# COMMENTS

## TAX TRAPS IN PARTNERSHIP TRANSFERS AND LIQUIDATING DISTRIBUTIONS

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### I. INTRODUCTION

Is it possible for a partner to sustain a loss of $55,556.95, upon the liquidation of his partnership interest, yet at the same time be assessed a tax of $17,388.77? It hardly seems possible but it happened in *Estate of Dupree v. United States*,[1] the facts of which will be analyzed later in this article. The apparent reason for the strange result in *Dupree* was a lack of knowledge of or proper advice as to the laws of taxation of partnerships contained in subchapter K of the Internal Revenue Code of 1954.[2] Although the taxation of partnerships may appear simple on the surface, there are many rules in subchapter K which, if not carefully followed may produce unexpected results when a partner retires or the partnership is liquidated.

There have been very few cases dealing with subchapter K since its enactment in 1954.[3] This could be because of its complexity, for as Judge Raum of the Tax Court stated:[4]

> The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. . . . Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at the most only a comparatively small number of specialists who have been initiated into its mysteries.

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1. 391 F.2d 753 (5th Cir. 1968).
2. 26 U.S.C. (1964).
3. J. CHOMMIE, FEDERAL INCOME TAXATION 354 (1968).
4. David A. Foxman, 41 T.C. 535, 551 (1964).

Obviously, it would be beyond the scope of this article to completely unravel the "mysteries" of subchapter K. The main thrust will be directed to those sections that contain the answers to the anomalous position that faced the taxpayer in *Dupree*. In the interest of simplicity the article will not attempt to explore all possible results as this frequently leads to more confusion than understanding.

## II. DETERMINATION OF PARTNER'S BASIS AND ALLOCATION OF INCOME

### A. *Income and Credits of Partner*

A starting point should be section 702[5] which in general states that each partner shall take into account separately his distributive share of the partnership's taxable income or loss and gains or losses from the sale of capital assets. The well known authority on partnership taxation, Mr. A. Willis described this section:[6]

> Each partner is taxable on his distributive share of partnership income, whether or not actually distributed. Thus, the partnership is a mere income reporting unit, a conduit through which the partners, as the taxable units realize taxable income or sustain deductible losses.

The partnership itself is a mere conduit with the character of gains and losses to be passed on to the partners. In *Bell v. Commissioner*[7] it was held that a partner is taxable on his share of partnership income, whether or not he received the full amount. In *Frederick S. Klein*[8] it was held that the partner's distributive share is taxable in the year earned, regardless of the time of distribution. In other words the partnership itself is not taxed; it does, however, file a return on Form 1065 and computes income similar to an individual. An exception is that it cannot take certain deductions listed in section 703(a) including the standard deduction, personal exemptions and charitable contributions. Under the rules of section 706 a partner's income from the partnership is deemed received (whether or not it is distributed) on the day the partnership tax year ends.

The Revenue Service encourages the partnership to operate on the same taxable year as the partners. According to section 706(b)(1) a partnership may not adopt a taxable year other than that of all its principal partners (one having an interest of 5% in partnership profits or capital) unless it establishes to the satisfaction of the Commissioner a valid business purpose. If all the principal partners are on a calendar

5. INT. REV. CODE OF 1954. Hereinafter all section references will be to the INT. REV. CODE OF 1954.
6. A. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 27 (1957).
7. 219 F.2d 442 (5th Cir. 1955).
8. 25 T.C. 1045 (1956).

year, this would mean the partnership should also report on a calendar year basis. According to the Regulations[9] the partnership may adopt a calendar year without prior approval from the Commissioner only if all of its principal partners are not on the same taxable year. It is possible for a partnership to operate on a fiscal year with some or all of the partners reporting on a calendar year basis. This would be if the principal partner happened to be on the fiscal year or if all the partners were on a calendar year and a good business reason was shown for operating on a fiscal year.

