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Accounting for Partnership Changes

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In the report of the Senate Committee on Finance on the Internal Revenue Code of 1954, the section relating to partners and partnerships begins with these words,[1] "The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field." I can agree completely with that statement. I wish it were possible to report that the new partnership provisions contained in the 1954 Code had removed all confusion from this area but, unfortunately, such is not the case.

Prior income tax law relating to partnerships grew largely by administrative rulings and judicial decisions. The Internal Revenue Code of 1954, for the first time, has attempted to provide, by statute, objective rules which would be, to paraphrase the Senate Committee Report,[2] simple, flexible, and equitable. While the new Code has made substantial strides toward that goal it is a goal which is very difficult, and perhaps impossible, of complete achievement. In the meantime we have to work within the framework of the existing statute where it applies and of law established by administrative and judicial precedents where it does not. My remarks today will be limited to a discussion of those provisions of the Internal Revenue Code which have been assigned to me.

My assignment is to discuss the rules relating to distributions by partnerships and transfers of partnership interests. I think that complicated provisions of tax law are always easier to understand if we can first understand the reasons why they were enacted and the general types of situations they are designed to produce or to prevent. It is not always easy to understand what a Congressman has in his mind when he introduces a new law, but I think there are a few general principles which we can all agree apply to the area of partnership distributions and transfers. Let me state three of them very briefly:

1. It should not be possible to convert ordinary income to capital gains by means of partnership distributions or transfers.
2. It should not be possible to shift income or categories of income, such as capital gain, among individuals by changes in the structure of partnerships.

3. Changes in partnership structure should not result in the acceleration or the deferral of the time for taxing income.

The first two of these principles seem to have been fairly well achieved by the partnership sections of the 1954 Code. The third principle, the prevention of acceleration or deferral of the imposition of tax, has been accomplished in some transactions. In certain transactions, however, e.g., those relating to distributions or exchanges of receivables or inventories, acceleration has been provided in some situations where it would not have occurred under prior law.

For purposes of this discussion I will divide partnership distributions into two categories. There are, first, those distributions which are covered by what I will call the "general rules" and, second, those which are covered by the exceptions and options provided in the 1954 Code. The problems which arise in either category may be divided again into three classifications. These are:

1. Recognition of gain or loss.
2. Determination of basis of assets received by a distributee partner.
3. Adjustment of basis of assets retained by the distributor partnership.

The "general rules" apply to those distributions in which a distributee partner receives his pro-rata share of money, of the value of unrealized receivables and inventories which have appreciated in value (Section 751 assets), and of other assets, and in which the elections for adjustment of basis provided by the Code in various circumstances have not been made.

Under the "general rules" a distributor partnership will recognize neither gain nor loss and will make no adjustments to the basis of its remaining assets because of a distribution. (3) A distributee partner will recognize gain only if and to the extent that money received exceeds the adjusted basis of his partnership interest. (4) A distributee partner will never recognize loss under the "general rules" unless a distribution is in complete liquidation of his partnership interest and unless he receives no assets other than money, unrealized receivables, and inventory; and then, only if and to the extent that the aggregate basis, to the partnership, of the assets received is less than his basis in his partnership interest. (5)

Having determined the amount of his recognizable gain or loss as a result of a distribution, a distributee partner still has the problem of

determining the basis of the assets he has received. If the distribution is not in complete liquidation of his partnership interest he will merely take over the basis which the assets had in the hands of the partnership, both in the aggregate and individually, unless the aggregate partnership basis exceeds his basis in his partnership interest, reduced by any money distributed. In that case his aggregate basis for the assets received will be equivalent to his basis in his partnership interest thus reduced. (6) To put it another way, he will assume the partnership's basis for assets received subject to the limitation that the basis he assumes cannot exceed his adjusted basis in his partnership interest.

If a distribution is in complete liquidation of a partner's interest, the distributee partner's aggregate basis for assets received will always be equal to his basis in his partnership interest, reduced by any money received and any loss recognized in the transaction.(7)

In any case in which the aggregate basis of assets received is determined by reference to the distributee partner's basis in his partnership interest there will be the further problem of allocating the aggregate basis to the particular assets. This allocation is accomplished in three steps:(8)

Step 1. The basis of the partnership interest is first reduced by the amount of money received. If the money received is equal to or exceeds the basis of the partnership interest, any other assets will have a zero basis in the hands of the distributee partner.

