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TAXABLE INCOME WITHOUT GAIN ON THE SALE OF A DECEASED PARTNER'S INTEREST: CODE, COMMON LAW, AND COMMUNITY PROPERTY

by

Alan R. Bromberg*

Summary.—A critical tax problem arises in the sale of a deceased partner's interest. It is the possibility of ordinary income even though there is no gain in the sense that the proceeds equal the new basis acquired by the interest at the owner's death. This anomaly stems from the complicated fragmentation rules which are linked to the "inside" basis of partnership property (unchanged by a partner's death) rather than to the "outside" basis of the interest in the partnership. An elective adjustment will remedy the situation but it is beset by strict time limits and substantial theoretical and practical difficulties. There is even some question whether the election is fully effective (e.g., as to unrealized receivables). Texas community property laws, if controlling, produce two significant variations. An unintended hardship is the possibility that the election may not be available for the survivor's community half of the partnership interest. An unintended benefit is that the community survivor may escape taxation on his or her half of what would otherwise be income in respect of a decedent.

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1. Background

At the death of a partner three basic things may happen:

(1) The surviving partners may wind up the partnership affairs, pay the debts, and distribute the remaining assets in liquidation to themselves and the deceased's successor (i.e., his estate, heir, or legatees).

(2) The surviving partners may continue the business with the deceased's successor as a partner.

(3) The surviving partners, or someone else, may purchase the deceased's interest from the successor.

Other arrangements are in reality only combinations of these. For example, "mutual insurance" payments from the partnership to the successor, in liquidation of the deceased's interest, are a blend of (1) and (2).¹

The first of these techniques mirrors the traditional common-law view that a partnership is dissolved by the death of any partner and, once dissolved, must be wound up and terminated.² The increasing complexity of business enterprise and the concomitant value of a going concern have made such a procedure undesirable in many instances.

The alternative procedures, obviously, depend on agreement by all concerned.³ The common law has been somewhat blind to this consensual modification of a consensual relation, particularly where the consent is given in advance or by implication. In consequence, even where it has recognized the alternative procedures as permissible, it has been uncertain whether they involve a continuation of the old partnership or a dissolution followed by the formation of a new one without winding up.⁴ The tax laws have taken the more realistic position that a partnership continues unless the business is completely

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² Uniform Partnership Act §§ 31(4), 38(1), 40, 43; Sher & Bromberg, Texas Partnership Law in the 20th Century—Why Texas Should Adopt the Uniform Partnership Act, 12 Sw. L.J. 263, 302 n.210, 307-11, 313-17 (1958) [hereinafter cited as Sher & Bromberg]. Similarly the common law has considered that a partnership is dissolved when a partner transfers his interest in it. Sher & Bromberg, 273 n.55, 303 n.217. Contra, Uniform Partnership Act § 27(1).

³ See Note, Partnership Continuation Agreements, 72 Harv. L. Rev. 1302 (1959).

⁴ See Crane, Partnership 392-93, 407 (2d ed. 1952).
wound up or 50% or more of the interest in capital and profits is sold or exchanged.  

Tax consequences depend on which arrangement is employed. On the whole, they have been amply analyzed elsewhere, and are superficially summarized below only as a predicate for closer examination of one aspect of the sale of a partnership interest.

2. Outside and Inside Basis

It is apropos here to observe some partnership peculiarities relative to basis, that primal tax attribute of property which determines allowable depreciation and depletion deductions as well as the gain or loss on a sale or exchange of the property. A partner’s interest in the partnership is a species of property owned by him; he has a basis for the interest which is referred to in this article as his “outside” basis. Its normal components are set forth in the margin; of these the most important are the cost of his interest and his share of undistributed partnership income. These are superseded at death when his interest takes on a new basis equal to its then fair market value. Since the

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1. IRC 706(c), 708.
3. A partner’s outside basis is at any time—
   - The sum of:
     - (1.1) The cost of any part of his interest purchased by him, IRC 742,
     - (1.2) The fair market value (for estate tax purposes) of any part of his interest acquired by inheritance or legacy, Regs. 1.742-1,
     - (1.3) The amount of money and the adjusted basis of any property contributed by him to the partnership for any part of his interest, IRC 722,
   - (1.4) His distributive share of partnership income (whether taxable or not), IRC 705(a)(1),
   - (1.5) His distributive share of partnership depletion in excess of the inside basis of the depletable property, IRC 705(a)(1)(C), and
   - (1.6) His distributive share in the increase of, or his assumption of any partnership liabilities, IRC 752(a), 722.

   - (2) Less the sum of:
     - (2.1) The amount of money and the inside basis of any property distributed to him by the partnership (other than in liquidation), IRC 733,
     - (2.2) His distributive share of partnership loss (whether deductible or not), IRC 705(a)(2), and
     - (2.3) His distributive share in the decrease of partnership liabilities, or the partnership’s assumption of any of his individual liabilities, IRC 752(b), 733.

   Outside basis may never be less than zero. IRC 733, 705(a)(2). It will be seen that outside basis is in part influenced by inside basis (items (1.5), (2.1)) but is largely unrelated to it. Since outside basis calculation by this method is unwieldy, an alternative method is offered by IRC 705. This in essence gives each partner an outside basis equal to his share of inside basis. It is irrelevant to this article, which is concerned with the inadequacy of inside basis compared to an outside basis newly fixed by death.
4. IRC 1014(a), 742; Regs. 1.742-1. The alternate valuation of IRC 2032 may be used. The text ignores the role of liabilities in outside basis since their effect in the typical death-
partnership is for many tax purposes a separate entity—not a mere joint ownership or aggregate of individuals—it is treated as the owner of its various assets and has a basis for each of these. I will talk of this as “inside” basis and will generally speak of a partner's inside basis as his share of the partnership's inside basis for its several properties. Although originally the sum of the outside bases may have equalled the sum of the inside bases, this will be true only by sheerest coincidence after a partner's death.