This may be best explained by example. If partnership *AB* were organized and the partnership were able to establish that its natural business year ended on September 30th, under the Regulations,[10] it would have a sufficient business purpose to file a report on a fiscal year ending September 30th even if both partners were on a calendar year basis. If after September 30th in 1966 the partnership sold a capital asset for a net gain of $30,000, each partner would show a capital gain in his 1967 return of $15,000 each. If however, under section 708, the sale constituted a termination of the partnership then each partner would report the capital gain in 1966.

### B. *Basis of Contributing Partner's Interest*

When a partnership is organized with each partner contributing cash, a partner's basis for his interest is equal to the amount of cash contributed. Suppose, however, partner *A* contributes $25,000 cash and partner *B* contributes property with a fair market value of $25,000 with an adjusted basis of $4,000, in this event *B's* basis in the partnership is $4,000 according to section 722. Under section 721 neither the partner nor the partnership shall recognize any gain or loss in the case of a contribution of property to the partnership in exchange for an interest therein. The partnership under section 723 takes as its basis the basis of the property in the hands of the contributing partner. Therefore in the example, even though the property was worth $25,000 and *B* received a 50% interest in profits and capital by virtue of making a contribution equal to *A's*, the basis of the property to the partnership would be $4,000 and *B* would have a $4,000 basis for his partnership interest.[11]

If the contributed property is sold for $30,000, absent an agreement to the contrary, the partnership will realize a gain of $26,000 ($30,000 less $4,000 basis) which will be shared equally by the partners, $13,000 each. However, according to section 704(c)(2) the partnership agreement may provide that the entire gain up to its fair market value at the time of contribution be attributed to the contributing partner, in this case *B*. Therefore, since the property had a fair market value of $25,000 the entire gain between the basis of $4,000 and $25,000 would be attrib-

9. Treas. Reg. § 706-1(b)(1)(ii) (1956).
10. Treas. Reg. § 706-1(b)(4)(iii) (1956).
11. *See* Treas. Reg. § 722-1 (1956).

uted to *B*, if the partnership agreement so provided. *B* would have a gain then of $21,000 ($25,000 less $4,000) plus 50% of the remaining gain between $25,000 and $30,000 or $2,500 so that *B* would have a total gain of $23,500 and *A* a total gain of $2,500.[12]

## III. Distributions and Transfers

### A. *Unrealized Receivables and Inventory Items*

Prior to 1954 a substantial number of courts treated "a partner's interest as a capital asset, ignoring the ordinary income nature of such underlying assets as uncollected accounts receivable and the like."[13] This meant, for instance, that a partnership, on a cash basis with uncollected accounts receivables would not take these receivables into income until they were collected; upon collection they would naturally represent ordinary income to the partnership. If a partner sold his interest in the partnership and the purchase price represented his proportionate share of uncollected accounts receivables, a court, by treating the entire sales price as capital gain, would in effect convert what would otherwise be ordinary income into capital gain. This is to be contrasted with the result that a sole proprietor would face under similar circumstances. Under the rule of *Williams v. McGowan*[14] the underlying assets must be fragmented. For the purposes of the comparison, if the sole proprietor were on a cash basis, the uncollected accounts receivable included in the sales price would be treated as ordinary income.

Congress changed this situation in 1954 with the enactment of section 751, which stated that any amount received upon sale of a partnership interest that included unrealized receivables and substantially appreciated inventory[15] would be considered ordinary gain or loss. Under section 751(c) "unrealized receivables" generally include existing rights to payment for past or future services or delivery of goods (not capital assets) to the extent not previously included in income.[16] Thus, the sale by a partner of his interest in a partnership that operated on a cash basis where the sales price included the value of uncollected accounts receivable would result in treating amounts attributed to such "unrealized receivables" as ordinary income. Section 751 can be of great importance to professional partnerships as they frequently operate on a cash basis and often have accounts subject to section 751 characterization.

12. *See* Treas. Reg. § 704-1(c)(2) (1956) for an example of the manner in which depreciation may be allocated to the partner that contributes the cash up to the "ceiling" amount determined by the partnership's basis in the property.

