proposal with one adjustment.¹⁷⁹ Instead of applying section 704(c) to distributions made within three years of contribution, the Conference Committee extended the period to five years.¹⁸⁰ The Committee did not elaborate as to why it adopted a five-year period.¹⁸¹

4. New Section 704(c)

Congress enacted sections 704(c)(1)(B) and 704(c)(2) as part of the 1989 Act.¹⁸² Section 704(c)(1)(B) provides that a distribution of contributed

¹⁷⁶ *Id.* at 197.

¹⁷⁷ *See id.*

Query whether the Senate was trying to have section 704(c) apply in a consistent manner with section 707(a)(2)(B). At the time of the 1989 Act, section 707(a)(2)(B) was thought to apply to contributions and distributions made within three years of each other. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 232 (Comm. Print 1985) ("Treasury regulations may provide for a period, such as three years, during which contributions by and distributions to the same or another partner normally will be presumed to be related for purposes of the disguised sale rule.")

The New York State Bar Association Tax Section, in commenting on the House's proposed changes to section 704(c), suggested that a time frame of "perhaps 10 years" be adopted. New York State Bar Association Tax Section, *Report on Certain Provisions of the Revenue Reconciliation Act of 1989*, 44 TAX NOTES 1543, 1557 (1989).

¹⁷⁸ S. PRT. NO. 56, 101st Cong., 1st Sess. 197 (1989).

¹⁷⁹ H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 624 (1989).

¹⁸⁰ *Id.*

¹⁸¹ Five years may have been adopted since that is the time frame consistently used in subchapter K in determining the characterization taint of contributed and distributed property. *See* I.R.C. §§ 724, 735 (1988).

¹⁸² Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7642, 103 Stat. 2106, 2379 (1989).

property other than to the contributing partner within five years of contribution will trigger any precontribution, built-in gain or loss.¹⁸³ The contributing partner must recognize gain or loss equal to the amount of gain or loss that would have been allocated to the contributing partner under section 704(c)(1)(A) if the contributed property had been sold for its fair market value at the time of distribution. The character of the gain or loss is the same as if the partnership had sold the property to the distributee partner.¹⁸⁴ Adjustments are also made to the contributing partner's basis in his partnership interest and to the basis of the distributed property to reflect the application of section 704(c)(1)(B).¹⁸⁵

Assume that A, B, and C are equal partners in ABC Partnership. A contributes property with an adjusted basis of \$100 and a fair market value of \$500, B contributes \$500 cash, and C contributes property with an adjusted basis of \$200 and a fair market value of \$500. The partnership takes A's property with an adjusted basis of \$100 and C's property with an adjusted basis of \$200.¹⁸⁶ A's basis in his partnership interest is \$100, and C's basis in her partnership interest is \$200.¹⁸⁷ The capital accounts of A, B, and C are all at \$500.¹⁸⁸ Later, the partnership distributes the property contributed by C to B when its fair market value is still \$500. If the distribution to B is made within five years of C's contribution, C must recognize \$300 of gain on the distribution of the property to B.¹⁸⁹ The character of the gain is determined by looking to what the character would have been if the partnership had sold the property to B.¹⁹⁰

C's basis in her partnership interest is increased by the \$300 of gain that C recognizes under section 704(c)(1)(B).¹⁹¹ The basis of the distributed property is also increased by the \$300 of gain, from \$200 to \$500, on the distribution.¹⁹² B will therefore take the distributed property with an adjusted basis of \$500, assuming that B's outside basis immediately prior to the distribution is at least \$500.¹⁹³

If the property contributed by C is only worth \$400 at the time of its distribution to B, then C recognizes only \$200 of gain if the distribution is

¹⁸³ I.R.C. § 704(c)(1)(B) (1991).

¹⁸⁴ I.R.C. § 704(c)(1)(B)(ii).

¹⁸⁵ I.R.C. § 704(c)(1)(B)(iii).

¹⁸⁶ I.R.C. § 723.

¹⁸⁷ I.R.C. § 722.

¹⁸⁸ Treas. Reg. § 1.704-1(b)(2)(iv)(b) (as amended in 1992).

¹⁸⁹ I.R.C. § 704(c)(1)(B)(i) (1991).

¹⁹⁰ I.R.C. § 704(c)(1)(B)(ii).

¹⁹¹ I.R.C. § 704(c)(1)(B)(iii).

¹⁹² *Id.*

¹⁹³ I.R.C. § 732(a)(1).

made within five years of contribution.¹⁹⁴ C's basis in the partnership interest is increased by the \$200 of gain recognized under section 704(c)(1)(B). The basis of the distributed property is increased from \$200 to \$400 on the distribution. B will therefore take the distributed property with an adjusted basis of \$400, again assuming that B has sufficient outside basis.

Congress provided four situations in which section 704(c)(1)(B) does not apply. First, if the contributed property is distributed to the contributing partner, then any built-in gain or loss will not be triggered under section 704(c).¹⁹⁵ Second, if the partnership makes an election under section 761(a) to be excluded from subchapter K, this will not trigger gain or loss under section 704(c).¹⁹⁶ Third, if the partnership distributes property contributed by a partner to another partner and other property of a like kind is distributed to the contributing partner within a certain time frame, then the contributing partner will be treated as receiving the contributed property from the partnership to the extent of the fair market value of the like kind property.¹⁹⁷ The like kind property must be distributed to the contributing partner by the earlier of 180 days after the date of the distribution of the contributed property or the due date of the contributing partner's tax return.¹⁹⁸ In essence, the contributing partner is making a like kind exchange through the partnership.¹⁹⁹ For example, assume that partner A contributes property with an adjusted basis of \$30 and a fair market value of \$100 to a partnership. The partnership later distributes the contributed property to partner B when it is still worth \$100 and also distributes like kind property to partner A. If the like kind property has a fair market value of at least \$100, then the contributing partner A will not recognize gain under section 704(c)(2). If the like kind property has a fair market value of only \$90, then the contributing partner A will recognize \$10 of gain under section 704(c)(2).²⁰⁰

In the fourth situation, precontribution gain or loss is not triggered by a constructive termination of the partnership under section 708(b)(1)(B).²⁰¹

¹⁹⁴ See S. PRT. NO. 56, 101st Cong., 1st Sess. 196-97 (1989).

¹⁹⁵ I.R.C. § 704(c)(1)(B) (1991).

¹⁹⁶ See S. PRT. NO. 56, 101st Cong., 1st Sess. 198 (1989).

¹⁹⁷ I.R.C. § 704(c)(2).

¹⁹⁸ I.R.C. § 704(c)(2)(B). The due date of the contributing partner's return is determined with regard to extensions of time to file. *Id.*

¹⁹⁹ See S. PRT. NO. 56, 101st Cong., 1st Sess. 197 (1989).

²⁰⁰ For an interesting way of applying the like kind rule contained in section 704(c)(2), see BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 86.2.3 (1991).

²⁰¹ S. PRT. NO. 56, 101st Cong., 1st Sess. 197-98 (1989). Section 708(b)(1)(B) states

A constructive termination "does not change the application of the sharing requirements of 704(c) (as amended by the bill) to pre-contribution gain or loss with respect to property contributed to the partnership before the termination."²⁰² However, the deemed property contribution resulting from constructive partnership termination requires "the application of section 704(c) (as amended by the bill) to the partners' shares of any increase or decrease in the value of the partnership's assets occurring after those assets were acquired (whether by purchase or contribution) by the partnership and before the termination."²⁰³ Consequently, "partners will recognize gain or loss in connection with any subsequent distribution of partnership property within 3 years [changed to 5 years] of the date of the termination, to the extent of their respective shares of the pre-termination appreciation or depreciation in the value of the partnership property that is not already required to be allocated under 704(c) to the original contributor (if any) of the property."²⁰⁴ As a result, it appears that section 704(c) can apply more than once to the same piece of property.

Assume that A and B are equal partners in AB Partnership. A contributes property X with an adjusted basis of zero and a fair market value of \$100. B contributes property Y with an adjusted basis and fair market value of \$100. After three years, B sells her partnership interest to C for \$110. At the time of sale, property X has appreciated in value to \$120. The sale triggers section 708(b)(1)(B), which creates a constructive termination of the partnership. Assume that the partnership has a section 754 election in effect, which means that a \$10 basis adjustment is made to property X under section 743(b).²⁰⁵

that a partnership is terminated if within a twelve month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.

²⁰² S. PRT. NO. 56, 101st Cong., 1st Sess. 198 (1989). Congress has stated that the rationale for this result "is that a termination could otherwise cause a shift of pre-contribution built-in gain or loss away from the contributed property to other property, which is contrary to the purpose of this provision of the bill." *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ The basis adjustment to property X is made in accordance with I.R.C. § 755 and Treas. Reg. § 1.755-1 (1960).

In Rev. Rul. 86-73, 1986-1 C.B. 283, the Service held that if a partnership has a section 754 election in effect at the time of a constructive termination under section 708(b)(1)(B), the election applies to the incoming partner in the terminating partnership. If the partnership does not have a section 754 election in effect at the time of the constructive termination, the partnership can make the section 754 election on its final, terminating year return. Rev. Rul. 88-42, 1988-1 C.B. 265.

Section 732(d) may apply to a partnership that does not have a section 754 election in effect. See, e.g., Priv. Ltr. Rul. 92-32-022 (May 5, 1992) (applying section 732(d) to a section 708(b)(1)(B) constructive termination). For the difficulty and possible

The partnership property is treated as being distributed to A and C in complete liquidation of the AB Partnership and then contributed to a new AC Partnership.²⁰⁶ After the deemed contribution to the new AC Partnership, it appears that \$100 of built-in gain with respect to property X is still subject to section 704(c)(1)(B) for at least two more years, and possibly for five years, as to A.²⁰⁷ In addition, the \$10 of remaining built-in gain with respect to property X is subject to section 704(c)(1)(B) for five years as to A. If, for example, property X is distributed to C shortly after the constructive termination, A must recognize \$110 of gain under section 704(c)(1)(B). More specifically, section 704(c)(1)(B) applies to trigger \$100 of gain and then applies again to trigger \$10 of gain.