Inside and outside basis figure in the tax on the successor to a deceased partner's interest, even in the simplified form in which they are treated as part of this background:

(1) If the partnership is wound up and the assets distributed, any sale of assets during the wind-up is taxable, and sale price minus inside basis measures the gain or loss of which each partner (including the successor) reports his distributive share. Capital gain is generally recognized to the extent that the successor receives money in excess of his outside basis. In the main, however, a partnership liquidation is not a taxable event, and the successor takes his basis for each asset distributed to him an aliquot part of his outside basis.

(2) If the successor remains as a partner in the business, his inside basis determines his share of depreciation and depletion deductions and of gain or loss on sales of assets by the partnership. His outside basis serves as a limit on the deductibility of his share of partnership losses.

(3) If the successor sells the partnership interest, he will usually have capital gain or loss in the amount of the difference between the sale proceeds and his outside basis. If the sale price equals the fair market value for estate tax purposes, the difference (and the gain) is zero. Indeed, if the sale is negotiated at arms length, the price will determine the fair market value. Inside basis would appear to have no significance under these circumstances.

and-sale situation is self-cancelling; basis will be increased by the liabilities and so will the amount realized. IRC 705, 722, 733, 752. See also section 6 of the text concerning income in respect of a decedent.

IRC 702, 704; Regs. 1.708-1(b)(1).

IRC 731(a)(1). Loss is generally not recognized unless distributions to the successor consist only of money, inventory, and unrealized receivables. IRC 731(a)(2).

IRC 732(b). IRC 732(c) specifies the method of allocation. This is a substitute basis in contrast to the carryover of inside basis which attaches to an asset distributed currently rather than in liquidation. IRC 732(a). IRC 732(d) may call for or allow certain adjustments.

IRC 704(d). The limit applies to capital as well as ordinary losses. Excesses may be carried forward and deducted in later years when basis is increased.

IRC 741.

3. The Fragmentation Problem

The foregoing is subject to modification if the partnership assets include "751 property," i.e., unrealized receivables or substantially appreciated inventory. A formidable array of provisions is imposed to prevent the conversion of ordinary income to capital gain. But for these provisions, a partner might realize the ordinary income latent in 751 property by selling his interest in the partnership at a price which includes the value of the income potential; this would be the sale of a capital asset. These provisions are often described as the "fragmentation" or "collapsible partnership" rules. Their method of operation is to treat as ordinary income that part of the sale proceeds which reflects unrealized receivables or substantially appreciated inventory. It is apparent that their primary impact is on service partnerships using the cash method (whose receivables will to a great extent be unrealized) and sales firms having significant inventories (particularly LIFO in times of rising prices).

The interplay of the fragmentation rules and the disparity between inside and outside basis is of critical importance in the sale of a deceased partner's interest. If a partnership interest is sold at a price approximating its death value, there is little or no gain measured by outside basis, for the latter is, by definition, the same as death value.

Cum. Bull. 10 (estate tax value of partnership interest fixed by partnership agreement provision for purchase by survivors at book value).

1 IRC 751. The section includes definitions:

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

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

(2) Services rendered, or to be rendered.

(d) Inventory items which have appreciated substantially in value—

(1) Substantial Appreciation.—Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds—

(A) 120 per cent of the adjusted basis to the partnership of such property, and

(B) 10 per cent of the fair market value of all partnership property, other than money.

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

(A) Property of the partnership of the kind described in section 1221(1).

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

(C) 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) or (B).

10 IRC 751. Similar results might be reached by a partnership distribution of 751 property to one partner and capital assets to another.
The taxpayer is likely to be unaware until too late that there may be ordinary income via the fragmentation rules even though there is no gain on the transaction as a whole.

4. The Reasons

To see why the fragmentation rules apply regardless of outside basis, it is necessary to follow these steps:

Step 1: Ordinary income results from that part of the consideration for the partnership interest "attributable to" 751 property.\(^{17}\)

Step 2: The Code does not state how to compute the consideration "attributable to" 751 property. The Regulations remedy the omission and quietly equate the phrase with "income or loss realized" on 751 property.\(^{18}\)

Step 3: "Income or loss realized" on 751 property is defined, again without direct statutory authority, as "the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property."\(^{19}\)

Step 4: Item (i) in Step 3 may be fixed by the parties in an arms

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\(^{17}\)IRC 751(a). The reader may follow the argument more easily with the aid of figures. Assume this balance sheet for a partnership composed of A and B with equal interests:

<table>
<thead>
<tr>
<th>Adjusted basis per books</th>
<th>Fair market value</th>
<th>Appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Receivables</strong></td>
<td>25,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Inventories</strong></td>
<td>20,000</td>
<td>35,000</td>
</tr>
<tr>
<td><strong>Other Assets</strong></td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$100,000</td>
<td>$120,000</td>
</tr>
<tr>
<td><strong>Payables</strong></td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Capital, A</strong></td>
<td>40,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Capital, B</strong></td>
<td>40,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$100,000</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

If B's interest is sold for its $50,000 fair market value, and this sum is allocated in accordance with the fair market value of the respective partnership properties, these figures will correspond to the several Steps delineated in the text:

<table>
<thead>
<tr>
<th>Attributable to Receivables</th>
<th>Attributable to Inventories</th>
<th>Total (attributable to 751 property)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 7</td>
<td>$12,500</td>
<td>$10,000</td>
</tr>
<tr>
<td>Step 6</td>
<td>12,500</td>
<td>10,000</td>
</tr>
<tr>
<td>Step 5</td>
<td>12,500</td>
<td>10,000</td>
</tr>
<tr>
<td>Step 4</td>
<td>15,000</td>
<td>17,500</td>
</tr>
<tr>
<td>Step 3</td>
<td>2,500</td>
<td>7,500</td>
</tr>
<tr>
<td>Step 2</td>
<td>2,500</td>
<td>7,500</td>
</tr>
<tr>
<td>Step 1</td>
<td>2,500</td>
<td>7,500</td>
</tr>
</tbody>
</table>

Thus, even if B's outside basis were increased to $50,000 a sale at this price would charge him with $10,000 ordinary income, of which $2,500 would be attributable to unrealized receivables and the remainder to substantially appreciated inventories.

\(^{18}\)Regs. 1.751-1(a) (1), (2).

\(^{19}\)Regs. 1.751-1(a) (2).
length bargain, just as may the fair market value of the entire interest.\textsuperscript{20}

Step 5: Item (ii) in Step 3 is the portion of the seller's outside basis allocated to 751 property and is determined as if the 751 property had been currently distributed to him.\textsuperscript{21}

Step 6: A partner's basis for currently distributed property is generally the same as the partnership's basis, \textit{i.e.}, the inside basis, for that property.\textsuperscript{22}

Step 7: By definition the inside basis includes neither (a) the value of unrealized receivables (which would have a basis as soon as realized),\textsuperscript{23} nor (b) the value of the appreciation in inventory (which is measured by the excess of its fair market value over basis).\textsuperscript{24}

5. \textit{The Solution: Election to Adjust Inside Basis}

It follows that a rise in outside basis alone—even though attributable to increase in value of 751 property—is no shield against section 751 and its ordinary income consequences. The solution is to translate the increase in outside basis to inside basis. The need for such a translation is envisioned by the Internal Revenue Code, which provides an incomplete set of tools for accomplishing it. The need may arise equally whether the new outside basis results from purchase or death. The procedure is to adjust the particular partner's share of inside basis of all partnership assets by adding to it the excess of his outside over his inside basis.\textsuperscript{25} In general, the aim is to allocate the adjustment in order to minimize the differential between the inside basis and the fair market value of each partnership asset.\textsuperscript{26} If the out-

\textsuperscript{20} It is generally conceded that the allocation of purchase price must be realistic. It cannot be artificially small for 751 property and large for its opposite. One author is of the view that the attribution is concerned not with the purchase price but solely with the components of the partnership interest. Keir, Sale or Exchange of a Partnership Interest and Retirement of a Partner, N.Y.U. 13th Inst. on Fed. Tax 873, 874 (1955). This hardly seems to comport with Regs. 1.751-1(a)(2): "Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct." Accord, Regs. 1.751-1(c)(3). I gloss over the difficulty of distinguishing between unrealized receivables and substantially appreciated inventory in some instances. Consider, for example, the anticipated profits on a seasonal line of merchandise which has been designed and displayed but neither manufactured nor sold. The distinction is relatively non-functional although if the inside basis adjustment is made, some bookkeeping entry is necessary. See also section 6 of the text.

\textsuperscript{21} Ibid.

\textsuperscript{22} IRC 732(a). The partner's basis may be even less if his outside basis is less, but this will not occur in the sale of an interest shortly after death since the new outside basis presumably reflects the value of 751 property. See IRC 732(c)(1).

\textsuperscript{23} IRC 751(c).

\textsuperscript{24} IRC 751(d).

\textsuperscript{25} IRC 743(b). If outside basis is less, inside basis must be reduced.

\textsuperscript{26} IRC 755. Capital and non-capital assets are segregated for this purpose. IRC 755(b). In particular, any change in outside basis reflecting change in value of 751 property will be allocated to 751 property.
side basis is fixed by the fair market value of the partnership interest at death, and this faithfully reflects the fair market value of the partnership’s assets, the adjusting partner will obtain an inside basis for each asset exactly equal to his share of its fair market value.

Thus the adjustment gives inside effect to the change in outside basis. To see how this shields against section 751, it is only necessary to retrace Steps 7 through 1. Intuitively one may perceive that with respect to the adjusting partner, the receivables are no longer unrealized, the inventory no longer substantially appreciated.

6. Basis in Unrealized Receivables; The Specter of Income in Respect of a Decedent

Although the analysis in the previous section is believed to be correct, the reader should be warned of contraindications. There is no question that inventory can enjoy higher basis from the elective adjustment and thereby cease to be substantially appreciated. It is not quite so clear that the adjustment can accomplish an analogous result for unrealized receivables. The mere changing of basis does not require or permit receivables to be included in income; hence, by statutory definition they remain unrealized. Nonetheless their absorption of basis means that in Step 3, no income is realized as to them when the partnership interest is sold. Therefore the problem appears to be solved completely, if obliquely.