13. J. Chommie, Federal Income Taxation 368 (1968).

14. 152 F.2d 570 (2d Cir. 1945).

15. An inventory item is deemed "substantially appreciated" if at the date of its transfer or distribution the fair market value of all inventory exceeds both (A) 120% of its aggregate adjusted basis and (B) 10% of the value of all partnership property except money.

16. § 751 also includes such items as potential recapture of depreciation under sections 1245 and 1250 which, for the purposes of this article, will be ignored along with substantially appreciated inventory.

B. *Optional Adjustment to Basis of Partnership Property*

Suppose *D* purchased an interest in partnership *ABC*[17] from *C* for $34,000. Assume that the asset account at the time of sale was as follows:

| | Adjusted Basis | Market Value |
|---|---|---|
| *Cash* | $ 3,000 | $ 3,000 |
| *Property X* | $27,000 | $ 99,000 |
| | $30,000 | $102,000 |

Assume also that property *X* is a capital asset not subject to depreciation (for instance land) that was purchased for $27,000 and at the time of sale had appreciated in value to $99,000. *C*'s basis in property *X* would be $9,000 (1/3 of $27,000) and he would realize capital gain of $24,000 (1/3 of $99,000 less $27,000). This would mean in effect that *D* would be paying $33,000 for his share of the interest in property *X* and $1,000 for his share of the cash. Would *D*, if property *X* were sold the next day for $99,000, have to pay a capital gains tax on $24,000? The answer under pre-1954 case law[18] and section 743 is yes. The entity theory[19] is applied so that although *D* has a $34,000 basis in the assets he must report capital gain based on the partnership's basis of property *X*. The 1954 Code did provide a measure of relief in the above situation. As stated in section 743(a):

> *General Rule.* The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

If the election under 754 were in effect in the above example, under section 743(b) *D* would acquire a special basis in property *X* of $33,000. Again if property *X* were sold the next day for $99,000 *A* and *B* would continue to realize a capital gain of $24,000. *D*, however, would show neither gain nor loss since his special basis in property *X* of $33,000 amounted to 1/3 of the sales price. It should be noted that the optional adjustment to basis may be made not only as a result of a transfer of interest by sale or exchange, but also a transfer resulting from the death of a partner. In the above example if *C*'s interest passed to *D* upon the death of *C*, *D*'s basis, via section 1014,[20] would be the fair market value

17. In the example a three-man partnership is used to prevent the application of § 708 which states that a partnership is terminated if within a twelve-month period there is a sale or exchange of fifty percent or more of the total interest in partnership capital and profits.

18. Robert E. Ford, 6 T.C. 499 (1946).

19. 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35-38 (1957).

> The general rule under the 1954 Code is that the basis of partnership assets is not affected by a sale of a partnership interest . . . or the death of a partner. This rule is based on the concept of the partnership as a business entity.

20. § 1014. Basis of Property Acquired from a Decedent—

of the interest at the time of *C*'s death. If the election under section 754 were in effect *D* would then be able to acquire a special basis in partnership property equal to the difference between *C*'s basis (1/3 of $30,000 or $10,000) and the fair market value at the time of *C*'s death (1/3 of $102,000 or $34,000) or $24,000 as a special basis to be added to partnership property according to the rules of section 755. In this case the entire adjustment to basis would be allocated to property *X*. *C*'s basis in property *X* was $9,000 so *D* would have an adjusted or special basis of $33,000 in the property. So again if property *X* were then sold the next day for $99,000 *D* would show neither gain nor loss but *C*, if he had not died, would have realized $24,000 capital gain as his share.

If the election under 754 were not in effect at the time of *C*'s death then *D* would not acquire a special basis in property *X* under section 743. Again, although *D*'s basis for his partnership interest would be $34,000 if property *X* were sold the next day for $99,000, *D* would have to report a capital gain of $24,000 since his basis in property *X* would still be $9,000.