The exact mechanics of the distribution and contribution on the constructive termination seem to be uncertain.²⁰⁸ There appear, however, to be at least two possible approaches.²⁰⁹ The first approach is to treat A and C as receiving an equal portion of each asset (\$60 of property X and \$50 of property Y) in the constructive termination and then contributing the assets back to the partnership.²¹⁰ This appears to be the approach adopted by the regulations promulgated in 1956 under section 708.²¹¹ Under this first approach, however, part of the original \$100 of section 704(c) built-in gain with respect to property X has been shifted from property X to property Y. More specifically, A is only subject to \$60, instead of \$110, of section 704(c) gain with respect to property X after the contribution to the new AC Partnership. Apparently, though, A is also subject to \$50 of section 704(c) gain with respect to property Y for five years after the constructive termination.²¹² In addition, the deemed distribution and contribution of section 708 will subject C to section 704(c) on one-half of property X and one-half of property Y.

inapplicability of applying section 732(d) to a section 708(b)(1)(B) constructive termination, see, e.g., MCKEE ET AL., *supra* note 11, ¶ 12.05[2][e] (Supp. No. 2 1992); WILLIS ET AL., *supra* note 112, § 162.06.

²⁰⁶ Treas. Reg. § 1.708-1(b)(1)(iv) (1960).

²⁰⁷ The constructive termination does not trigger the built-in gain under section 704(c)(1)(B). See S. PRT. NO. 56, 101st Cong., 1st Sess. 197-198 (1989); WILLIS ET AL., *supra* note 112, at § 132.10, § 162.06.

²⁰⁸ See, e.g., MCKEE ET AL., *supra* note 11, ¶ 10.04[4] (Supp. No. 3 1992) (suggesting two possible approaches).

²⁰⁹ *Id.*

²¹⁰ See *id.*

²¹¹ See *id.*; *id.* ¶ 12.05[2][e].

²¹² See *id.* ¶ 10.04[4].

The second approach is to treat A as receiving \$110 of property X and C as receiving \$100 of property Y and \$10 of property X in the constructive termination, and to then contribute the assets back into the partnership.²¹³ This second approach preserves the original \$100 of built-in gain to A with respect to property X and also preserves the \$10 of built-in gain that occurred during the time that the partnership held property X. C is not subject to any section 704(c) gain with respect to either property X or property Y. Such an approach seems to be consistent with the legislative history to section 704(c)(1)(B).²¹⁴

There are several interesting issues with respect to section 704(c)(1)(B) and its interaction with various distribution provisions. Does it apply to a distribution of property that is subject to a reverse section 704(c) allocation?²¹⁵ The statute does not address this issue. The section 704(b) regulations that provide for reverse section 704(c) allocations have not been changed to reflect the enactment of section 704(c)(1)(B), so they also do not address the issue. The legislative history obliquely addresses the issue in the following statement: "The provision applies only to a transfer of contributed property to a partner in a transaction that is properly characterized as a distribution."²¹⁶ Property that is subject to a reverse section 704(c) allocation is not contributed property, at least as to the built-in gain or loss that is created by the revaluation, i.e., the book-up. In addition, the legislative history implies that section 704(c)(1)(B) only applies to a contribution of property by specifically stating that section 704(c)(1)(B) applies to the deemed contribution of property that takes place after a constructive termination.²¹⁷ At least one commentator has concluded that section 704(c)(1)(B) does not apply to a distribution of property subject to a reverse section 704(c) allocation.²¹⁸ While this seems to be the proper view, it remains to be seen whether the

²¹³ See *id.*

²¹⁴ See *supra* text accompanying notes 201-04.

²¹⁵ Generally, a reverse section 704(c) allocation is created when a partnership restates its assets upon admitting a new partner into the partnership. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 1992). Although the restatement of assets, often referred to as a "book-up," is not required, most partnerships will do so. *Id.* When the partnership books-up, the partners' distributive shares of depreciation, depletion, amortization, and gain or loss must be determined so as to take account of the variation between the adjusted tax basis of the property and the book value of such property in the same manner as under section 704(c). Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4); see Treas. Reg. § 1.704-1(b)(2)(iv)(g), -1(b)(5) Ex. 14, 18; Treas. Reg. § 1.704-3(a)(4).

²¹⁶ S. PRT. NO. 56, 101st Cong., 1st Sess. 198 (1989).

²¹⁷ *Id.*

²¹⁸ John P. Steines, *supra* note 171, at 640; see WILLIS ET AL., *supra* note 112, § 108.10.

Treasury Department will attempt to apply section 704(c)(1)(B) to a distribution of property that is subject to a reverse section 704(c) allocation.

Another issue to consider when practicing in this area is how section 704(c)(1)(B) interacts with section 751(b). It appears that section 704(c)(1)(B) applies first, followed by section 751(b).²¹⁹ For example, assume that AB Partnership has two assets, cash of \$15,000 and inventory with an adjusted basis of \$3,000 and a fair market value (and book value) of \$15,000. Partner A contributed the \$15,000 cash and partner B contributed the \$15,000 of inventory. The partnership later distributes \$5,000 of inventory to A who has an adjusted basis in the partnership interest of \$15,000 and a capital account of \$15,000. Section 704(c)(1)(B) triggers \$4,000 of gain to B on the distribution. This increases the adjusted basis of the distributed inventory to \$5,000, as well as increasing B's adjusted basis in his partnership interest by \$4,000, to a total of \$7,000. A is treated as receiving \$5,000 of inventory with an adjusted basis of \$5,000 and as receiving the inventory, a substantially appreciated inventory item,²²⁰ in exchange for part of A's interest in other partnership property. Thus, A is treated as purchasing \$1,500 of inventory for \$1,500 of cash that was received in a phantom distribution. A will recognize no gain or loss as a result of the deemed purchase under section 751(b). The partnership also will not recognize gain or loss on the deemed sale of the inventory for \$1,500 cash because its basis in the inventory was \$1,500.

If section 704(c)(1)(B) applies at the same time as section 751(b), then the results appear to be the same. A is still treated as receiving a phantom distribution of \$1,500 cash which A uses to acquire \$1,500 of inventory from the partnership triggering \$1,200 of gain to B under section 704(c)(1)(A). On the remaining distribution of \$3,500 of inventory to A, \$2,800 of gain will be triggered to B under section 704(c)(1)(B). B's total gain recognized will still be \$4,000.

Finally, section 704(c)(1)(B) appears to render section 731(a)(2) inapplicable in certain situations. For example, assume that partner A is receiving an inventory item in liquidation of his partnership interest. The inventory item has an adjusted basis of \$10 and a fair market value (and book value) of \$100. A's basis in his partnership interest is \$80. The inventory item was contributed by partner B within the last five years, at a time when its fair market value was \$100. Prior to the enactment of section 704(c)(1)(B), A would have taken the inventory item with an adjusted basis of \$10 and would

²¹⁹ See S. PRT. NO. 56, 101st Cong., 1st Sess. 197 (1989).

²²⁰ The appropriate time for determining whether the partnership has unrealized receivables or substantially appreciated inventory items seems to be subsequent to the application of section 704(c)(1)(B).

have recognized a \$70 capital loss.²²¹ After the Revenue Reconciliation Act of 1989, however, section 704(c)(1)(B) will trigger \$90 of gain to B, resulting in a \$90 basis adjustment to the inventory.²²² The inventory item will have an adjusted basis of \$100 on distribution to A.²²³ A will therefore take the inventory item with an adjusted basis of \$80 and will not recognize a loss on the distribution.

IV. PARTNERSHIP DISTRIBUTIONS THAT ARE RECHARACTERIZED AS OTHER TRANSACTIONS

Congress made a number of changes to the tax treatment of partnerships in the Tax Reform Act of 1984 (the "1984 Act").²²⁴ Two of the changes involve partnership distributions.²²⁵ In essence, the changes recharacterize what the partners and the partnership term a distribution and treat the distribution as a payment to a partner who is not acting in his capacity as a partner.²²⁶ In other words, the distribution is not treated as a distribution subject to the rules contained in subpart B of subchapter K (sections 731 through 737). The recharacterization can result in either gain or loss to a partner.

The Service has also recharacterized a particular type of transaction commonly referred to as a "May Company" transaction.²²⁷ Generally, a May Company transaction attempts to achieve nonrecognition by utilizing the partnership distribution rules rather than the corporate distribution rules, which now result in recognition of gain due to the

²²¹ See *supra* text accompanying notes 117-39.

²²² S. PRT. NO. 56, 101st Cong., 1st Sess. 197 (1989) ("[T]he partnership's adjusted basis for the distributed property will be increased or decreased respectively, to reflect any gain or loss to the contributor recognized . . . upon the distribution.").

²²³ See *id.* (stating that the basis adjustment to the distributed property is taken into account in determining the distributee's adjusted basis for the distributed property under section 732).

²²⁴ Pub. L. No. 98-369, 98 Stat. 494 (1984) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter the 1984 Act]. For a description of all of the changes made to subchapter K, see generally JAMES S. EUSTICE, *THE TAX REFORM ACT OF 1984: A SELECTIVE ANALYSIS* (1984); William S. McKee et al., *Tax Reform Act of 1984: Provisions Affecting the Taxation of Partnerships and Partners*, 43 N.Y.U. ANNUAL INST. ON FED. TAX'N ch. 28 (1985).

²²⁵ Pub. L. No. 98-369, § 73(a)-(b), 98 Stat. 494, 591 (codified at I.R.C. § 707(a)(2)(A)-(B) (1989)).

²²⁶ I.R.C. § 707(a)(2)(A), (B).

²²⁷ I.R.S. Notice 89-37, 1989-1 C.B. 679. For a discussion of the May Company transaction, see generally Lee A. Sheppard, *Curbing General Utilities Abuses: The Scope of Notice 89-37*, 47 TAX NOTES 1433 (1989).

repeal of the *General Utilities* doctrine by the Tax Reform Act of 1986.²²⁸ Under authority granted to it pursuant to section 337(d), the Service issued a Notice to prevent May Company transactions.²²⁹ Generally, the Notice recharacterizes and treats an acquisition or distribution of stock as a redemption of stock, thereby triggering recognition of gain.²³⁰

A. Section 707(a)(2)

1. Section 707(a)(2)(A)

Section 707(a)(2), enacted as part of the 1984 Act, contains two separate rules. Congress enacted the first rule, contained in section 707(a)(2)(A), in order to prevent a partnership from deducting, or achieving the effect of a deduction for, a capital expenditure.²³¹ For example,²³² a partnership constructs a commercial office building that is projected to generate gross income of at least \$100,000 per year for an indefinite period after lease-up.²³³ The architect of the office building is also a 25% partner in the partnership and acquired his interest by paying cash. The architect's normal fee with respect to the office building is \$40,000. In addition to the architect's receipt of a 25% distributive share of income from the partnership for the life of the partnership, the partnership makes a special allocation of \$20,000 of partnership gross income to the architect for the first two years of partnership operations after lease-up. The partnership is expected to have enough cash in each of its first two years after lease-up to distribute \$20,000 to the architect in each year, and the partnership agreement requires such distributions.