Two contrary arguments might be advanced:

(1) Basis is a characteristic of “property.” If unrealized receivables are disembodied income rights rather than property, they cannot possess a basis. The distinction between property and income has been influential in deciding who is to be taxed on the realization following a gratuitous transfer, or whether a non-gratuitous transfer is a sale or an anticipation. But there is no suggestion that a right to income cannot take a basis in proper circumstances. Undoubtedly one may buy a receivable and thereby acquire a cost basis in it. No reason is evident why a death basis should have any less efficacy. To be sure, the Code bars a death basis for “property which constitutes a right to receive an item of income in respect of a

\[27\text{See note 13 supra.}\]
\[28\text{Accord, Tenen, Tax Problems of Service Partnerships, N.Y.U. 16th Inst. on Fed. Tax 137, 162-64 (1958).}\]
\[29\text{See, e.g., Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Clifford, 309 U.S. 331 (1940); Eugene T. Flewellen, 32 T. C. No. 31 (May 11, 1959).}\]
\[31\text{This is conceded by Regs. 1.751(c)(2).}\]
(2) The provision just mentioned forces us to speculate whether unrealized receivables differ from income in respect of a decedent. If they are the same, basis is unmistakably denied to them. In the partnership context, income in respect of a decedent includes "mutual insurance" payments and the distributive share of partnership income "attributable to the decedent for the period ending with the date of his death. The former are of no concern here and the latter (if a meaning can be agreed upon) will produce ordinary income by any process of reasoning. Not much more can be said. Unrealized receivables have an expansive definition, while income in respect of a decedent has none in the Code and little in the Regulations. For example, it is clear that fees charged but not collected would for a cash-method taxpayer be both income in respect of a decedent and unrealized receivables. In contrast, fees not yet charged for work not yet completed would seem to be unrealized receivables but not income in respect of a decedent.

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IRC 1014(c).

Similarly, where fragmentation is in question, unrealized receivables are spoken of as property. IRC 711(b)(1)(A), (B). Regs. 1.751-1(a),(e) coin the phrase "section 751 property" to describe unrealized receivables as well as substantially appreciated inventory.

IRC 1014(c). A compensatory deduction is allowed against the realization of income in respect of a decedent. It is based upon the estate tax paid on the death value of the items of income in respect of a decedent. IRC 691(c). But it is never as favorable as a basis equal to death value which may be equivalent to a 100% deduction.

IRC 753.

Regs. 1.706-1(c)(3)(v). Accord, Regs. 1.753-1(b). Regs. 1.742-1 denies outside basis to the extent of items of income in respect of a decedent.

Supra note 15.

IRC 691. Regs. 1.691(a)-1(b): "In general, the term 'income in respect of a decedent' refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. . . . Thus the term includes:

1. All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

2. Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

3. Income to which the decedent had a contingent claim at the time of his death."

Cf. Regs. 1.691(a)-2(b), ex.(1). The Advisory Committee has recommended that partnership unrealized receivables be specifically denied basis and treated as income in respect of a decedent. House Ways and Means Advisory Committee on Subchapter K, Revised Report on Partners and Partnerships 44-47 and proposed § 713 (1917). The latter corresponds to H.R. 4460, 86th Cong., 1st Sess., § 777 (1959). See also § 776(b)(2)(A), (B) concerning liquidating payments by the partnership, and § 749 concerning sale of a partnership interest. For an indication of the factors deemed significant in cases arising prior to the 1914 Code partnership intricacies, compare U. S. v. Ellis, 264 F.2d 125 (2d Cir. 1959) (successor's 10-year share of income of insurance brokerage partnership was income in respect of a decedent; capital was not a material income-producing
Even if unrealized receivables are identical with income in respect of a decedent or are naked non-property rights incapable of acquiring basis, the taxpayer can fall back on the elaborate statutory scheme. This recognizes the separate partnership entity in all but highly specific instances. Thus the income rights are the partnership’s, not the partner’s. His partnership interest is technically distinct; it cannot be shorn of its death basis merely because its value includes income rights. If the income rights acquire a basis, it is not because they were owned by the decedent but because an election is made to adjust inside basis to conform to outside basis. The result would be to permit indirectly what could not be done directly, but this is fair game in tax law.

7. Capital Loss Without Election

If the inside basis adjustment is not effectively made, the anomaly of ordinary income from a no-gain transaction appears to have one compensation: an offsetting capital loss. The consideration for a partnership interest “attributable to” 751 property is not “attributable to” the partnership interest itself. In the main, the section 751 aspect leaves the outside basis unchanged. The outside basis will therefore exceed the amount realized from non-751 property by exactly the amount of ordinary income under section 751. Since the partnership interest (apart from 751 property) is a capital asset, the excess represents a capital loss. It scarcely needs saying that in most instances this is small comfort. In general, it will be desirable to make the adjustment.
8. Possible Methods of Electing to Adjust Inside Basis

Method 1: The adjustment is available upon proper election by the partnership, and this is the surest way to achieve it. However, there are two complications. One, discussed in the next section, concerns timing and is potentially grave because the need for the election may easily not be grasped until the deadline is passed. The other is that the election applies to all transferees of partnership interests. Moreover, once the election is made, it is permanently binding unless governmental consent is given for revocation. If the election has not been previously made, the decedent’s successor may have non-legal difficulties in inducing the surviving partners to make it. More probably than not, such difficulties will arise from failure to understand the legal intricacies or from reluctance to undertake the record-keeping complexities which are required. However, they may stem from real economic detriment; for example, where a substantial downward adjustment in inside basis might result for other partners (e.g., one whose outside basis is less than his inside basis). The election will normally be advantageous to the purchaser of the decedent’s interest since it will offset his future ordinary income to the extent that his purchase price represents value for unrealized receivables or appreciation in inventory. This will frequently occur in prosperous businesses or inflationary periods. Situations can be imagined, however, in which he has more to lose than to gain by the election. And if he buys during the partnership tax year following the death, he might cause an election to be made only for the later year (which is too late to help the seller). Prudence suggests a provision in the sale contract obligating the buyer to have the partnership make the election for the year of death, if it is still possible.