If the election under section 754 is in effect, section 743 also permits the transferee partner to acquire a special basis in section 751 assets such as unrealized receivables. For example, suppose *D* paid *C* $5,000 for his 1/3 interest in the *ABC* partnership and the asset account was as follows:

| | Adjusted Basis | Market Value |
|---|---|---|
| *Cash* | $3,000 | $ 3,000 |
| *Unrealized Receivables* | 0 | $12,000 |
| | $3,000 | $15,000 |

Under the terms of section 741[21] *C* would realize ordinary income to the extent that the sales price represented section 751 assets, in this case unrealized receivables. Therefore, in the example, *C* would have to report as ordinary income $4,000 (1/3 of $12,000 or $4,000) as a result of the sale of his interest. If the election under 754 were in effect, section 743 would permit *D* to acquire a special basis in the unrealized receivables of $4,000. If the next day *D* sold his interest to *E* for $15,000 and the election under 754 were not in effect, the prescribed formula would require *D* to report $4,000 as ordinary income and to take a $4,000 capital loss.[22] To carry the example one step further, suppose the partnership collected the $12,000 of receivables and *D* did not sell the next day. Under sec-

(a) In General . . . the basis of property in the hands of a person acquiring the property from a decedent . . . shall . . . be the fair market value of the property at the date of the decedent's death . . . .

21. § 741. Recognition and Character of Gain or Loss on Sale or Exchange—
In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 . . . .

22. J. Chommie, Federal Income Taxation 371 (1968).

tion 702 *D* would be required to report $4,000 of ordinary income regardless of whether or not the partnership distributed the money received. Then if the following year the partnership built up another $12,000 of unrealized receivables on its books and *D* at that time sold his interest for $15,000 (assuming the cash account remained at $3,000) he would still have to report $4,000 as ordinary income and take a $4,000 capital loss.[23] If the election under 754 had been in effect *D* would have acquired a section 743 special basis of $4,000 in the unrealized receivables. Thus, in the above example, *D* would still have to report $4,000 if the receivables were collected by the partnership, but upon sale of his interest for $15,000 he would show neither capital gain or loss nor ordinary income or loss.

### C. *Filing of the Election to Adjust Basis*

As can be seen it is vital to a transferee partner, upon receiving an interest in a partnership by purchase or by the death of a partner, that the election under section 754 is in effect in order that he may make the adjustment to the basis of partnership property permitted by section 743(b). According to the Regulations:[24]

> An election under this section [754] to adjust the basis of the partnership property under sections 734(b) and 743(b) shall be made in a written statement filed with the partnership return for the first taxable year to which the election applies. . . .

According to Revenue Ruling 57-347[25] the election need not be in effect before the occurrence of an event, such as death, which would make the election operative, but it should be made with "the partnership return for the first taxable year for which the partners wish the election to become effective." If the partnership fails to file an election, a purchasing partner may be vulnerable to characterization of gain as ordinary income in two situations: in event of distribution of property and in case of a resale of his interest. In event of a distribution, section 732(d) authorizes the partner to make the election himself if the distribution is received within two years of the purchase of his interest. With this one exception the courts have generally followed the Regulations and required the election to be filed with the partnership return for the first taxable year to which the election applies. Recently, however, one district court declared that the time of filing provisions of the Regulations were invalid. In *Neel v. United States*[26] a partner died on December 28, 1958; the partnership return, filed for the fiscal year ending June 30, 1959, did not contain a statement that the partnership wished to make an election under section 754. On April 2, 1962 the partnership filed an amended return seeking to

23. *Contra*, Barnes v. United States, 253 F. Supp. 116 (S.D. Ill. 1966).
24. Treas. Reg. § 1.754-1(b) (1956).
25. 1957-2 Cum. Bull. 365.
26. 266 F. Supp. 7 (N.D. Ga. 1966).

make a retroactive election; the Commissioner contended that the election was untimely. The court said:[27]

> § 754 by its terms does not require the election to be made with the partnership's return for the taxable year in which the taxpayer acquired her partnership interest. Nor does the statute impose any new limitation on the time in which the partnership may exercise its right to election. This limitation is imposed only by the Commissioner's regulation § 1.754-1.