²²⁸ Under the *General Utilities* doctrine "a corporation does not recognize gain or loss on a distribution of appreciated or depreciated property to its shareholders with respect to their stock." BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.20 (5th ed. 1987). For a full explanation of the *General Utilities* doctrine and its repeal, see generally George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 573 (1987).

²²⁹ I.R.S. Notice 89-37, 1989-1 C.B. 679.

²³⁰ On December 14, 1992, the Service issued proposed regulations interpreting the Notice.

²³¹ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 223.

²³² This example is adopted from the legislative history to section 707(a)(2)(A). See *id.* at 229-30.

²³³ The term "lease-up" refers to the point where a rental property has reached full projected occupancy.

The architect fee should be capitalized under sections 263 and 263A, because if the partnership had agreed to pay the \$40,000 architect fee, the fee would have been capitalized as part of the cost of the office building. If the allocation and distribution scheme is respected, however, the partnership, in essence, is deducting the \$40,000 architect fee. More specifically, the special allocation and distribution of \$20,000 to the architect in each of the first two years after lease-up will reduce the income allocated to the partners. Thus, the partners, other than the architect, will be allocated less income, and the architect will still receive \$40,000.²³⁴ It was this type of scheme that led Congress to enact section 707(a)(2)(A).²³⁵ Section 707(a)(2)(A) provides:

If (i) a partner performs services for a partnership or transfers property to a partnership, (ii) there is a related direct or indirect allocation and distribution to such partner, and (iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership. . . .²³⁶

Therefore, when section 707(a)(2)(A) is applicable, the allocation and distribution is treated as a transaction occurring between the partnership and a person who is not a partner pursuant to section 707(a)(1).

The Treasury Department has yet to issue regulations under section 707(a)(2)(A) since its enactment nine years ago.²³⁷ Thus, the only guidance in applying section 707(a)(2)(A) is the legislative history. The legislative history stated that, in developing regulations, the Treasury should focus on transactions that "avoid capitalization requirements or other rules and restrictions governing direct payments . . . [rather than

²³⁴ The architect's basis in his partnership interest and capital account will each be increased by the \$40,000 income allocation and decreased by the \$40,000 distribution, thereby leaving both the basis and capital account at their original balances.

²³⁵ See *supra* note 231 and accompanying text.

²³⁶ I.R.C. § 707(a)(2)(A).

²³⁷ In 1992, the Treasury Department promulgated Treas. Reg. § 1.707-3(e), which states that Treas. Reg. §§ 1.707-3 to 1.707-9 are applicable to sections 707(a)(2)(A) and 707(a)(2)(B). Treas. Reg. § 1.707-3(e) (1992). The examples in the regulations, however, all involve transfers of property under section 707(a)(2)(B). The reason for this omission of section 707(a)(2)(A) is that section 707(a)(2)(A) rarely involves transfers of property to a partnership; it is primarily limited to the performance of services. The regulations dealing with performance of services have been reserved. See Treas. Reg. § 1.707-2 (1992).

focusing on] non-abusive allocations that accurately reflect the various economic contributions of the partners."²³⁸

The Joint Committee Report provided six factors to consider in applying section 707(a)(2)(A).²³⁹ The first factor, which is the most important of the six, is "whether the payment is subject to an appreciable amount of risk."²⁴⁰ A partner's receipt of profits from a partnership is dependent upon the success of the partnership, while third parties receive payments that are not dependent on the success of the partnership.²⁴¹ Therefore, an allocation and distribution given to a service partner that subjects the partner to the entrepreneurial risk of the partnership as to both the amount and payment should be respected as a distributive share and partnership distribution.²⁴² If, on the other hand, the allocation and distribution subjects the service partner to a limited amount of risk as to the amount and payment of his fee, it should be treated as a fee for services under section 707(a)(1).²⁴³ The Joint Committee gave several examples of allocations that limit a partner's risk,²⁴⁴ including capped allocations of partnership income²⁴⁵ and "allocations for a fixed number of years under which the income that will go to the partner is reasonably certain."²⁴⁶

²³⁸ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 227.

²³⁹ *Id.* at 227-29. The Committee provided the six factors as a way to determine whether a partner is receiving the putative allocation and distribution in his capacity as a partner. If so, then the form is respected. If not, then the putative allocation and distribution is recast under section 707(a)(2)(A) as a transaction occurring between the partnership and a partner not acting in his capacity as a partner under section 707(a)(1). It is interesting to note that Congress was focusing on the *capacity* of the services being rendered by the partner and not on the *nature* of the services. The case law and rulings, however, that have developed under section 707(a)(1) in determining whether a partner is acting in his capacity as a partner have focused on the nature of the services being rendered and not on the capacity in which they are rendered. See, e.g., Pratt v. Commissioner, 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977); Rev. Rul. 81-300, 1981-2 C.B. 143; Rev. Rul. 81-301, 1981-2 C.B. 144.

²⁴⁰ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 227.

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ *Id.*

²⁴⁴ *Id.* at 227-28.

²⁴⁵ The Joint Committee defined capped allocations as "percentage or fixed dollar amount allocations subject to an annual maximum amount when the parties could reasonably expect the cap to apply in most years." *Id.* at 228.

²⁴⁶ *Id.*

The second factor to consider in applying section 707(a)(2)(A) is whether the recipient's status as a partner is transitory.²⁴⁷ Transitory partner status suggests a fee payment.²⁴⁸ Non-transitory partner status, however, is given no particular relevance.²⁴⁹ The third factor is whether the allocation and distribution are close in time to the partner's rendering of services for, or transferring of property to, the partnership.²⁵⁰ An allocation made within a close proximity in time suggests that the allocation is related to the services or property.²⁵¹ If the allocation is remote in time or extends over a period of time, then the risk of not receiving payment may increase.²⁵²

The fourth factor is "whether, under all the facts and circumstances, it appears that the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered services to the partnership in a third party capacity."²⁵³ No relevance is given to the fact that the recipient also has significant non-tax motivations for becoming a partner.²⁵⁴ The fifth factor is "whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question."²⁵⁵ If so, the allocation appears to be a fee.²⁵⁶ As with some of the other factors, though, the converse is not true. Thus, the fact that the recipient's interest in general and continuing partnership profits is substantial, does not suggest that the allocation and distribution should be respected.²⁵⁷ The sixth, and final factor, to consider in applying section 707(a)(2)(A) relates only to transfers of property and not to the performance of services.²⁵⁸

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ *Id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.*

²⁵⁸ The sixth factor is whether the first requirement under the test for economic effect under the section 704(b) regulations is met. If it is, then allocations of income which are disguised payments for capital are "economically unfeasible and unlikely to occur." *Id.* at 229. The first requirement for economic effect is proper maintenance of capital accounts under Treas. Reg. § 1.704-1(b)(2)(iv). Treas. Reg. § 1.704-1(b)(2)(ii). If capital accounts are properly maintained, then section 707(a)(2)(A) generally has no application

Although section 707(a)(2)(A) applies to transfers of property with a related direct (or indirect) allocation and distribution to such partner,²⁵⁹ such a transfer is unlikely to occur. The reason is that the partnership has not circumvented the capitalization requirements of the Code. In fact, the sixth factor given by the Committee, which applies to a transfer of property, is "whether the requirement that capital accounts be respected under section 704(b) (and the proposed regulations thereunder) makes income allocations which are disguised payments for capital economically unfeasible and therefore unlikely to occur."²⁶⁰ For example, assume that C contributes property with an adjusted basis and fair market value of \$20,000 to ABC Partnership. C's capital account must be increased by \$20,000.²⁶¹ The partnership will take the property with an adjusted basis and book value of \$20,000. An allocation and distribution of \$20,000 to C will merely increase and then decrease C's capital account by \$20,000, leaving it at its original balance of \$20,000. The adjusted basis and book value of the property will be unaffected by the allocation and distribution to C.

The Joint Committee did recognize several situations in which section 707(a)(2)(A) may apply to a transfer of property.²⁶² If (1) the valuation of the contributed property is below the fair market value of the property, (2) the property is sold by the partner to the partnership below the fair market value of the property, or (3) the capital account will not be respected until such a distant point in the future that there is no meaningful return on the capital account, then section 707(a)(2)(A) may apply.²⁶³ The first two situations are essentially fraudulent or sham types of transactions. The third situation seems to require that the partners set up a guaranteed payment or preferred return provision in the partnership agreement.

In addition to applying to transfers of property, section 707(a)(2)(A) can apply to the partnership's use of property from a partner. Assume that a cash method partnership wants to use property of partner A. The partnership will

to transfers of property unless (1) the partnership improperly values the property below its fair market value, (2) the partner sells the property to the partnership below its fair market value, or (3) the capital account will not be respected until some distant time such that its present value is small and, in addition, no meaningful return is made on the capital account during the intervening period.

²⁵⁹ I.R.C. § 707(a)(2)(A)(ii) (1989).

²⁶⁰ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 229.

²⁶¹ Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1) (as amended in 1992).

²⁶² STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 229.

²⁶³ *Id.*

use the property for three years and then return it to A. A would normally charge \$1,000 per year rental for the property. If the partnership paid A \$1,000 per year, it would get a \$1,000 deduction each year.²⁶⁴ If, instead, it paid A \$3,000 for three years' rental, the partnership would only be allowed to deduct \$1,000 each year.²⁶⁵ As an alternative, the partnership specially allocates and distributes \$3,000 to A in year one and makes no rental payments to A. The partnership has achieved the equivalence of a deduction for \$3,000 in the first year that would otherwise be capitalized and amortized. This scheme should be caught by section 707(a)(2)(A) because the partnership is circumventing the capitalization requirements of the Code, the very evil that section 707(a)(2)(A) was designed to prevent.