Step 2. Basis remaining after step 1 will then be allocated to unrealized receivables and inventory in an amount equal to the adjusted basis of these assets to the partnership or, if the remaining amount is less than the total adjusted basis of these assets to the partnership, in proportion to such bases.

Step 3. Any basis remaining after steps 1 and 2 will be allocated to remaining assets in proportion to their adjusted bases to the partnership.

At this point we should consider the definitions of the terms "unrealized receivables" and "inventory" as they are used in this connection. Bear these definitions in mind, as they will be important when we consider, a little later, the provisions of Section 751. The term "unrealized receivables" includes any rights to receive payment for goods delivered, or to be delivered, or for services rendered, or to be ren-

dered, to the extent not previously includible in income by the partnership.[9] The term "inventory" includes not only stock in trade but any property which, in the hands of either the partnership or the distributee partner, would not be considered either a capital asset or property used in the trade or business on which gain or loss would be subject to the alternative tax under Section 1231.[10]

I will repeat that the rules I have thus far described are what I have called the "general rules". There are certain exceptions where these rules do not apply and certain elections which will result in modification of these rules. The exceptions and elections to which I refer include the following:

1. Payments to a retiring partner or to a deceased partner's successor in interest.[11]
2. Distributions considered, under Section 751, to be sales or exchanges of unrealized receivables or of inventory which has appreciated substantially in value.[12]
3. Distributions in connection with which a distributee partner has elected or is required, under Section 732 (d), to treat as the adjusted basis of the partnership property, the adjusted basis it would have if the adjustment provided in Section 743 (b) were in effect as to the partnership.[13] This election is available to a partner who acquired his interest, by transfer, no longer than two years prior to the distribution.

You will forgive me, I hope, for referring to Sections 751 and 743 (b) without further explanation at this point. I do this because the explanations would be rather involved and I wish to discuss them a little later on.

Payments of money to a retiring partner or to a deceased partner's successor in interest[14] may fall into one of four categories. These are:

1. Distributive share of partnership income,[15] taxable in the same manner as distributive shares of income applicable to active partners,[16] if the amount is determined with regard to the income of the partnership.
2. Guaranteed payments for services or for use of capital,[17] deductible by the partnership and taxable as ordinary income to the recipient,[18] if determined without regard to partnership income.

3. Payments considered to be in exchange for the interest of the retiring or deceased partner in unrealized receivables of the partnership,[19] taxable as ordinary income.[20]
4. Distributions taxable in the same manner as distributions to active partners.[20]

I cannot take the time for a detailed discussion of payments to retiring partners or successors of deceased partners, but I should point out a few rules to be remembered:

The rules as to such payments relate only to payments of money. They do not apply to distributions of other property.[21]

With respect to the application of these rules a retiring partner or the successor of a deceased partner is considered to be a partner, and the partnership does not terminate, until all payments to be made are completed.[22]

No payment will be considered to be a payment for goodwill unless the partnership agreement provides for such payment[23] in an amount or in accordance with a formula which is reasonable.[24]

Some of the more troublesome problems with regard to partnership distributions arise under Section 751, relating to distributions equivalent to sales or exchanges of interests in unrealized receivables or inventory which has appreciated substantially in value (which I shall refer to as Section 751 assets). Inventories are Section 751 assets only if their fair market value at the time of the exchange exceeds 120 per cent of their adjusted basis to the partnership and if their fair market value exceeds 10 per cent of the value of all partnership property, other than money.[25] Any distribution by a partnership in which a partner either receives more than his pro-rata share of Section 751 assets and, as a result, gives up all or part of his equity in other partnership assets (including money), or in which he receives an excess of other assets and, as a result, gives up all or part of his equity in Section 751 assets of the partnership, will be considered as a sale or exchange of the assets received for the assets given up.[26] Any gain or loss on the exchange will be a taxable gain or a deductible loss, subject to the limitation on deduction of capital losses, at the time the exchange takes place. Gain or loss will be the difference between the fair value of the assets received over the basis to the partnership of the equity given up.[27] This rule works both ways and in the event of such an exchange without termination of the partnership, the continuing partnership will

realize gain or loss determined under the same rules.[28] The gain or loss will be ordinary income or loss to the party giving up Section 751 assets and capital gain or loss to the party giving up other assets.[29] Note that if all partnership assets have appreciated in value, both parties to such an exchange may have taxable gain even though no real gain has been realized as a result of the exchange.