The court stated that treasury regulations are entitled to consideration and respect but in order to be valid they must be consistent with the statute and reasonable. The court felt the regulation imposed a penalty by limiting the time of election under section 754. Since the statute had no such requirement it could not be validly imposed by the Commissioner.

As of June 28, 1968 *Neel* has not been followed by any other court, nevertheless it is an extremely interesting decision. Obviously the Commissioner is probably not anxious to have *Neel* followed as it would involve radical change of a ten-year-old treasury regulation. However, as shown below, another district court has reached a similar conclusion but not through the employment of the *Neel* rationale.

In *Barnes v. United States*[28] Dr. M. purchased an interest in a medical clinic operated as a partnership. The purchase price included $3,363.91 allocated to unrealized receivables. The election under section 754 was not in effect nor filed in the first partnership return after the sale. The selling partner paid ordinary income tax on $3,363.91 because of section 751. Dr. M. did not acquire a special basis in the unrealized receivables since the election was not in effect. The unrealized receivables were collected and Dr. M. paid ordinary income tax on the amounts collected. Several years later Dr. M. wished to sell, and at that time his share of the unrealized receivables was above $3,363.91. The government contended that Dr. M. must adopt the partnership's zero basis as his basis for the unrealized receivables. This was in accord with the prescribed formula, explained early in this article, and would have resulted in a capital loss and ordinary income as was pointed out. The court, however, said that the inequity of this position was fairly obvious: First, Dr. M. had to pay ordinary income tax to accumulate the funds to invest in the clinic. Second, the selling partner paid ordinary income tax on the $3,363.91 at the time of sale. Third, as the receivables were collected Dr. M. paid ordinary income tax on $3,363.91. Finally, upon sale of Dr. M.'s interest in the partnership the government contended that he should pay ordinary income tax on his share of the unrealized receivables. The court said:[29]

27. *Id.* at 10.
28. 253 F. Supp. 116 (S.D. Ill. 1966).
29. *Id.* at 118.

> How many times does the Government expect to collect taxes for this $3,363.91 worth of unrealized receivables? . . . [T]o hold that because no . . . election was made by the partnership the individual has lost forever his right to recoupment of his cost before any tax is due, is rather clearly an unconstitutional taking of property without due process of law.

The court then held that Dr. M. could recoup his cost in the unrealized receivables before any tax was due, thus in effect granting him the benefit of an election under section 754 even though no election was made, timely or otherwise! It is the writer's opinion that of the two, *Neel* is on firmer ground. *Barnes* completely disregards the clear mandates of a statute on the ground that the results would be inequitable. Although the court in *Barnes* expressed serious doubts as to the constitutionality of the section, it did not go so far as to clearly declare the section unconstitutional. Nevertheless, both cases demonstrate the wisdom of the statement by A. Willis:[30]

> The statutory provisions dealing with the adjustment of basis of partnership property upon the sale or exchange of a partnership interest or upon the death of a partner are far too complicated and involved. . . .

In the author's opinion this is one of the least satisfactory provisions in the partnership law.

### D. *Termination of a Partnership Interest*

In general, a partnership interest may be terminated in any one of three ways: (1) sale of the partnership interest under section 741; (2) a distribution in liquidation of a partnership interest under section 732(b); and (3) payments made in liquidation of the interest of a retiring partner or a deceased partner's successor in interest under section 736.