2. Section 707(a)(2)(B)

The second rule contained in section 707(a)(2), known as the "disguised sales" provision, is completely different than the first rule. The first rule applies almost exclusively to the performance of services with a related allocation *and* distribution.²⁶⁶ The second rule, contained in section 707(a)(2)(B), applies to a transfer of property with a related distribution but *not* a corresponding allocation.²⁶⁷ If applicable, section 707(a)(2)(B) recharacterizes the transfer of property and related distribution as a sale or exchange. As a result, the distribution is recharacterized as part of the sale proceeds of the transferred property. For example, assume that partner A contributes property with an adjusted basis of \$10 and a fair market value of \$100 to ABC Partnership. Also assume immediately prior to the transaction, A's basis in his partnership interest is \$150. The partnership immediately distributes \$100 cash to A. The cash reduces A's basis in his partnership interest, and no gain or loss is

²⁶⁴ See I.R.C. § 162(a)(3) (1988). *But see* I.R.C. § 263 (capitalization rules); I.R.C. § 263A (uniform capitalization rules); *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (noting that expenditures that might normally be currently deducted must be capitalized when attributable to the construction of a capital asset).

²⁶⁵ Treas. Reg. § 1.461-1(a) (as amended in 1992); *see, e.g., Blitzer v. United States*, 684 F.2d 874, 894 (Ct. Cl. 1982); *Commissioner v. Boylston Market Assoc.*, 131 F.2d 966 (1st Cir. 1942); *Williamson v. Commissioner*, 37 T.C. 941, 943 (1962); Rev. Rul. 80-70, 1980-1 C.B. 104. *But see, e.g., Commissioner v. Van Raden*, 650 F.2d 1046, 1050 n.7 (9th Cir. 1981); *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980); *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823, 825 (8th Cir. 1957).

²⁶⁶ I.R.C. § 707(a)(2)(A) (1989).

²⁶⁷ *See* I.R.C. § 707(a)(2)(B) (1989).

recognized by A. It appears that A has, in effect, sold the property to the partnership for \$100 cash. By structuring it as a contribution and distribution, however, A has deferred recognizing the \$90 of built-in gain with respect to the property.

The drafters of the original regulations under subchapter K in 1956 anticipated that some taxpayers would try to utilize the contribution and distribution provisions in subchapter K to achieve tax deferral in situations where, in substance, a sale or exchange had taken place. Therefore, regulations were promulgated under sections 721²⁶⁸ and 731²⁶⁹ to recharacterize a contribution of property and a related distribution as a sale or exchange. Unfortunately, the courts rarely applied the regulations to find a sale and almost unanimously respected the form of the transaction as a contribution and distribution.²⁷⁰

In 1984, Congress enacted section 707(a)(2)(B), which basically codified regulations promulgated under sections 721 and 731 recharacter-

²⁶⁸ Treas. Reg. § 1.721-1(a), promulgated in 1956, states in pertinent part: Rather than contributing property to a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See Treas. Reg. § 1.731-1(c)(3) (1956). Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

²⁶⁹ Treas. Reg. § 1.731-1(c)(3), also promulgated in 1956, states: If there is a contribution of property to a partnership and within a short period: (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (ii) After such contribution the contributed property is distributed to another partner, such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

See also Rev. Rul. 57-200, 1957-1 C.B. 205 (applying Treas. Reg. § 1.731-1(c)(3) to the transfer of stock of two corporations to a partnership owned by the same taxpayers who owned the stock, followed by a liquidation of the partnership).

²⁷⁰ See *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980); *Otey v. Commissioner*, 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980); *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983); *Park Realty v. Commissioner*, 77 T.C. 412 (1981); *Barenholtz v. Commissioner*, 77 T.C. 85 (1981); *Oliver v. Commissioner*, 13 T.C.M. (CCH) 67 (1954). But see *Jacobson v. Commissioner*, 96 T.C. 577 (1991), *aff'd*, 963 F.2d 218 (8th Cir. 1992); *Colonnade Condominium Inc. v. Commissioner*, 91 T.C. 793 (1988).

izing a contribution and related distribution as a sale or exchange. In enacting section 707(a)(2)(B), Congress specifically intended to overrule a number of cases that respected the form of a transaction as a contribution and distribution.²⁷¹ Section 707(a)(2)(B) provides:

If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) [section 707(a)(1)] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.²⁷²

Almost seven years after the enactment of section 707(a)(2)(B), the Treasury Department finally issued proposed regulations interpreting the section.²⁷³ After the incorporation of several changes, the proposed regulations were finalized on September 25, 1992.²⁷⁴ The proposed regulations and the final regulations have been described in detail in a number of articles and no attempt will be made to do so here.²⁷⁵

²⁷¹ See Senate Finance Committee, *Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. 225 (S. Prt. No. 169 Comm. Print 1984); STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 226.

²⁷² I.R.C. § 707(a)(2)(B).

²⁷³ PS-163-84, 1991-1 C.B. 951; 56 Fed. Reg. 19055 (April 25, 1991).

²⁷⁴ T.D. 8439, 1992-44 I.R.B. 101; 57 Fed. Reg. 44974 (September 30, 1992).

²⁷⁵ See, e.g., Terence F. Cuff, *Disguised Sales from Partners to Partnerships: An Overview of the Proposed Regulations*, 19 J. REAL ESTATE TAX'N 171 (1991); Susan T. Edlavitch, *The Disguised Sale Question Under the Service's Final Regulations*, 20 J. REAL ESTATE TAX'N 211 (1993); Michael J. Grace, *Final Disguised Sale Regs. Add Clarification but Leave Some Issues Unaddressed*, 10 J. PARTNERSHIP TAX'N 3 (1993); Robert D. Howard & John Delaney, *Partner Transactions Under the Final Section 707 Regs. and New Law*, 78 J. TAX'N 46 (1993); Robert D. Howard & John Delaney, *Unmasking Disguised Sales from Partners to Partnerships Under New IRS Guidelines*, 75 J. TAX'N 132 (1991); New York State Bar Association Tax Section, *Report on Proposed Section 707 Regulations Concerning Disguised Sales of Property Through Partnerships*, 54 TAX NOTES 65 (1992); Blake D. Rubin et al., *The Proposed Partnership Disguised Sale Regulations*, 52 TAX NOTES 1051 (1991); Mark J. Silverman & Blake D. Rubin, *Tax Planning for Contributions of Property to Partnerships: The New Proposed Regulations Under Section 707(a)(2)*, in TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, FINANCINGS, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS (PLI Tax Law and Estate Planning Course Handbook Series No. 317, 1991).

Generally, the regulations provide that section 707(a)(2)(B) is applicable if based on all the facts and circumstances, "the transfer of money or other consideration would not have been made but for the transfer of property; and *in* cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations."²⁷⁶ If a sale or exchange has taken place, it is determined to have taken place on the date that the partnership is considered to be the owner of the property under general principles of federal tax law.²⁷⁷ Fortunately, the Treasury Department has provided a number of safe harbors and presumptions in applying section 707(a)(2)(B). For example, if a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period, then the transfers are presumed to be a sale unless the facts and circumstances clearly establish that the transfers do not constitute a sale.²⁷⁸ Conversely, if the transfers are more than two years apart, they are presumed not to be a sale unless the facts and circumstances clearly establish a sale.²⁷⁹

B. Internal Revenue Service Notice 89-37

1. Background

In 1988, May Department Stores ("May Company") approached Skadden, Arps, Slate, Meagher & Flom ("Skadden Arps") with respect to May Company's disposition of its real estate subsidiary. May Company's stock basis in its subsidiary was zero, and the stock had a value of approximately \$550 million. May Company wanted to dispose of the stock of its subsidiary without recognizing any gain. Skadden Arps thus devised the following transaction for May Company. Skadden Arps had May Company form a partnership with Prudential Insurance Co. of America and Melvin Simon & Associates, Inc. ("Pru-Simon"). In

²⁷⁶ Treas. Reg. § 1.707-3(b)(1) (1992). Generally, the relevant facts and circumstances in determining whether a sale has taken place are the ones existing on the date of the earliest transfer. Treas. Reg. § 1.707-3(b)(2). The Treasury Department has provided a list of ten factors that may be relevant in determining whether a sale has taken place. *Id.*

²⁷⁷ Treas. Reg. § 1.707-3(a)(2). Therefore, sections 453, 483, 1001, 1012, 1031, and 1274 of the Code may be applicable. *Id.* Treating the sale as occurring on the date that the partnership becomes the owner of the property seems to create unnecessary complexity and arguably cannot be supported by the statutory language.

²⁷⁸ Treas. Reg. § 1.707-3(c)(1); *see* Treas. Reg. § 1.707-3(f) Ex. 3, 4.

²⁷⁹ Treas. Reg. § 1.707-3(d); *see* Treas. Reg. § 1.707-3(f) Ex. 5, 6, 7, 8.

exchange for a 50% interest in a partnership, May Company contributed the stock of its real estate subsidiary. Pru-Simon contributed \$550 million cash in exchange for its 50% interest in the partnership.

May Company then acquired \$550 million of May Company stock in a self-tender offer and sold the stock to the partnership for \$550 million. As a result, the partnership owned two assets: all of the stock of the real estate subsidiary and \$550 million of stock of May Company. Skadden Arps' plan called for the partnership to operate for several years.²⁸⁰ Upon liquidation, the partnership would distribute the stock of the real estate subsidiary to Pru-Simon. Pru-Simon would take the stock with an adjusted basis of \$550 million.²⁸¹ May Company would be left with \$550 million of its own stock. The end result was that May Company had redeemed \$550 million of its stock using appreciated property—the stock of the real estate subsidiary—without recognizing gain. More specifically, May Company had avoided the repeal of *General Utilities*.²⁸²

2. The Service's Response

On March 9, 1989, the Service released Notice 89-37²⁸³ in direct response to the May Company transaction. The Notice eliminates the benefit of May Company-type transactions in one of two ways, depending upon when the partnership acquired the stock of its corporate partner.²⁸⁴

²⁸⁰ The purpose of having the partnership operate for several years was apparently to avoid the application of section 707(a)(2)(B).

²⁸¹ I.R.C. § 732(b) (1988).

²⁸² If May Company had simply redeemed \$550 million of its stock using appreciated property (the stock of the real estate subsidiary), it would have been forced to recognize \$550 million of gain under section 311(b).

²⁸³ 1989-1 C.B. 679.