It is sometimes suggested that the partnership agreements be fashioned to bind each partner to make the section 754 election. Such a provision may cause more trouble (in terms of filings, multiple records, and disadvantage to various partners) than it is worth. It does, however, insure against the possible misfortune described here. A less rigid clause may be preferable; e.g., one giving each partner (or his successor) an enforceable right to have the election made upon a showing that it will benefit him in a certain minimum amount, or that it will benefit him more than it will harm the other partners at the same time.

Method 2: Since the election is made by a statement in the partner-
ship return signed by one of the partners, it may be that the decedent's successor can file such a statement and return if the surviving partners refuse. He is treated as a partner for some tax purposes, but his status for this purpose is not clear. Nor, if conflicting returns are filed, is it certain which will be honored. Possibly the determination of his authority so to act would be made under local law, which will in turn depend on the agreement of the partners.

Method 3: Some writers conclude that the decedent's successor may, on the sale of his partnership interest within two years of death, make an inside basis adjustment even though no partnership election is in effect. They rely on the reference in the Regulations dealing with Step 5, supra, to basis determined under "section 732 (including subsection (d) thereof)." Section 732 (d) does permit a distinct election to adjust inside basis. It is attractive in that it is made on the taxpayer's individual return and does not require adjustment of basis by any other partner. The express language of the provision deals only with distributions of partnership property to transferees of partnership interests. While the successor to a deceased partner is a transferee in this sense, there is nothing in the Code or the legislative history to make him a distributee in law if he is not one in fact. Yet, the intent of the Regulations may be to permit the independent election to any transferee; unfortunately, they are not free of ambiguity. A theory of "constructive distribution" could be postulated to bring section 732 (d) into play, but the Regulations do not even remotely articulate it. Even if they were explicit on the point, they might exceed their statutory authority. The seller of a deceased partner's interest would be rash to rely on section

47 Regs. 1.751-1 (b); IRC 6063.
48 E.g., Regs. 1.708-1 (b) (1) (i) & (ii), 1.736-1 (a) (1) (ii).
49 Cf. Uniform Partnership Act §§ 18 (g), 35, 37; Crane, Partnership 29 n.10, 465 (2d ed. 1952); Sher & Bromberg, 302 n.210; Note, Partnership Continuation Agreements, 72 Harv. L. Rev. 1302-03 (1959).
50 E.g., Little, Tax Planning for Professional Partnerships, 35 Taxes 991, 1004 n.72 (1957); Willis, Little and McDonald, Problems on Death, Retirement, or Withdrawal of a Partner, N.Y.U. 17th Inst. on Fed. Tax 1033, 1050, 1053 (1959).
51 Regs. 1.751-1 (a) (2).
52 Regs. 1.732-1 (d) (2).
53 Regs. 1.732-1 (d) (1) (i).
54 Since the election affects only the property distributed, a token distribution would be of little help. In most cases it will be easier to induce the surviving partners to make the election than to distribute the partnership property. If, however, the time for partnership election has passed, relief might be had by procuring a distribution of partnership property and then selling it, rather than selling the interest in the partnership. Such a tactic raises a host of other questions which will not be considered here. With respect to timing, see section 9 of the text.
55 The reference could pertain to property which has been actually distributed and thereby affected outside basis or inside basis of other property.
732(d) to guard against fragmentation. Possibly a ruling might be obtained; apparently none has yet been issued.

9. When Elections Must be Made

The adjustment under Methods 1 and 2 must be made for all transfers, deaths, and distributions in the year to which the election applies, and in all subsequent years. But it need not be made prior to death, so long as it is made for the year of death. It must be made in “the partnership return for the first taxable year to which the election applies.” Analogizing from litigation concerning other elections, this presumably includes an original or amended return filed before the due date, or any extension thereof. But it does not include an amended return filed after the due date (including extensions). A fortiori, it does not include a refund claim. Conceivably, but not probably, a late election might be allowed on the ground that it was not timely made because of a material mistake of fact; however, lateness would clearly not be excused because of a mistake of law. A failure to perceive the importance of the inside basis adjustment under the circumstances described above would seem to be a mistake of law, although the distinction is generally hazy. Finally to be considered is the possibility that the election might be deemed to have been made by the way the taxpayer reported his gain, even though the filing formalities were not complied with. Certainly no confidence should be placed in it in planning.