Section 736 deals with the problem of allocation of the amount of the payments to be considered as payments for an interest in the partnership and the amount to be characterized as ordinary income. Under section 741 the sale of an interest in a partnership will be all capital gain except for the amount paid for section 751 assets, such as unrealized receivables with the gain or loss recognized at the time of the sale. Under section 732(b), a distribution in liquidation of the partner's interest, if the distribution includes property[31] the basis of the property received is the amount equal to the adjusted basis of such partner's interest in the part-

30. A. WILLIS, HANDBOOK OF PARTNERSHIP TAXATION 247-48 (1957).

31. If the distribution is in all cash then section 731(a) applies and no gain is recognized unless the money distributed exceeds the adjusted basis of the partner's interest and loss is not recognized except in a liquidating distribution and in general only to the extent that the adjusted basis of the partner's interest exceeds the sum of money distributed; if the partnership has any § 751 assets then provision is also made for the recognition of the proportionate share as ordinary income.

nership reduced by any money received. Section 732(b) in effect postpones the realization of any gain or loss on a liquidating distribution. For example, if a partner with an adjusted basis of $12,000 for his partnership interest received a distribution in liquidation of $2,000 cash and property, with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000, his basis in the property would be $10,000 ($12,000 basis of partnership interest reduced by $2,000 cash distributed). In this event he actually had a gain on liquidation with its realization postponed until he sells the property. If when sold the property were still worth $14,000 he would realize a capital gain of $4,000.

In the above example if the partner's basis for his partnership interest was $20,000, then he would have a basis in the property of $18,000 ($20,000 basis of partnership interest reduced by $2,000 cash distributed). Again if a year later the property were still worth $14,000 he would sustain a $4,000 capital loss at the time of the sale. In other words, until such time as the property is sold loss on distribution will be reflected in the increased basis of the property received; the loss will not be realized until the sale of the property.

## IV. ANALYSIS

At this point sufficient background has been set forth to analyze the introductory case of *Estate of Dupree v. United States*.[32] Mr. Dupree and his wife owned a 15% interest in a partnership as community property; at that time Mr. Dupree's proportionate share of the adjusted basis of the partnership property was $14,973.27. On September 25, 1957 Mrs. Dupree died, leaving her share of the partnership interest to her son. Mr. Dupree then had a 7½% interest but with a new basis pursuant to section 1014(b)(6). The Internal Revenue Service determined that the new basis was $71,250, representing 7½% of the fair market value of the partnership interest as of September 25, 1957.

At the time of Mrs. Dupree's death an election under section 754 was not in effect, nor was one filed with the next partnership return. Thus, Mr. Dupree was not entitled to a 743(b) special basis adjustment.

The partnership operated a motel which was sold to a corporation on August 1, 1960. The sale was reported in the final partnership return for its fiscal year ending March 31, 1961 as a capital gain with $52,441.31 attributed to the taxpayer as his share of the gain. The assets of the partnership were distributed to the various partners and Mr. Dupree received $42,150 cash, and a 7½% interest in two promissory notes with a face value of $700,000 or, in effect, $52,500. However, the Internal Revenue Service stipulated that the fair market value of the notes was $400,000. Consequently Mr. Dupree's 7½% interest in the two notes was actually worth $30,000.

32. 391 F.2d 753 (5th Cir. 1968).

The parties stipulated that the taxpayer's basis in his partnership interest after the sale but before the distribution was $127,706.95.[33] The Internal Revenue Service determined that the partnership ended in 1960[34] and not in 1961 as claimed on the return and subsequently audited Mr. Dupree's individual return for 1960. This resulted in a deficiency assessment of $17,388.77 based on the $52,441.31 capital gain from Mr. Dupree's share of the proceeds from the sale of the motel properties by the application of section 702.