²⁸⁴ The Notice also prevented May Company from successfully completing its transaction and avoiding the repeal of *General Utilities*. See I.R.S. Notice 89-37, 1989-1 C.B. 679 (In order to preserve the repeal of the *General Utilities* Doctrine, "a partnership's distribution to a corporate partner of the stock of such corporation . . . should be characterized as a redemption."). Apparently, May Company unsuccessfully attempted to have Senator Robert Dole intervene on its behalf. See Sheppard, *supra* note 227, at 1434.

The *Wall Street Journal* recently reported that May Company was dissolving the real estate partnership that it had formed with Pru-Simon. The real estate partnership, May Centers Associates, owned two real estate firms which would be owned 50% each by May Company and Prudential Insurance Co. of America, which had purchased from Melvin, Simon & Associates, Inc. its interest in the partnership. The two companies are May Centers Associates Corp. and Center-Mark Properties, Inc., formerly known as May Centers Inc. Apparently, Center-Mark Properties, Inc. was the real estate subsidiary that May Company wanted to dispose of without recognizing gain. No mention was made as

The critical date is March 9, 1989—the effective date of Notice 89-37. If the partnership distributes to a corporate partner the stock of such corporation or the stock of an affiliate of such corporation after March 9, 1989, the distribution is characterized as a redemption of the corporate partner's stock with "property consisting of its partnership interest."²⁸⁵ In other words, section 311(b) will apply instead of section 731(a).²⁸⁶ This rule is generally referred to as the "back-end" rule.

In addition to the "back-end" rule, Notice 89-37 also establishes the "front-end" rule. If a partnership acquires stock of a corporate partner after March 9, 1989, the Service treats the acquisition as resulting in a "deemed redemption" of the corporate partner's stock. In such a case, the deemed redemption rule will apply so that "gain will be recognized at the time of, and to the extent that, the acquisition has the economic effect of an exchange by a corporate partner of its interest in appreciated property for an interest in its stock [or stock of an affiliate] owned or acquired by the partnership."²⁸⁷

For example, assume that X Corporation contributes appreciated property with an adjusted basis of \$100 and a fair market value of \$300 for a 30% interest in the partnership. Y contributes X Corporation stock with an adjusted basis of \$400 and a fair market value of \$700 for a 70% interest in the partnership. Under the deemed redemption rule, at the time that the X Corporation stock is contributed, X Corporation will be treated as redeeming 30% of its stock that is being held by the partnership in exchange for 70% of the appreciated property that it contributed to the partnership. Therefore, X Corporation has section 311(b) gain of \$140 (\$210-\$70) under the deemed redemption rule.

In the Notice, the Service stated that the deemed redemption rule would apply to other transactions, including partnership purchases of a corporate partner's stock, disproportionate distributions, and amendments to the partnership agreement.²⁸⁸ The Service also stated that it was considering a de minimis rule as well as other possible exceptions.²⁸⁹

to what happened to the May Company stock that the partnership had purchased several years earlier. See *May Dep't Stores Co.*, WALL ST. J., May 19, 1992, at A4; *May Dep't Stores and Affiliate of Prudential to Dissolve Partnership*, WALL ST. J., Mar. 2, 1992, at B4.

²⁸⁵ I.R.S. Notice 89-37, 1989-1 C.B. 679.

²⁸⁶ The result of applying section 311(b) is that gain but not loss will be recognized by the corporate partner.

²⁸⁷ I.R.S. Notice 89-37, 1989-1 C.B. 679.

²⁸⁸ *Id.*

²⁸⁹ *Id.*

Unfortunately, however, the Service left many questions concerning the deemed redemption rule unanswered.²⁹⁰ Does the partnership in the above example have gain under section 302(b)? If so, to whom is the gain allocated? If 30% of the section 302(b) gain is allocated to X Corporation, must X Corporation include the gain in gross income? Can a special allocation of the entire gain be made to X Corporation under section 704(b)? What if the deemed redemption results in a dividend to the partnership under sections 302(d) and 301? Can a special allocation of all of the dividend be made to X Corporation under section 704(b)?²⁹¹ How does the Notice interact with section 704(c)(1)(B), which was enacted several months after the IRS issued the Notice?

On December 14, 1992, the Service issued proposed regulations interpreting the Notice,²⁹² yet the proposed regulations give little guidance beyond that given in the Notice. The proposed regulations describe the tax consequences of a distribution of a partner's stock after the application of the deemed redemption rule. For example, assume that in 1992 Corporation C and individual A form a CA partnership with C and A being equal partners.²⁹³ C contributes asset #1 with a basis of zero and a fair market value of \$100. A contributes C stock with a basis and fair market value of \$100. Under the deemed redemption rule, C is treated as exchanging an appreciated asset with a basis of zero and a fair market value of \$50 for 50% of the partnership's C stock. C will recognize a \$50 gain and increase its basis in the partnership interest by \$50. The partnership will also increase its basis in asset #1 by \$50.

In 1998, when asset #1 and the C stock have increased in value to \$200 each, the partnership liquidates, with C and A each receiving 50% of asset #1 and the C stock. Under the distribution rule contained in Proposed Regulation § 1.337(d)-3(e), C is treated as redeeming the \$100 of C stock received from the partnership in exchange for \$100 of C's partnership interest with a basis of \$25. C has a recognized gain of \$75 under section 311.²⁹⁴

²⁹⁰ See, e.g., Mark J. Silverman, *Using Partnerships as Acquisition Vehicles*, TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, FINANCINGS, JOINT VENTURES, REORGANIZATIONS, AND RESTRUCTURINGS 331 (PLI Tax Law and Estate Planning Course Handbook Series No. 317, 1991).

²⁹¹ See Priv. Ltr. Rul. 80-22-010 (February 1980) (if a partnership owns stock of a corporate partner, the corporate partner should not have gross income with respect to its distributive share of its own dividends).

²⁹² PS-91-90, 1993-2 I.R.B. 29; 57 Fed. Reg. 59324 (December 15, 1992); see, e.g., New York State Bar Association Tax Section Committee on Corporations, *Report on Proposed Regulations Implementing Notice 89-37*, 59 TAX NOTES 691, 691-92 (1993).

²⁹³ This example is found in Prop. Treas. Reg. § 1.337(d)-3(h) Ex. 1.

²⁹⁴ *Id.*

In the proposed regulations, the Service does not discuss how sections 704(c)(1)(B) and 737 interact with the distribution rule. Rather, the distribution of the partner's stock in the examples takes place more than five years after the contribution so as to render sections 704(c)(1)(B) and 737 inapplicable.

The proposed regulations provide a de minimis rule as promised by the Notice. The de minimis rule provides that Proposed Regulation § 1.337(d)-3 will not apply to a partner for a taxable year

if the partner has never owned more than five percent of the partnership, and as of the close of the partnership's taxable year and while the partner is a partner, the partnership has not held in the aggregate (whether or not held at any one time) the lesser of \$250,000 of stock of the partner or two percent of the value of any class of stock of the partner.²⁹⁵

The proposed regulations also provide an inadvertence rule. Proposed Regulation § 1.337(d)-3 will not apply to stock of a partner that is (1) disposed of by the partnership prior to the due date, including extensions, of its federal income tax return for the taxable year during which the stock is acquired or for the taxable year in which the partner becomes a partner, whichever is applicable, and (2) not distributed to the partner or the partner's affiliate.²⁹⁶

The Service has stated that "further study is appropriate for cases in which affiliation did not exist prior to a distribution of stock by a partnership to a corporate partner, but rather results from such distribution."²⁹⁷ As a result, the proposed regulations will be amended to limit their application to cases in which affiliation exists *immediately before* the deemed redemption or distribution.²⁹⁸

V. CRITIQUE OF PARTNERSHIP DISTRIBUTIONS PROVISIONS

The drafters of subchapter K of the Internal Revenue Code, as well as the drafters of the regulations promulgated in 1956, had remarkable insight into the problems and issues that would arise in the future under subchapter K. They foresaw many of the problems and resolved them, in

²⁹⁵ Prop. Treas. Reg. § 1.337(d)-3(f)(1).

²⁹⁶ Prop. Treas. Reg. § 1.337(d)-3(f)(2).

²⁹⁷ I.R.S. Notice 93-2, 1993-3 I.R.B. 11.

²⁹⁸ *Id.*

most instances, in a very logical and coherent manner.²⁹⁹ Unfortunately, in recent years, Congress has made changes to the distribution provisions in subchapter K that have not followed the path set by the original drafters. Rather, Congress has adopted more targeted legislation, "fixing" what it perceives to be loopholes in subchapter K without thoroughly evaluating all of the ramifications.³⁰⁰ The problem with targeted legislation is that Congress, in correcting one problem, raises a host of other problems, thereby adding complexity to an already difficult area of the tax laws. As recent as the Energy Policy Act of 1992,³⁰¹ Congress enacted another change to the distribution provisions, section 737, that is essentially targeted legislation.

A. Section 731(a)(1)

As enacted in 1954, the Internal Revenue Code provided for several provisions in which a distributee partner could recognize gain or loss. At the time of enactment, such provisions arguably made sense. Congress should retain two of the original provisions, sections 731(a)(1) and 731(a)(2). Section 731(a)(1) is a necessary provision in subchapter K because it prevents a partner from having a negative basis in his partnership interest and avoids any potential time-value-of-money problem. A partner's basis going negative might force Congress to consider charging interest to that partner, based on the amount and length of time that the basis is negative. For example, assume that partner A has an outside basis of \$0 and receives an operating cash distribution of \$100,000. Under section 731(a)(1), A will have capital gain of \$100,000. Assuming a tax rate of 40%, A will pay tax of \$40,000, leaving A with \$60,000 to invest.³⁰² If A were to invest the remaining \$60,000 at an interest rate of 10% annually, A would earn \$6,000 the following year. A would pay tax of \$2,400 (40 percent tax rate times \$6,000), thereby leaving A with \$3,600.

If a partner's basis can go negative so that A's outside basis is negative \$100,000, the \$100,000 cash distribution is not a return of capital and does not represent a share of previously taxed earnings. It appears that Congress should charge the partner interest on the deferred gain based on the amount of time that the partner's basis is negative. In

²⁹⁹ See *supra* part I.E.

³⁰⁰ See *supra* text accompanying notes 147-60, 165-223.

³⁰¹ Pub. L. No. 102-486, 106 Stat. 2776 (1992).