The adjustment under Method 3 is, as already noted, of very doubtful applicability. Its hypothetical character promotes uncertainties as to its timing. In the situation expressly foreseen by the Code, i.e., a distribution of partnership property to the transferee of a partnership interest, the election is to be made for the year of distribution. If the Regulations imply a constructive distribution to

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57 Regs. 1.754-1 (b).
59 J. E. Riley Inv. Co. v. Commissioner, 311 U. S. 55 (1940) (election to deduct percentage depletion required to be made in “first return”; dictum on extension).
60 Burford Oil Co. v. Commissioner, 153 F.2d 745 (5th Cir. 1946) (election to expense intangible drilling costs required to be made in “return for first taxable year”).
61 Barnhill v. Commissioner, 241 F.2d 496 (5th Cir. 1957) (election to amortize bond premium required to be made “in his return for the first taxable year”).
62 Estate of R. B. Meyer, 200 F.2d 592 (5th Cir. 1952) (taxpayer permitted to “abandon” his irrevocable election not to recognize certain gain in corporate liquidation).
63 Frank T. Shull, 30 T. C. 821 (1958), on appeal to 4th Cir.
64 Cf. Commissioner v. Sklar Oil Corp., 134 F.2d 221 (5th Cir. 1943) (election to expense intangibles was made by deducting some of them in computation of income).
65 Regs. 1.732-1 (d) (2) (i).
the transferee or successor, logic suggests that the election be made for the year of the constructive distribution. There is no guidance whether this is the year of death, or the year of sale by the transferee. Caution would certainly suggest that the election be attempted, if at all, for the earlier year. If property actually distributed is not subject to depreciation, depletion, or amortization allowance, the election is permitted for any year up to the first in which the basis of the property is pertinent in determining the transferee’s income tax. Assuming that this also applies to constructive distributions, we cannot very well assume a constructive distribution of less than all the partnership property. It follows that a later election under this clause is permissible only in connection with the rare partnership which owns no depreciable, depletable, or amortizable property. To be safe, the election should be made in the timely return for the year of death.

10. Proposed Legislation

Although the problem of income without gain on the sale of a deceased partner’s interest is largely soluble in present law, proposed legislation would ease this along with other partnership perplexities. H.R. 4460, referred to the Ways and Means Committee in February, 1959, is based on the comprehensive and penetrating recommendations of the Advisory Group on Subchapter K. The Bill provides among other things that no ordinary income can arise from the sale of a partnership interest unless there is a gain on the total transaction. Hence an interest sold for fair market value equal to its death basis would generate no ordinary income regardless of the presence of 751 property. However, outside basis would not include the value of items corresponding to the unrealized receivables of the present statute. Insofar as the sale price of a partnership interest is attributable to such value, gain would be realized and treated as ordinary income. The result would be equally to preclude (a) the inadvertent application of the fragmentation rules to produce ordinary income from inventory appreciated at death, and (b) the deliberate application of the inside basis adjustment to avoid ordinary income from unrealized receivables. H.R. 4460 liberalizes the timing of the partnership election and affords an explicit inside adjustment to one
who sells a partnership interest within two years after acquiring it.70
Thus a decedent’s successor could make the inside adjustment whether
or not the surviving partners desired to exercise the election. These
changes would be most welcome, as would all simplifications of the
hypergeometric partnership rules.

11. Texas Community Property Variations

A synthesis of federal and local law would be desirable since life
takes place under both. Unfortunately, it can hardly be achieved in
the present state of affairs. In some domains, federal law feels obliged
to ignore state variations in order to achieve national uniformity. In
others, primary rights and relations determined by state law are taken
as facts to which federal law applies.71 For example, the local law of
business associations has received little credence in federal taxation72
and is superseded in almost every conceivable partnership instance
by the provisions of the Internal Revenue Code. On the other hand,
the local law of community property has commanded high respect in
federal taxation.73 Admittedly there have been few recent cases, but
this is because joint returns and marital deductions have since
1948 made universal the principal tax benefits of community property.
There is no indication that community property will not be recognized
where relevant. We may therefore fruitfully consider its ramifications
in partnership even though the conclusions are supported by virtually
no direct authority.

Exactly what a partner owns is unclear in Texas. The usual char-
acterization is an interest in the partnership surplus, i.e., the partner-

70 Section 785; House Ways and Means Advisory Committee on Subchapter K, Revised
Report on Partners and Partnerships 39, 42-43 and proposed § 751(d) (1957). Com-
pare the section 732(d) election discussed in the text at notes 50-55. The proposal of section
785 may be argued as confirmation of doubts whether section 732(d) is now available to the
seller of a partnership interest.

71 See Note, The Role of State Law in Federal Tax Determinations, 72 Harv. L. Rev.
1350, 1351 (1959).

72 Id. at 1353.

73 Poe v. Seaborn, 282 U. S. 101 (1930) (half of community income taxable to Wash-
ington wife); Hopkins v. Bacon, 282 U. S. 122 (1930) (same, Texas law); T.D. 3138,
munity estate taxable at death of either spouse). The latter result was (for the period
See also Lang v. Commissioner, 304 U.S. 264 (1938) (under Washington law and Treasury
Regulations, only husband’s half of proceeds of insurance on his life, paid for with com-
munity funds, is includible in his gross estate); U. S. v. Stewart, ___F.2d___, 59-1 U. S. Tax
Cas. Para. 11,884 (5th Cir., June 18, 1959) (under California law, wife’s half of cash value
of insurance on surviving husband’s life, paid for with community funds, is includible in her
gross estate); Commissioner v. Chase Manhattan Bank, 259 F.2d 231 (5th Cir. 1958), cert.
denied, 359 U. S. 913 (1959) (under Texas law, at husband’s death, wife made taxable
gift of her half of community property in living trust over which husband had sole power
of revocation).
ship assets after payment of all partnership debts. Whatever the interest is, it is capable of being owned as community by husband and wife. And it will be community unless one of the spouses acquired it by gift, devise, or inheritance or already owned it at marriage. Even in these cases it will probably be community insofar as its value results from the retention of post-nuptial earnings, for these (at least when withdrawn) are community.