Subsequent to the audit an amended partnership return was filed in September 1963 which sought to make a retroactive election under section 754. If the election had been in effect at the time of Mrs. Dupree's death or filed with the next partnership return, Mr. Dupree would have been entitled to a special basis in partnership property under section 743(b) in the amount of $56,276.73 (the difference between $71,250.00 and $14,973.27). A 743(b) adjustment would have resulted in Mr. Dupree's sustaining a $3,834.42 loss rather than a $52,444.13 capital gain, on the sale of the motel properties. The government's contention that the election was too late to be effective was upheld by the court. It should be recalled that in *Neel* a retroactive election was held to be valid; the court in the instant case noted *Neel* but expressed no opinion on the case.[35]

Mr. Dupree denied that he owed the $17,388.77 tax and contended that he was not given credit for an ordinary loss of $33,056.95 realized by him in 1960 computed as follows:

| | |
|---|---|
| *Mr. Dupree's basis of his 7½% interest in the partnership August 1, 1960:* | $127,706.95 |
| *Less cash received:* | $ 42,150.00 |
| | $ 85,556.95 |
| *Less 7½% of face value of notes:* | $ 52,500.00 |
| *Claimed loss:* | $ 33,056.95 |

Note that in the calculation of the ordinary loss that Mr. Dupree valued the notes at their face value of $52,500 having argued that they would never produce more than their face value. However, based on the stipulated fair market value for the notes of $30,000 the actual loss was $55,556.95.

33. The basis was determined in accordance with § 705:

| | |
|---|---|
| *Fair market value of 7½% partnership interest on September 25, 1957:* | $71,250.00 |
| *Plus Mr. Dupree's share of net earnings through July 31, 1960:* | $22,015.64 |
| *Less Mr. Dupree's withdrawal through July 31, 1960:* | ($18,000.00) |
| *Plus Mr. Dupree's share of capital gain on sale of assets on Aug. 1, 1960:* | $52,441.31 |
| *Mr. Dupree's basis of 7½% partnership interest after the sale but before liquidation distribution:* | $127,706.95 |

34. Under § 708(b) a partnership shall be considered terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. This can sometimes be a close determination of fact but apparently in this case no portion of the partnership was carried on after the sale of the motel.

35. Estate of Dupree v. United States, 391 F.2d 753, 759 (5th Cir. 1968).

36. *Id.* at 758.

The court rejected his argument and said the specific language of sections 731 and 732(b) prevailed over the general language of section 165(a):[36]

> [T]he loss—though unquestioned—would not be recognized in 1960 .... [W]e note that taxpayer's death deprived him of ever receiving income tax recognition of the loss sustained. Even if this were inequitable, there is no equity in tax law....

Thus a tax of $17,388.77 was paid by a partner who sustained an actual loss of $55,556.95 upon the liquidation of his partnership interest. Under the rules of section 732(b) Mr. Dupree's basis of the notes was $85,556.95 ($127,706.95 basis of partnership interest reduced by $42,150.00 cash distributed), his loss being reflected in the increased basis of the notes. As the court noted, Mr. Dupree's death deprived him of ever realizing this loss because under section 1014 their basis to his beneficiary would be their fair market value or $30,000.

Mr. Dupree, at the time of his wife's death, should have seen to it that an election under section 754 was effected in order that section 743(b) might be utilized. If this suggested procedure were followed Mr. Dupree would have saved $17,388.77 in taxes and, notwithstanding a loss on liquidation, he would have avoided the anomalous position of paying a tax while sustaining a loss. However, as a practical matter, how many partners have ever heard of special basis adjustments and elections under section 754? It probably did not occur to Mr. Dupree that his wife's death would call for advice as to partnership taxation. It is for this reason that the writer feels that the decision in *Neel*, to allow a retroactive election, deserves serious consideration. As the court pointed out, the time limit for making the election is not imposed by statute and can only be explained by adherence to the entity theory.[37] Otherwise, there is no apparent valid reason for requiring that the election be made with the first partnership return after the transfer. If retroactive elections under section 754 were allowed, it could help to correct some of the inequities of partnership tax law which impressed the court in *Barnes*.[38]

Mr. Dupree's other problem revolved around the application of section 732(b) concerning a liquidating distribution that included property. The results obtained by section 732(b) are to be contrasted with the

37. 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.38 (1957):

> The general rule under the 1954 Code is that the basis of partnership assets is not affected by the sale of a partnership interest . . . or the death of a partner. This rule is based on the concept of the partnership as a business entity.