³⁰² Assume for purposes of this example that the distribution is made on the last day of the year and that the tax is due that same day.

the example, A can invest the \$100,000 at 10% interest annually, thereby earning \$10,000 the following year. A will pay tax of \$4,000, leaving A with \$6,000. Using an underpayment rate of 10%, A should pay interest equal to the 10% underpayment rate times the amount of gain being deferred (\$100,000 times 40% tax rate, or \$40,000). Therefore, A should pay interest to the government of \$4,000. This will leave A with \$2,000 (\$6,000 minus \$4,000). If the interest payment to the government is deductible, however, then A will be left with \$3,600 (\$6,000 less \$4,000 plus (\$4,000 times 40 percent)). By being charged interest and also being able to deduct the interest, A will be left in the same economic position as if A had recognized \$100,000 gain at the time of the distribution.³⁰³

The above example can be generalized algebraically. In the case of immediate recognition of gain under section 731(a)(1), an amount A of gain is reduced by tax T such that $A(1-T)$ may be invested. At an annual rate of return r , $A(1-T)$ invested will earn $rA(1-T)$ per year, which will be subject to tax at rate t equalling tax each year of $trA(1-T)$. The partner's net annual after-tax position each year will be

$$rA(1-T) - trA(1-T) \text{ which equals } rA(1-T)(1-t).$$

In the case of a negative basis situation in which gain is not immediately recognized, the amount A of negative basis is not reduced by tax. At an annual rate of return r , A invested will earn rA per year, which will be subject to tax at rate t , equalling tax each year of trA . If interest r is charged on the tax of TA , the interest to the government will be rTA . The deduction of the interest will be $trAT$, leaving the partner

³⁰³ This example is a demonstration of a variation of the Cary Brown model. *E.g.*, E. Cary Brown, *Business Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN* 309 (1948); see also Christopher H. Hanna & Samuel Olchyk, *Interest Under Section 453A(c): Is It or Isn't It?*, 56 *TAX NOTES* 1345, 1349 (1992) (timing of deductions for interest on deferred tax liability should be determined under taxpayer's method of accounting); Calvin H. Johnson, *Soft Money Investing Under the Income Tax*, 1989 *ILL. L. REV.* 1019, 1020 (1990) (allowing deduction for soft-money investments essentially allows the effective tax rate to fall below the statutory rate and does not tax fully the income from the investment); Alvin C. Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 *TAX LAW.* 549, 574 (1985) (capital recovery systems should follow the realities of economic depreciation to avoid full deductibility of interest with tax-exempt income); Alvin C. Warren, *The Timing of Taxes*, 39 *NAT'L TAX J.* 499, 503 (1987) (the present value of a consistently defined tax will be same, whether deferred or accelerated, as long as the tax rate remains constant and the base of a defined tax increases over time by a rate of return applicable to investment of proceeds available after payment of an accelerated tax).

with an interest burden of $rAT - trAT$ which equals $rAT(1-t)$. The partner's net, annual, after-tax position will be

$$rA(1-t) - rAT(1-t) \text{ which equals } rA(1-T)(1-t).$$

This equation will result in an amount equal to the partner's net, annual, after-tax position when the distribution results in recognition of gain and tax is immediately imposed.

Requiring the immediate recognition of gain on a distribution of money that exceeds a partner's basis seems to be much easier than imposing an interest charge rule. As a result, section 731(a)(1) should remain unchanged.

B. Section 731(a)(2)

Section 731(a)(2) has been unchanged since its enactment in 1954 and should remain so. Despite its slight technical flaw,³⁰⁴ the section does an adequate job of preventing the conversion of capital losses into ordinary losses. If Congress were to eliminate the capital/ordinary income distinction from the Code, however, section 731(a)(2) would then be ripe for change, because it was enacted for the purpose of characterization and not timing. Congress could then limit the application of section 731(a)(2) to liquidating distributions involving only distributions of money as opposed to its current application to distributions involving money, unrealized receivables, or inventory items. This change could lead to substantial simplification of subchapter K because it would involve deleting the definitions of "unrealized receivables" and "inventory items."

Much of the complexity contained in subchapter K is attributable to the constant reference to unrealized receivables and inventory items. Congress included these two definitions in subchapter K because of its concern with various characterization abuses. When section 731(a)(2) was enacted, characterization was a critical issue. From January 1, 1991 until December 31, 1992, characterization was less controversial, as there was only a 3% point differential between ordinary income and capital gains.³⁰⁵ However, with the recent passage of the Revenue Reconciliation Act of 1993,³⁰⁶ the highest tax rate for ordinary income rose to 39.6% creating an 11.6% differential between ordinary income and capital

³⁰⁴ See *supra* text accompanying notes 127-39.

³⁰⁵ I.R.C. § 1(a)(1), (h) (1990) (providing a 31% bracket for ordinary income, while the capital gains rate remained at 28%).

³⁰⁶ Pub. L. 103-66 (Aug. 10, 1993).

gains, thus illustrating that characterization may once again become a critical issue. As a result, section 731(a)(2) should also remain unchanged.

C. Section 751(b)

Congress should give serious consideration to repealing section 751(b). Section 751(b) is incredibly complex, even for subchapter K. Much has been written on the mechanics of section 751(b), and this Article will not delve any further into this area.³⁰⁷ In addition, much has been written regarding its usefulness, or lack thereof.³⁰⁸ The almost unanimous consensus has been that section 751(b) never should have been enacted or, at the very least, should have been repealed years ago.

While the purpose of this Article is not to renew the debate over the usefulness of section 751(b), it may be helpful to mention the arguments

³⁰⁷ See *supra* text accompanying notes 140-46, 162-64 for a general discussion of the mechanics of section 751(b). E.g., Dale E. Anderson & Melvin A. Coffee, *Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K (Second Installment)*, 15 TAX L. REV. 497, 528-35 (1960); Jackson, *The Internal Revenue Code of 1954*, *supra* note 14, at 1214-15; Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (First Installment)*, 10 TAX L. REV. 161, 182-89 (1955) [hereinafter Little I]; Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (Second Installment)*, 10 TAX L. REV. 335, 335-48 (1955) [hereinafter Little II]; MCKEE ET AL., *supra* note 11, ¶ 21.01; WILLIS ET AL., *supra* note 112, §§ 141.01-143.06.

³⁰⁸ E.g., Donald C. Alexander, *Collapsible Partnerships*, 19 N.Y.U. ANNUAL INST. ON FED. TAX'N 257 (1961); Michael S. Applebaum, *Collapsible-Partnership Danger Increases with Use of Partnerships As Tax Shelters*, 42 J. OF TAX'N 272 (1975); Anderson & Coffee, *supra* note 307, at 528-35; Russell Aycock, *Sec. 751 Revisited*, 20 TAX ADVISOR 630 (1989); John J. Costello, *Problems Under Section 751 Upon Current and Liquidating Distributions and Sales of Partnership Interests*, 15 N.Y.U. ANNUAL INST. ON FED. TAX'N 131 (1957); J. Littleton Daniel, *Watch Out for Trouble Areas in Code Provisions on Partnership Taxation*, 8 J. OF TAX'N 32 (1958); Meyer Drucker & Mark A. Segal, *Problems and Opportunities in Working with Collapsible Partnerships*, 61 TAXES 110 (1983); Paul R. Erickson, *An Appeal for Repeal of Section 751*, 65 TAXES 365 (1987); Gary A. Fox, *Using "Parameter Checks" in Analyzing Partnership Distributions Under Section 751*, 52 TAXES 298 (1974); Harry Janin, *Current and Liquidating Distributions and Partnership Elections Under Section 754*, 15 N.Y.U. ANNUAL INST. ON FED. TAX'N 95 (1957); Benjamin B. Levin, *Partnership Contributions and Distributions (During Partnership)*, 13 N.Y.U. ANNUAL INST. ON FED. TAX'N 859 (1955); Little I, *supra* note 307, at 183-89; Little II, *supra* note 307, at 348-50; M. Jill Martin & Jarell Jones, *Tax Consequences of a Disproportionate Partnership Distribution*, 20 TAX ADVISOR 112 (1989); Arthur B. Willis, *Distributions of Partnership Property and Payments to a Retiring or Deceased Partner*, 1955 SO. CALIF. TAX INST. 229.

for the repeal of section 751(b) that the ALI presented in 1984.³⁰⁹ First, section 751(b) is

extraordinarily complex. It constructs hypothetical exchanges of capital and non-capital assets in situations where an actual exchange has not occurred As a result of that expansion [the definition of unrealized receivables in section 751(c)], it is difficult to imagine a pro-rata partnership distribution to which section 751(b) does not apply. If the reports of noncompliance with section 751(b) are correct, the continuance of such a provision must have an adverse bearing on taxpayer respect for the law.³¹⁰

Second, section 751(b) "produces too harsh a result for the policy it is intended to enforce,"³¹¹ namely, the shifting of ordinary income and capital gain among the partners. It "imposes a tax on some non-pro rata

³⁰⁹ AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS, ADOPTED BY THE AMERICAN LAW INSTITUTE AT PHILADELPHIA, PENNSYLVANIA, May 20, 1982, 49-51 (1984).

³¹⁰ *Id.* at 51. The ALI stated that "[s]ince compliance with section 751(b) requires highly sophisticated tax analysis, it has been suggested that section 751(b) is a trap for the wary." *Id.*

The expansion of the definition of unrealized receivables under section 751(c) to which the ALI refers was first started in the *Revenue Act of 1962*, Pub. L. No. 87-834, 76 Stat. 960 (1962). Today, for purposes of sections 731, 741, and 751, the definition of unrealized receivables 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)), 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.

I.R.C. § 751(c) (1993).