Generally, control of the community is lodged in the husband as manager, but the wife's interest is regarded as equal and vested from the outset. Upon dissolution of the community by death, each spouse's half is segregated as separate property. Thus, one half of a community interest in a partnership belongs to the surviving spouse and one half to the successor of the deceased. Consequently, income from one half should be taxed to the survivor and income from one half to the successor. Moreover, both halves of the partnership interest take on new bases equal to fair market value for estate tax purposes, although only the latter half is subject to estate tax.

Typically, it is the husband rather than the wife who has been the active member of the partnership. In this event, if the wife predeceases, her death will have no effect on the partnership even though community property is invested in it. Her husband will in all likelihood continue as a partner, and her share of taxable income and of distributions will go to her successor (who may, of course, be her husband). Because of the lack of apparent change in the partnership, the need for an inside basis adjustment may easily be overlooked. Such an adjustment would, however, affect only the computation of

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74 Sher & Bromberg, 272. It is customary and probably wise for conveyances to refer to a partner's interest in the various partnership assets as well as his interest in the partnership.

75 Comment, Profits and Increases in the Value of Partnerships and Corporations as Governed by Community Property Law, 36 Texas L. Rev. 187, 189-91 (1957); cf. Norris v. Vaughan, 152 Tex. 490, 498-99, 260 S.W.2d 676, 680-81 (1957) (separate interest in partnership remained separate where profits were withdrawn; community effort to make it productive did not make it community); Blumer v. Kallison, 297 S.W.2d 898 (1956) error ref. n.r.e. (separate interest in partnership remained separate where profits were accounted for separately from capital and were withdrawn).

76 The partnership assets are subject to possession by the surviving partners for carrying on or winding up the partnership affairs. Sher & Bromberg, 307-08, 271-72. The survivor's half may be subject to community administration. Tex. Prob. Code Ann. §§ 155-77 (1956).

77 The matter is not free from doubt even where there are no partnership complications. See Jackson, Community Property and Federal Taxes, 12 Sw. L.J. 1, 34-36 (1958).

78 IRC 1014(a), (b) (6).

79 The wife's disabilities to deal even with her separate property make it risky for others to accept her as a partner. Cf. King v. Matney, 259 S.W.2d 606 (Tex. Civ. App. 1953) error ref. n.r.e. (wife entitled as creditor to recover funds contributed as partner).

80 Simpson v. Gregg, 1 Posey 380 (Tex. Comm. App. 1880). Wives are usually made signatories to Texas partnership agreements to assure this result.
distributive shares of partnership income and loss so long as her interest in the partnership remains in the hands of her successor, and her husband’s in his. Any time her or his interest is sold, the collapsible problem dealt with in this article will arise.

If the husband is the first to die, the probability is much greater that the partnership interests—his as well as his wife’s—will be sold. Each then faces the fragmentation peril. Each can hope to benefit from the inside basis adjustment if the election is properly made. However, a literal application of the statute may block the adjustment as to the community survivor’s interest. The Code authorizes the adjustment “in the case of a transfer of an interest ... by sale or exchange or upon the death of a partner” and measures the adjustment by the difference between the inside and outside bases of the “transferee partner.” Neither the Code nor the Regulations address the problem of whether a community survivor’s interest is transferred, or merely receives a change of basis without transfer. The question could easily have been overlooked, for it is difficult to imagine any other situation (besides a death or transfer) when a partnership interest undergoes a change of basis unconnected with some action of the partnership.

There are several arguments supporting the survivor’s right to the adjustment. A new basis at the first spouse’s death is in other respects indistinguishable from a new basis by purchase; perhaps the two can be assimilated for the treatment of the survivor, like the purchaser, as a transferee. More directly, it can be advanced that any person whose partnership interest experiences a change of basis independent of partnership action is a transferee within the contemplation of the statute. To rule otherwise would at least partially frustrate the explicit provision giving a new basis to the community survivor, and would put a surviving wife at a disadvantage compared to the beneficiary of a marital deduction where community property is not involved.

Alternatively, it may be that for federal use, there is a transfer in that the community survivor’s interest is freed from the control and rights of the decedent. Finally, it is possible that the community property laws are irrelevant and that the entire community interest

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81 IRC 743 (a).
82 IRC 743 (b).
83 See note 7 supra for the components of outside basis.
will be deemed, as in a common-law jurisdiction, to pass from the decedent to the survivor.

All this naturally leaves some doubt whether Methods 1 and 2 (discussed in section 8, supra) are open to the community survivor, although they plainly are to the successor of the deceased's interest. It should be noted that, with respect to Method 2, a community survivor is in a stronger position than an ordinary surviving spouse to speak and act for the partnership. The doubt that already exists regarding Method 3 (i.e., whether there is the necessary distribution) is compounded by the doubt whether a community survivor is a transferee.

The local law continuity of the surviving spouse's interest produces another tax contrast to common-law jurisdictions. The survivor's holding period dates from the community's acquisition of the property (e.g., the partnership interest) and not from the first spouse's death, even though a basis change takes place at the latter event. Consequently, if the property is sold within six months after death, it is possible that long-term gain or loss will be realized by the survivor and short-term by the decedent's successor. Such a situation will be rare indeed, for it depends not only on a prompt sale but also on a price differing from the estate tax value of the interest and/or a capital loss offsetting ordinary income evoked by the collapsible provisions.