The basis of the excessive portion of assets received by either a partner or a partnership in a transaction to which Section 751 applies will, of course, be increased or decreased by the amount of gain or loss recognized by the recipient in the transaction.[30]

Section 751 also applies to sales of partnership interests. To the extent that the value of a partnership interest is represented by the fair value of Section 751 assets, any amount received will be considered as received from a sale of such assets.[31] The excess of such amount over the adjusted basis of such assets to the partnership will be ordinary income to the seller.[32]

Some interesting questions may arise under Section 751. One question arose in a case in which my firm was recently involved, relating to the definition of unrealized receivables. The receivables in question were instalment contracts arising from sales of real estate by a partnership which was a real estate dealer. One of the partners was retiring from the partnership and was to receive a distribution of his pro-rata portion of the face amount of the contracts, which was equivalent to their fair value. However, for various reasons, the specific contracts he was to receive included more than his pro-rata portion of the total unrealized profit included therein. The question arose as to whether the entire amount of the contracts represented unrealized receivables or only the unrealized profit portion. To me, the answer seemed to revolve around the accounting concept of when the basis, or cost element, of the contract is "includible in income" under the instalment method of accounting. I thought, and still think, that the basic theory of installment accounting is that the entire amount is "includible in income" at the time it is collected. For example, if an asset with a cost of $1,000 is sold for $2,000, a gross profit ratio of 50% is to be applied to collections to determine the amount of taxable income. Nevertheless, I reasoned, the income realized because of collections would consist of the amount collected less a pro-rata portion of the related cost and both elements would be "includible in income" in the year of collection. If I was correct, the entire face amount of the contracts

represented unrealized receivables and, since the division was in proportion, we did not have a Section 751 transaction. On the other hand, if only the profit element represented unrealized receivables we had a disproportionate division and came under Section 751. Wishing to be sure of our ground before our client was committed, I went to Washington with the client's attorney and discussed the matter with one of the men in the Internal Revenue Service who were then engaged in writing the proposed partnership regulations.[33] He stated that, in his opinion, only the unrealized profit portion of such contracts represented "unrealized receivables" within the meaning of Section 751. He further stated that "unrealized receivables," as there defined, could never have other than a zero basis. I pointed out that, if this were true, the provision of Section 732(c)(1), requiring allocation of basis to unrealized receivables to the extent of their basis to the partnership, would never have any application. He did not appear to be impressed by this argument. I remind you that this was not an official ruling and that the proposed regulations do not discuss the question. In the case I mentioned we readjusted the distribution so that the question would not arise, but I think the matter is still debatable if you have a situation where the answer is important.

Another interesting point is what would happen if there were, in effect, an exchange of unrealized receivables for appreciated inventory. The same person with whom I discussed the preceding question stated that, in his opinion, this also would be an exchange which would be taxable under Section 751. He said that the proposed regulations would include an example of such a transaction but there is no such example in the proposed regulations as issued. This interpretation I also believe to be wrong but I am not certain enough of that to advise a client to stick his neck out unnecessarily. It seems to me that Section 751 assets ought to be treated, for this purpose, as a unit and that divisions of specific items within that unit ought to have no bearing as long as the unit as a whole is divided proportionately. In support of that opinion I cite the language of Section 751(b)(1)(A) which refers to the receipt of Section 751 assets by a partner "in exchange for all or a part of his interest in other partnership property". Nevertheless, I recognize some logic in the opinion expressed to me in that an exchange of unrealized receivables for inventory would involve a shifting of basis between the parties and, therefore, an eventual shifting of income. However, this could also result from distributions which do not involve Section 751 assets.