³¹¹ AMERICAN LAW INSTITUTE, *supra* note 309, at 51.

exchanges, not because that is an appropriate moment for tax, but because it is the only convenient way to prevent the reallocation of ordinary income and capital gain between partners."³¹² In other words, section 751(b) accelerates realization of income to both the distributee and the partnership.³¹³ Finally, "the tax shifting which section 751(b) is designed to prevent is limited by a number of factors that will operate in the absence of section 751(b)."³¹⁴ The most important of these factors is the differential in tax rates between capital gains and ordinary income. In 1954, when section 751(b) was enacted, "capital gains were taxed at a maximum 25% rate while the top individual rate was 91%, a differential of approximately 66%."³¹⁵ In 1992, capital gains were taxed at a maximum of 28% while the top individual rate was only 31%,³¹⁶ a differential of only 3%. Even though the present Administration increased the differential between the tax treatment of capital gains versus ordinary income, the current 11.6% differential is still significantly less than 66%.³¹⁷

The ALI stated that "the argument in favor of section 751(b) is that it prevents reallocation of capital gain and ordinary income between partners."³¹⁸ This argument, however, seems difficult to justify based on the above reasons,³¹⁹ particularly in 1993, when there is an 11.6% differential between the maximum rates on capital gains and ordinary income, which though not insignificant is still much less than 66%. It should be noted that section 751(b) does not prevent reallocation of income *within* a class, i.e., capital gains or ordinary income. Rather, section 751(b) prevents reallocation *between* classes of income. For example, assume that ABC Partnership has three equal partners A, B, and C. Each partner's adjusted basis in his partnership interest is \$7,000, and each partner's capital account is \$12,000. The partnership has three assets: (1) accounts receivables with an adjusted basis of zero and a fair market value (and book value) of \$9,000, (2) inventory with an adjusted basis and fair market value (and book value) of \$18,000, and (3) a capital asset

³¹² *Id.* at 51-52.

³¹³ See BERGER & WIEDENBECK, *supra* note 112, § 9.07.

³¹⁴ AMERICAN LAW INSTITUTE, *supra* note 309, at 52.

³¹⁵ *Id.*; see I.R.C. § 1(a) (1954) (ordinary income top bracket at 91%); *id.* § 1201(b)(2) (maximum capital gains rate at 25%).

³¹⁶ I.R.C. § 1(a)(1), (h) (1990).

³¹⁷ In 1984, when the ALI published its report, capital gains were taxed at a maximum of 20% while the top individual rate was 50%. AMERICAN LAW INSTITUTE, *supra* note 309, at 52.

³¹⁸ *Id.*

³¹⁹ *Id.*

with an adjusted basis of \$3,000 and fair market value (and book value) of \$9,000. The partnership distributes the \$9,000 of accounts receivables to A and the \$18,000 of inventory equally to B and C. Section 751(b) will not apply to this distribution because neither A, B, nor C has received a disproportionate amount of unrealized receivables or substantially appreciated inventory items. However, all of the ordinary income of the unrealized receivables and substantially appreciated inventory items has been shifted to A.

Section 751(b) is also a trap for the unwary because the Service has applied section 751(b) in a situation that even a knowledgeable tax planner may have overlooked. In Revenue Ruling 84-102,³²⁰ A, B, and C were equal partners in partnership P. Each partner's interest was worth \$25. The partnership had liabilities of \$100, with each partner's share being \$33.33. The partnership also had unrealized receivables of \$40 with each partner's share being \$13.33. D contributed \$25 to partnership P in exchange for a 25% interest in the partnership. After D's contribution, A's, B's, and C's share of the liabilities decreased by \$8.33 to \$25. In addition, A, B, and C's shares of the unrealized receivables each decreased by \$3.33 to \$10.³²¹

According to the Service, partners A, B, and C are deemed to have received a distribution of \$8.33 under section 752(b). Of this amount, \$3.33 is treated as being received by each partner in exchange for unrealized receivables under section 751(b)(1)(B).³²² Section 751(b) does not apply to new partner D because there is no actual or deemed distribution of property from the partnership to D. As a result, section 751(b) can apply to existing partners in a partnership upon the admission of a new partner. A number of commentators have questioned this result.³²³

In 1957, only three years after the enactment of section 751(b), the Advisory Group on Subchapter K, in its Revised Report on Partners and Partnerships, recommended repeal of section 751(b).³²⁴ The Ways and

³²⁰ 1984-2 C.B. 119.

³²¹ *Id.*

³²² *Id.*

³²³ See, e.g., William T. Carman, *Revenue Ruling 84-102—An Erroneous Conclusion*, 2 J. PARTNERSHIP TAX'N 371, 372 (1986); Francis J. Emmons & S. Richard Fine, *Coping with IRS' Ruling Which Applies Sec. 751 on the Admission of New Partners*, 62 J. TAX'N 160, 161 (1985).

³²⁴ ADVISORY GROUP ON SUBCHAPTER K OF THE INTERNAL REVENUE CODE OF 1954, 85TH CONG., 1ST SESS., REVISED REPORT ON PARTNERS AND PARTNERSHIPS 40 (1957). The Subcommittee on Internal Revenue Taxation appointed the Advisory Group on November 28, 1956, to assist the subcommittee in its study of subchapter K. The Advisory Group published its first report on subchapter K on May 8, 1957, and its revised report on December 31, 1957. *Id.*

Means Committee, however, did not include this recommendation in House Report 9662,³²⁵ an unenacted Bill that contained many of the recommendations of the Advisory Group. Almost thirty years after the Advisory Group's recommendation for repeal of section 751(b), the Tax Reform Act of 1986 presented Congress with the perfect opportunity to repeal section 751(b)³²⁶ when it eliminated the preferential treatment for capital gains. Again, Congress failed to take advantage of the opportunity. Now, since still slight preferential treatment for capital gains exists, it seems unlikely that Congress will repeal section 751(b) in the near future.

D. Section 707(a)(2)(A)

Section 707(a)(2)(A), enacted by Congress in 1984,³²⁷ was a needed addition to the Code. It is an anti-abuse provision designed to prevent partnerships from circumventing the capitalization requirements of the Code.³²⁸ Without it, partnerships, through the use of special allocations and corresponding distributions, could achieve the equivalence of a deduction for an otherwise capital expenditure.³²⁹ As a result, section 707(a)(2)(A) should remain unchanged. Although the Treasury Department has yet to issue regulations under section 707(a)(2)(A), its application to various factual situations seems pretty clear. Hopefully, though, the Treasury Department will issue regulations interpreting section 707(a)(2)(A) in the near future.

E. Section 707(a)(2)(B)

Section 707(a)(2)(B), also enacted in 1984, is simply a codification of regulations that were originally promulgated in 1956 under sections

³²⁵ Representative Wilbur D. Mills, chairman of the Ways and Means Committee, introduced House Report 9662 on January 18, 1960; the Ways and Means Committee reported the Bill out of committee, without amendments, on January 28, 1960. It was passed by the House on February 4, 1960, but failed in the Senate. Apparently, House Report 9662 was not passed by the Senate because of the provisions relating to subchapter J and not because of the provisions relating to subchapter K. *See Report of the ABA Tax Section Committee on Partnerships*, 27 TAX LAW. 839 (1974); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT 2 (Tentative Draft No. 3, 1979).

³²⁶ Pub. L. No. 99-514, 100 Stat. 2085 (1986).

³²⁷ *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 994 (1984).

³²⁸ STAFF OF THE JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., *supra* note 177, at 227.

³²⁹ *See id.*

721 and 731.³³⁰ Like section 707(a)(2)(A), section 707(a)(2)(B) is an improvement to subchapter K primarily because of the courts' unwillingness to apply the regulations in a stringent manner. By issuing regulations under section 707(a)(2)(B), the Treasury Department has clarified the scope of the provision. The Treasury Department has also provided in the regulations a number of safe harbors that are of tremendous aide to practitioners. It remains to be seen whether the Treasury Department will be successful in adhering to its position that, if a disguised sale has taken place, it will be treated as having taken place at the time of the initial transfer. A much simpler approach for the Treasury would be to treat the sale as taking place at the time of the later distribution, thereby rendering sections 453, 483 and 1274 inapplicable. In addition, the Treasury should utilize section 707(a)(2)(B) as the exclusive provision for preventing abusive mixing bowl transactions. Thus, a mixing bowl transaction that is structured so as to avoid the reaches of section 707(a)(2)(B) should be respected. In conducting partnership business for more than two years and exposing their contributions to entrepreneurial risks, the partners have engaged in legitimate, nonabusive partnership activities, which section 707(a)(2)(B) was not designed to prohibit.³³¹

F. Section 704(c)(1)(B) and Section 737

Sections 704(c)(1)(B) and 737, which are designed to attack the same types of transactions, should be repealed. Congress enacted these sections in order to prevent transactions like the May Company transaction and mixing bowl transactions in general, all of which attempted to either circumvent the repeal of *General Utilities* or defer the recognition of gain.³³² Both sections are unnecessary because the Service has completely shut down May Company transactions through Notice 89-37³³³ and has prevented the use of abusive mixing bowl transactions through regulations under section 707(a)(2)(B).³³⁴ By repealing sections

³³⁰ See Treas. Reg. §§ 1.721-1, 1.731-1 (1956).

³³¹ See *infra* text at notes 332-40.

³³² See, e.g., MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS AND LEVERAGED BUYOUTS* ¶ 1404 (1993) ("[A]mended section 704(c) [was] enacted by Congress out of concern that GU [General Utilities] Repeal significantly increased the attractiveness of mixing-bowl partnerships . . ."); New York State Bar Association Tax Section, *Report on Certain Provisions of the Revenue Reconciliation Act of 1989*, 44 TAX NOTES 1543, 1557 (1989) ("This provision appears to be intended primarily as an extension of the 'disguised sale' rule of section 707(a)(2)(B).").

³³³ 1989-1 C.B. 679.

³³⁴ See Treas. Reg. § 1.707-3(f) Ex. 8.

704(c)(1)(B) and 737, Congress can make the distribution provisions much simpler and, yet, still achieve fairness and uniformity, which were Congress' goals when it enacted the distribution provisions in 1954.

1. *May Company Transactions*

Notice 89-37, along with Proposed Regulation § 1.337(d)-3, has prevented transactions like the May Company transaction. A May Company transaction will result in immediate adverse tax consequences under the front-end rule of Notice 89-37³³⁵ and Treasury Regulation § 1.337(d)-3. Sections 704(c)(1)(B) and 737 seem to be overkill directed toward preventing May Company transactions. In fact, it is not clear how Notice 89-37, Proposed Regulation § 1.337(d)-3 and sections 704(c)(1)(B) and 737 work together to prevent a May Company transaction, although they were all intended to address that specific transaction.