Another community property peculiarity deserves comment. The decedent's half of partnership income earned but not accrued before death will be income in respect of a decedent, but the surviving spouse's half will not. Therefore, the survivor may effectively avoid tax on such income to the extent that the right to receive it had a fair market value at the death of the first spouse. Such value becomes the basis in the hands of the survivor and offsets the realization of income just as though the right had been purchased. Arguably, the result is the same for partnership income which was accrued prior to death but which was not then taxable because the partnership's year

83 See text accompanying notes 50-55.
84 Rev. Rul. 59-220, 1959-25 Int. Rev. Bull. 14. The ruling deals generally with Texas community property and says nothing specifically about partnership interests. An argument might be made that a partnership interest is not a distinct species of property but a collection of interests in partnership assets whose holding periods are measured separately from the partnership's acquisitions of the respective assets. Quite apart from questions of allocating liabilities, the explicit fragmentation of IRC 751 as to type of income generates strong implications against fragmentation as to time of holding.
85 See section 7 of the text.
86 Supra note 38.
had not yet reached an end. The successor's half of this is income in respect of a decedent, but the survivor's half is not. Insofar as the right to receive this income is reflected in the death value and ensuing basis, taxable realization will be counteracted. Thus, while an item of income in respect of a decedent is subject to estate tax but does not take a basis at death, a community survivor's half of the same item is not subject to estate tax but does take a basis equal to its value at the death of the first spouse. If the careless sale of the decedent's interest results in income without gain, the careful sale of the community survivor's results in gain without income.

12. Planning the Sale of a Deceased Partner's Interest

Plainly, planning pays in the sale of a deceased partner's interest. A timely election to adjust inside basis will often be the crucial need. This can be buttressed by a clause in the sales documents allocating consideration between property and other property. Within the class of property value should, as far as is realistic, be assigned to inventory rather than receivables.

A number of other matters merit attention, particularly with respect to timing. Since the effective date of the sale closes the partnership year with respect to the seller, acceleration or postponement of this date may shift from one year to another the income tax on the distributive share of partnership income up to the date of sale. Similar control may within limits be exercised by an appropriate choice of the estate's taxable year. This, plus thoughtful discretion in spacing distributions from estate to beneficiaries, can minimize the bracket rates to which total income is subject. In a non-community property state, delicate co-ordination of date of sale, selection of estate's taxable year, and timing of distributions from estate to surviving spouse may permit partnership income for the entire year of death to be reported on a joint return of the decedent and the surviving spouse. It is patently impossible to generalize as to the desirability of any of these maneuvers in particular situations, but the possibilities must be reckoned with.

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89 Supra note 36.
90 IRC 1014(c); Regs. 1.742-1.
91 IRC 706(c)(2).
92 IRC 706(a) taxes the partner in his taxable year within or with which the partnership year ends.
93 See Frank, Estate Planning: The Taxable Year, 34 Taxes 202 (1956).
94 See IRC 661(a)(2), 662(a)(2).
Whatever choices are made should be scrupulously supported by the records and returns of the partnership, the estate, and the surviving spouse. This is particularly important where a community property partnership interest is left to the surviving spouse. Advantages may accrue from keeping the decedent’s interest in his estate during administration (e.g., splitting of income) but this will be difficult to substantiate without segregation on the partnership books and separate payments to the surviving spouse and the estate. The optimum time for transfer of the partnership interest from the estate to the heir or legatee should be selected, then executed with full documentation. If the community partnership interest is sold, the surviving spouse and the decedent’s executor or administrator will each be parties and should receive their proceeds separately, and account for them on their respective returns.

13. Conclusions

A summary has been given at the beginning of the article. Nothing remains but musing and moralizing.

There are many troublesome implications and ramifications of the questions discussed in this paper. One, in particular, has already been mentioned: the uncertain role of state law in federal taxation. Several others may be profitably identified now.

The law of taxation and the law of business associations share many problems. The one dramatized here is ambivalence toward the partnership. Inside and outside basis derive from the entity theory. Fragmentation rules reflect the aggregate theory. Synthesis of the two fields of law cannot be complete because of the different considerations which underlie them. Yet neither can be sensibly treated in isolation, and each is helpful in understanding the other. They are not as far apart as some specialists might have us believe, and a consistent theory in one would materially aid the other.

It has long been evident that business decisions are influenced, if not dictated, by tax aspirations. What distortions this produces in the economy or in the law of business associations is yet to be fully evaluated. One result has been well-meaning congressional efforts to minimize tax factors in the selection of a business organization. but so far these have only produced more cross-breeds and a greater demand for tax divination. Substantive considerations may be demphasized in the process.66

66 For an example and exhortation to the contrary, see Crane, Election of Certain Small Business Corporations as to Income Tax Status, 10 Hastings L.J. 271, 276-82 (1959).
Pervasiveness of the internal revenue laws is due as much to their economic impact as to their intricacy. The common sale of a deceased partner's interest is a prime example. The reader should by now be convinced that this transaction resembles a gamble, with the rules partially unknown and the stakes frightfully high.

Proliferation of tax law seems doomed to continue. Its explanation lies in the unending conflict between citizen and government, between the finite specificity of statutes and the infinite variety of commerce. Every detail invites circumvention which in turn invites new detail. So, paraphrasing Shaw's Caesar, to the end of history, complexity shall breed complexity, always in the name of certainty, clarity, and equity.

Resolution of the problem cannot be easy. Government must be financed. Clients must be served. To return, as some suggest, to a simpler Code and broader judicial interpretation could hardly increase predictability or decrease maneuvering. If there is a cure, it must come out of deep analysis. One obvious subject for consideration is the rate structure, which pits progression for ordinary income against proportion for capital gains. Another is the distinction between property and income, which favors the owner over the earner.