Thus far I have talked only about distributions by partnerships. Now I shall take a few minutes to discuss sales or exchanges of partnership interests not involving distributions by the partnership. As I have already pointed out, to the extent that the value of a partnership interest is represented by the value of Section 751 assets, any amount received from the sale or exchange of a partnership interest is to be treated as an amount received from the sale or exchange of such assets and resulting gains or losses thereon will be ordinary income.(34) With this exception, proceeds of a sale of a partnership interest will be from a sale of a capital asset(35) and gain or loss will be subject to the usual rules relating to capital gains or losses. Mr. Lungershausen has already discussed the determination of basis for partnership interests acquired by direct contributions of capital. Basis for partnership interests acquired by any other means will be determined by the same rules by which basis of any other asset is determined.(36)

In any of the transactions I have described, any increases in a partner's share of partnership liabilities or in his personal liabilities which result shall be treated as a contribution of money to the partnership by the partner.(37) Any decreases in a partner's share of partnership liabilities or in his personal liabilities shall be treated as a distribution of money by the partnership to the partner.(38)

As I have previously stated, the basis of partnership assets to the partnership will not be affected by any partnership distributions (except as a result of recognition of gain or loss in a Section 751 transaction), or by any transfers of partnership interests, unless an election has been made as provided in Section 754.(39) This election, if made, must be applied to all distributions or transfers in the year it is made and to all subsequent distributions or transfers.(40) The election can be revoked only with the permission of the Secretary.(41) For these reasons it is important to consider not only the immediate effect of the election but also possible future effects since the election may be harmful in the future even though it is beneficial at the time it is made. If the election is made, the basis of partnership assets will be adjusted every time there is a distribution by a partnership or a transfer of a partnership interest. The election is to be made by the partnership,(42) not by the individual partners. It relates to the adjustment of basis of partnership assets only,(43) although the partners may be affected in the event of subsequent distributions to them or of sales by them of their partnership interests.

If the Section 754 election has been made, the basis of partnership property shall be adjusted, in the event of a distribution, as follows:[44]

> Basis of remaining assets shall be increased by the amount of any gain recognized to the distributee partner and by the amount by which the basis to the partnership of property distributed exceeds the basis at which it is taken by the distributee partner.
>
> Basis of remaining assets shall be decreased by the amount of any loss recognized to the distributee partner and by the amount by which the basis at which distributed assets are taken exceeds the basis of such property to the partnership.

If the Section 754 election has been made, the basis of partnership property shall be adjusted, in the event of a transfer of a partnership interest, as follows:[45]

> Basis shall be increased by the excess of the basis to the transferee partner of his partnership interest over his proportionate share of the basis of the partnership property.
>
> Basis shall be decreased by the excess of the basis of the partnership property over the basis to the transferee partner of his partnership interest.

I will have time only to summarize very briefly the rules relating to allocation to the respective partnership assets of adjustments made under the election:

> An increase in basis shall be allocated only to assets whose values exceed their bases and in proportion to such excesses.[46]
>
> A decrease in basis shall be allocated only to assets whose bases exceed their values and in proportion to such excesses.[47]
> If goodwill exists and if its value exceeds its basis, a portion of any increase in basis must be applied to goodwill.[48]
>
> Either an increase or a decrease in basis may be allocated only to assets of a character similar to the assets whose distribution or transfer gave rise to the adjustment.[49]
>
> Basis of any asset shall never be reduced below zero.[50]
> Any part of the adjustment which cannot be allocated because the partnership owns no property of the proper character or because such property has insufficient basis, shall be carried in sus-

pense, so to speak, and applied to subsequently acquired property of the proper character.(51)

In closing I want to point out the extreme importance of careful accounting records for partnerships under the 1954 Code. This is particularly true if a partnership has made elections which require adjustments to the basis of assets. Failure to keep careful records may involve you some day in a hopeless mire from which you cannot extricate yourself. These records, of course, must be kept in a manner which will provide the information necessary to apply the complicated provisions of the Revenue Code relating to partnerships. For this reason it is extremely important that every accountant who has any responsibility for partnership affairs have an understanding of these provisions. It is equally important, I believe, that lawyers and others having any responsibility for partnership tax matters have an understanding of the problems and techniques of accounting for partnership transactions. There is probably no area in which the combined talents of the lawyer and the accountant are more urgently required.