The Service had to prevent May Company transactions in order to enforce the repeal of the *General Utilities* doctrine. Without Notice 89-37 and Proposed Regulation § 1.337(d)-3, such a transaction will avoid the reach of sections 704(c)(1)(B) and 737 as long as the parties wait the five-year period. A May Company transaction, however, should not enable the parties to the transaction to avoid the repeal of *General Utilities*, no matter how long the parties wait. For example, assume that X Corporation contributes appreciated property with an adjusted basis of \$100 and a fair market value of \$300 in exchange for a 30% interest in the partnership. Y contributes X Corporation stock with an adjusted basis of \$400 and a fair market value of \$700 in exchange for a 70% interest in the partnership. Without Notice 89-37 and Prop. Treas. Reg. § 1.337(d)-3, and relying solely on sections 704(c)(1)(B) and 737, if the parties wait longer than five years, they can avoid the repeal of *General Utilities*.³³⁶ The parties should not be able to avoid the repeal of *General Utilities* even if they conduct the partnership for more than five years. Under the front-end rule of Notice 89-37 and Prop. Treas. Reg. § 1.337(d)-3, at the time of contribution of X Corporation stock by Y, X Corporation has section 311(b) gain under the deemed redemption rule of \$140 (\$210-\$70). This is a proper result so as to enforce the repeal of *General Utilities*.

As a result, sections 704(c)(1)(B) and 737 are unnecessary and inadequate in preventing May Company transactions. Notice 89-37 and Prop. Treas. Reg. § 1.337(d)-3 are sufficient to address the problem.

³³⁵ See *supra* note 287 and accompanying text.

³³⁶ By waiting more than five years, the parties have also avoided the two-year presumption of a disguised sale in Treas. Reg. § 1.707-3(c)(1).

2. *Mixing Bowl Transactions*

As to mixing bowl transactions, it appears that section 707(a)(2)(B) is sufficient to attack them. Mixing bowl transactions that are able to avoid the reaches of section 707(a)(2)(B) should be respected as they are not abusive transactions. These transactions are not abusive since the partnership, at a minimum, must be conducted for more than two years in order to avoid application of the two-year presumption. Even if the two-year presumption is avoided, however, the transaction must be structured so that there is sufficient economic risk among the partners, based on the entrepreneurial risks of the partnership, to have the transaction respected.

For example, assume that X owns a business that he wishes to dispose of for cash or other property. X's basis in the business is \$200,000 and its fair market value is \$500,000. Y wishes to acquire the business. X contributes the business to XY Partnership, and Y contributes property worth \$500,000. The partnership agreement provides for straight-up allocations so that income and loss will be allocated equally between X and Y. In addition, there is no express agreement among the partners to liquidate the partnership after a set number of years or for determining which properties will be distributed to a particular partner upon liquidation. If the partnership is conducted for more than two years, the presumption of a disguised sale under section 707(a)(2)(B) will not apply. Assuming that the property that Y contributed is neither cash nor an equally safe type of investment, X and Y should not be subject to section 707(a)(2)(B) because they are already subject to the entrepreneurial risks of the partnership.³³⁷ The business that X contributed may appreciate or depreciate in value over time, and the same is true of the property that Y contributed. If the partnership is liquidated after more than two years with X receiving the property that Y contributed and Y receiving X's business, the form of the transaction should be respected.³³⁸ Sections 704(c)(1)(B) and 737 seem like unnecessary hurdles for partners to clear in order to accomplish a mixing bowl transaction. A mixing bowl transaction that has successfully avoided the application of section 707(a)(2)(B) is not an abusive transaction and should be respected.

Sections 704(c)(1)(B) and 737 seem to apply to mixing bowl transactions during years three through five of the transaction. During the first two years of the mixing bowl transaction, the parties must success-

³³⁷ See, e.g., GINSBURG & LEVIN, *supra* note 332, at ¶ 1404.

³³⁸ *Id.*

fully avoid the presumption of section 707(a)(2)(B). After the fifth year, sections 704(c)(1)(B) and 737 are no longer applicable. If the Treasury feels that section 707(a)(2)(B) is inadequate to deal with the mixing bowl transaction, it may want to consider promulgating stricter regulations under section 707(a)(2)(B). For example, the two-year presumption provided for in Treasury Regulation § 1.707-3(c)(1) could be extended to three, four, or even five years to prevent abusive mixing bowl transactions. A five-year presumption, which seems a bit long, would appear to generally render sections 704(c)(1)(B) and 737 unnecessary.

On a more practical level, several leading practitioners have stated that mixing bowl transactions have been discussed by speakers and written about by commentators much more frequently than the transactions actually occur, even before the enactment of sections 704(c)(1)(B) and 737.³³⁹ In other words, Congress may have attacked a transaction that never existed to any great extent. In addition, it has been suggested that sections 704(c)(1)(B) and 737 hinder legitimate business transactions conducted in partnership form.³⁴⁰ For example, parties may enter into a legitimate joint venture transaction structured as a partnership but decide after several years to unwind the partnership. At the time of entering into the joint venture, the parties may have no tax avoidance motive. Sections 704(c)(1)(B) and 737, however, may create adverse tax consequences on unwinding the partnership, even when the parties want to end the joint venture in good faith and for legitimate business reasons.

3. *Replacement of Section 704(c)(1)(B) and Section 737*

A possible replacement for sections 704(c)(1)(B) and 737, if Congress determines that a replacement is necessary, is to completely overhaul section 704(c) by adopting a deferred sale approach to contributions of

³³⁹ See *Roundtable Discussion on Partnership Taxation with William S. McKee, Blake D. Rubin, and R. Donald Turlington*, 12 A.B.A. SEC. TAX'N, Spring 1993, at 47 (Blake D. Rubin commenting that "many more mixing bowl partnerships have been discussed than actually done"). R. Donald Turlington stated that

[t]here is a lot more smoke than fire in this particular type of transaction. It is true that mixing bowl transactions have become the rage of speakers on the Subchapter K circuit. But they certainly have not become the rage of business men and women who are trying to buy or sell assets. Mixing bowl transactions may have been a great tax loophole in theory, but, in fact, that loophole is virtually impossible to exploit in the real world.

Id. at 48.

³⁴⁰ *Id.* at 49.

property. This approach was considered by the ALI in 1954³⁴¹ and again in 1984,³⁴² and proposed by Congress for large partnerships as part of the Tax Fairness and Economic Growth Act of 1992³⁴³ and the Revenue Act of 1992,³⁴⁴ both of which were vetoed by President Bush in 1992.³⁴⁵ Under this proposed taxing scheme, which is similar to deferred intercompany transactions under the consolidated return regulations,³⁴⁶ sections 704(c) and 737 would not apply to a contribution of property.³⁴⁷ The basis and book value of the property to the partnership would be its fair market value at the time of contribution. If the partnership were to later distribute or sell the property, any pre-contribution gain or loss would be triggered to the contributing partner. If the contributing partner disposes of part or all of its partnership interest, a corresponding portion of pre-contribution gain or loss would be triggered. As a result, under the deferred sale approach, a distribution can still result in gain or loss to a non-distributee partner.

For example, assume that A contributes appreciated property X to a partnership. The basis of the property is \$20 and its fair market value is \$100. Under the deferred sale approach, the partnership will take a tax basis and book value of \$100 in the property. A's basis in her partnership interest is increased by \$20, the tax basis of the property. If the partnership were then to sell or distribute the property, the \$80 of deferred gain is triggered to A, and A would increase her basis in the partnership by \$80.

The principal drawback to the deferred sale approach appears to be its complexity, which led the ALI to reject it in 1954 and 1984.³⁴⁸ The Treasury has recently issued proposed regulations under section 704(c) in which the parties can elect to use the deferred sale approach on a

³⁴¹ AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX MODEL STATUTE, § X753(b), at 376 (1954 Draft).

³⁴² AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS, ADOPTED BY THE AMERICAN LAW INSTITUTE AT PHILADELPHIA, PENNSYLVANIA, May 20, 1982, 129-42 (1984).

³⁴³ H.R. 4210, 102d Cong., 2d Sess. (1992).

³⁴⁴ H.R. 11, 102d Cong., 2d Sess. (1992).

³⁴⁵ See Memorandum of Disapproval For the Revenue Act of 1992, in 28 WEEKLY COMP. PRES. DOC. 2283 (Nov. 4, 1992); Message to the House of Representatives Returning Without Approval the Tax Fairness and Economic Growth Acceleration Act of 1992, in 28 WEEKLY COMP. PRES. DOC. 510 (Mar. 20, 1992).

³⁴⁶ See Treas. Reg. § 1.1502-13 (1990); Temp. Treas. Reg. § 1.1502-13T (1992).

³⁴⁷ See H.R. 11, 102d Cong., 2d Sess. § 4301 (1992) (proposing new section 774(b)(1)).

³⁴⁸ See *supra* notes 340-42 and accompanying text.

property-by-property basis.³⁴⁹ It remains to be seen how many taxpayers will opt for this approach as opposed to the two other methods provided for in the regulations—the traditional method or the traditional method with curative allocations.

CONCLUSION

Subchapter K, as originally enacted by Congress in 1954, was a masterful scheme for taxing partnerships.³⁵⁰ In general, Congress went to great lengths to provide for nonrecognition on distributions without sacrificing simplicity. In recent years, however, Congress seems to be more concerned with attacking certain transactions it deems abusive rather than maintaining the consistency and simplicity that it strived for almost forty years ago. Although this criticism can be directed at Congress' action in numerous areas, it fortunately has not reached epidemic proportions as to the partnership distribution provisions in subchapter K. By repealing sections 751(b), 704(c)(1)(B), and 737, Congress can make the distribution provisions of subchapter K much more workable. When a partnership makes a distribution of money or property, tax planners will only have to be concerned with two recognition provisions, sections 731(a)(1) and 731(a)(2). Tax planners will still have to be concerned with three recharacterization provisions but this seems unavoidable.

³⁴⁹ PS-164-84, 1993-5 I.R.B. 34, 57 Fed. Reg. 61345 (1992); see, e.g., Blake D. Rubin & Seth Green, *The Proposed Regulations on Partnership Allocations with Respect to Contributed Property*, 59 TAX NOTES 257, 263 (1993).

³⁵⁰ See Jackson, *The Internal Revenue Code of 1954*, *supra* note 14, at 1235 (noting that subchapter K is "among the notable achievements of the 1954 Internal Revenue Code"). But see BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 85.1.1 ("The assertion in 1954 that subchapter K is 'among the notable achievements of the 1954 Internal Revenue Code' is undoubtedly still true, however, since calamities are as worthy of note as good news.").