38. Barnes v. United States, 253 F. Supp. 116, 118 (S.D. Ill. 1966):

> It is fundamental to the tax laws of this nation that a taxpayer is entitled to recoupment of his legitimate cost before he is required to report a gain and pay a tax. He cannot be required to pay a tax on a gain he did not realize, nor can he be required to report a loss he did not in fact suffer.

Admittedly in *Barnes* no attempt was made to make a retroactive election under section 754; however as pointed out before in order to relieve the inequity of the situation a retroactive election as permitted by *Neel* would be preferable to the *Barnes* solution.

results under section 741, dealing with the sale or exchange of an interest in a partnership. If Mr. Dupree had sold his interest in the partnership for $42,150 cash plus notes with a fair market value of $30,000 he would have realized a capital loss of $55,556.95 at the time of the sale.[39]

If this had been the liquidation of a corporation rather than a partnership, would the results have been the same? Under section 331 the answer would be no; in a complete liquidation the amounts distributed are treated as full payment in exchange for the stock. Any property received is valued at its fair market value and the shareholder must report his gain or loss, as the case might be, at the time of distribution.[40] This means that if he has a gain he has to pay the capital gains tax even though the bulk of the distribution might be property that he does not wish to sell in the near future. The closest thing to section 732(b) in a corporate liquidating distribution is section 333 which postpones the recognition of gain or loss in a manner similar to section 732(b) but in contrast to that section, section 333 does not come into effect unless an election is made by the qualifying shareholders and distribution is made in one month.

It appears to the writer that section 732(b) has many drawbacks. First, "gains" on a liquidating distribution are reflected in a lower basis of the property received. However, a partner may never sell the property and upon his death, via section 1014, the property regains a basis equal to its fair market value in which case the government will be deprived of the capital gains tax on the gain. Secondly, if the partner sustained a loss, he might never be able to realize his loss before his death. This was Mr. Dupree's position since he died before selling the notes.

In the writer's opinion there should be a section similar to section 331 for partnership distributions so that a gain or loss is realized at the time of distribution. Section 732(b) should be an elective alternative similar to section 333 to provide for situations where a high percentage of the liquidating distribution is in property that the distributee does not wish to sell immediately. If the realization of gain or loss on a partnership liquidating distribution that included property were permitted at the time of distribution and a retroactive election under section 754 were permitted, then Mr. Dupree (or his estate) would not have been forced to pay a tax of $17,388.77. In addition he would have been able to realize a capital loss of $55,556.95 at the time of the liquidating distribution plus a $3,834.42 capital loss at the time of the sale of the motel. This is quite a contrast to the actual result.

## V. Conclusion

*Dupree* demonstrates the pitfalls that may trap a partner unfamiliar with the partnership taxation laws of subchapter K. If one receives an interest in a partnership, either by purchase or upon the death of a

39. *See* 6 Mertens, Law of Federal Income Taxation § 35.55 (1957).
40. 1 Mertens, Law of Federal Income Taxation § 9.74 (1962).

partner, it is important to make sure that an election under section 754 is either in effect or filed with the next partnership return in order to obtain the benefits of the 743(b) special basis adjustments. This is of particular importance to one receiving an interest in a professional partnership since a high percentage of the value might represent unrealized receivables. The benefit of the 743(b) special basis adjustment regarding such assets will become apparent when the interest is sold and the government is prevented from again asserting a tax as ordinary income for the amount of the unrealized receivables included in the purchase price, such as was attempted in *Barnes*. *Neel* and *Barnes* are exceptions to the general rule and it is far too risky to depend on such sympathetic courts to extricate a taxpayer who fails to have the partnership make a timely election under section 754.

If one sustains a loss on a liquidating distribution under section 732(b) that includes property, *Dupree* shows that the wise course would be to sell the property as soon as possible in order to realize the loss.

In conclusion, sound tax advice at the proper times may save a partner from the pitfalls of subchapter K.