List of Citations

(1) Report of the Committee on Finance, United States Senate
to Accompany H. R. 8300 - Page 89.
(2) Ibid
(3) Sec. 731 (b), I. R. C.; Reg. 1.731-1(b).
Sec. 734 (a), I. R. C.; Reg. 1.734-1(a).
(4) Sec. 731 (a)(1), I. R. C.; Reg. 1.731-1(a)(1).
(5) Sec. 731 (a)(2), I. R. C.; Reg. 1.731-1(a)(2).
(6) Sec. 732 (a), I. R. C.; Reg. 1.732-1(a).
(7) Sec. 732 (b), I. R. C.; Reg. 1.732-1(b).
(8) Sec. 732 (c), I. R. C.; Reg. 1.732-1(c).
(9) Sec. 751 (c), I. R. C.; Reg. 1.751-1(c).
(10) Sec. 751 (d)(2), I. R. C.; Reg. 1.751-1(d)(2).
(11) Sec. 731 (c), I. R. C.; Reg. 1.731-1(c).
(12) Sec. 731 (c), I. R. C.; Reg. 1.731-1(c).
(13) Sec. 732 (d), I. R. C.; Reg. 1.732-1(d).
(14) Sec. 736, I. R. C.; Reg. 1.736-1.
(15) Sec. 736 (a)(1), I. R. C.; Reg. 1.736-1(a)(1)(i).
(16) Reg. 1.736-1 (a)(3).
(17) Sec. 736 (a)(2), I. R. C.; Reg. 1.736-1(a)(1)(i).
(18) Reg. 1.736-1 (a)(3).

(19) Sec. 736 (b)(2)(A), I. R. C.; Reg. 1.736-1(b)(2).
(20) Sec. 736 (b)(1), I. R. C.; Reg. 1.736-1(b)(1).
(21) Reg. 1.736-1 (a) (2).
(22) Reg. 1.736-1 (a)(5).
(23) Sec. 736 (b)(2)(B), I. R. C.; Reg. 1.736 (b)(3).
(24) Sec. 736 (b)(2)(B), I. R. C.; Reg. 1.736 (b)(3).
(25) Sec. 751 (d), I. R. C.; Reg. 1.751 (d)(1).
(26) Sec. 751 (b)(1), I. R. C.; Reg. 1.751-1 (b)(1) and (2).
(27) Reg. 1.751-1 (b)(1) and (2).
(28) Reg. 1.751-1 (b)(1) and (2).
(29) Reg. 1.751 (b)(1) and (2).
(30) Sec. 1012, I. R. C.
(31) Sec. 741, I. R. C.; Reg. 1.741-1 (a).
(32) Reg. 1.751-1 (a)(2).
(33)
(34) Sec. 751 (a), I. R. C.; Reg. 1.751-1 (a)(1).
(35) Sec. 741, I. R. C.; Reg. 1.741-1 (a); Reg. 1.751-1 (a)(1).
(36) Sec. 742, I. R. C.; Reg. 1.742-1.
(37) Sec. 752 (a), I. R. C.; Reg. 1.752-1 (a).
(38) Sec. 752 (b), I. R. C.; Reg. 1.752-1 (b).
(39) Sec. 734 (a), I. R. C.; Reg. 1.734-1 (a).
Sec. 743 (a), I. R. C.; Reg. 1.743-1 (a).
(40) Sec. 754, I. R. C.; Reg. 1.754-1 (a).
(41) Sec. 754, I. R. C.; Reg. 1.754-1 (c).
(42) Sec. 754, I. R. C.; Reg. 1.754-1 (b).
(43) Sec. 754, I. R. C.; Reg. 1.754-1 (a).
(44) Sec. 734 (b), I. R. C.; Reg. 1.734-1 (b).
(45) Sec. 743 (b), I. R. C.; Reg. 1.743-1 (b).
(46) Reg. 1.755-1 (a)(1)(ii).
(47) Reg. 1.755-1 (a)(1)(iii).
(48) Reg. 1.755-1 (a)(1)(iv).
(49) Sec. 755 (b), I. R. C.; Reg. 1.755-1(b)(1).
(50) Sec. 755 (b), I. R. C.; Reg. 1.755-1(b)(3).
(51) Sec. 755 (b), I. R. C.; Reg. 1.755-1(b)(4).

Reg. refers to the proposed Regulations prescribed under Subchapter K of Chapter 1 of the Internal Revenue Code of 1954, as published in the Federal Register of August 12, 1955.