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PROBLEM AREAS IN PARTNERSHIP FEDERAL INCOME TAXATION*

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The 1954 Internal Revenue Code contains the first complete statutory codification ever attempted of the federal income tax rules covering partnerships. When one considers that partnerships operate in almost every conceivable line of business and under partnership agreements which reflect a wide range of formal and informal contractual relationships among the participating partners, the difficulties that might have been encountered in any such codification of the partnership tax rules can be easily visualized. In view of the need to work with a maze of conflicting court decisions at all levels and necessarily only an intuitive insight into numerous partnership problems which had not been the subject of litigation, it must be admitted that the draftsmen of the 1954 Internal Revenue Code partnership provisions did a workmanlike job.

But being only human, and being charged with codifying rules affecting many controversial areas, it is not surprising that the work of the draftsmen of the 1954 Code has come in for some criticism and, even in the short period of time since the enactment of the Code, numerous suggestions for improvement in the partnership provisions have been forthcoming.

The extent of careful analytical study to which the tax laws in this country are subjected cannot be overexaggerated. Taxpayers' representatives necessarily make it their business to study the tax rules with a critical eye and with a dual objective: (1) to determine the effect of the rules upon the specific problems which are faced by taxpayers in order to avoid pitfalls apparent in the rules, and (2) with the objective of devising transactions and approaches to problems whereby taxpayers may be guided safely through the beneficial opportunities that may exist in the tax structure so that the after tax income of taxpayers may be maximized.

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Constant analysis of this sort serves a useful purpose in the development of our tax laws. In the first place, where the structure of the law is such as to invoke an unintended hardship upon the taxpayer, it is certain that this result will promptly be brought to the attention of the legislative authorities. If agreement can be reached that the hardship is inequitable and unintended, remedial legislation often results. On the other side of the picture, when escape mechanisms are found within the tax structure which may permit transactions to take a form whereby taxation is escaped beyond the intent of the legislative authorities, taxpayers taking advantage of these possibilities necessarily bring attention to the fact that the possibilities do exist, and these so-called "loopholes" may soon be closed by subsequent legislation.

In the case of the partnership provisions of our Code this process has not gone on for too long because of the relative newness of the codification of the partnership rules. It is interesting to note, however, that the subchapter dealing with partnerships in the 1954 Internal Revenue Code has been singled out by the Subcommittee on Internal Revenue Taxation of the Ways and Means Committee of the House of Representatives as one of the three subchapters requiring extensive, careful study, following the enactment of the 1954 Code. In November of 1956 a special advisory group was appointed by the Subcommittee on Internal Revenue Taxation to the House Ways and Means Committee to study Subchapter K. This advisory group has since rendered two reports — a preliminary report on May 8, 1957,[1] and a revised report on December 31, 1957.[2]

These reports provide a valuable study of the pitfalls and unintended benefits which have become apparent in the 1954 Code partnership provisions, and an analysis of the major findings of this advisory group will be the main purpose of this paper. It should be emphasized that the advisory group

1. *First Report on Partners and Partnerships Received by the Subcommittee on Internal Revenue Taxation and Transmitted to The Committee on Ways and Means, U. S. House of Representatives, from the Advisory Group on Subchapter K of the Internal Revenue Code of 1954*, May 8, 1957.

2. *Revised Report on Partners and Partnerships Received by the Subcommittee on Internal Revenue Taxation and Transmitted to The Committee on Ways and Means, U. S. House of Representatives, from the Advisory Group on Subchapter K of the Internal Revenue Code of 1954*, December 31, 1957. All subsequent references to the advisory group's report will be to the December 31, 1957 revised report.

was charged with the responsibility of recommending whatever legislative changes it considered desirable in all Subchapter K. Because of the scope of this charter a number of the recommendations of the advisory group are highly technical in nature and many of them are changes which do not materially affect the substance of the partnership problem. A discussion of these problems is necessarily beyond the scope of this presentation.

An understanding of the advisory group's position with respect to the major problems it considered can also give some indication of the course of possible future legislative corrections. The reports of the advisory group contain specific recommendations for statutory change embodied in the form of statutory language. Subsequent to the issue of the report on December 31 hearings were held by the House Ways and Means Committee.[3] It is interesting to note that although the advisory group on partnerships did not recommend an effective date for the changes which it suggests, the advisory group did not seem to be inclined to recommend any retroactive changes.

The "conduit" principle:

One of the first problems considered by the advisory group was the general effect of the "conduit" principle upon the tax computations of the individual partners in a partnership. Under the present Code seven specific items of partnership income or expenses are required to be separately accounted for and allocated individually to each of the partners.[4] By reason of the authority granted to the Commissioner in the present Code other items may be required to be separately determined for each partner,[5] and under the regulations promulgated under the 1954 Code a large group of such items is so identified.[6]

The objective of this separate identification of special items and their allocation to each partner is to preserve the character of the items for the purpose of applying special limitations or some other unique treatment which may be required by

3. See *Hearings Before the House Committee on Ways and Means on Topics Pertaining to the General Revision of the Internal Revenue Code*, 85th Cong. 2d Sess. Pages 2159-2222 pertain specifically to the Report of the Subchapter K Advisory Group.
4. INT. REV. CODE OF 1954, § 702(a).
5. INT. REV. CODE OF 1954, § 702(a)(8).
6. Reg. § 1.702(a)(8).

other sections of the Code to be applied to the specific item of income or expense. Thus, for example, contributions are limited in their deductibility to a stipulated percentage of the adjusted gross income of individual taxpayers. To the extent that a partnership makes contributions, those contributions are considered to have been made on behalf of the individual partners, and each partner is required to report separately his share of the partnership contributions for the purpose of applying the statutory limitation on their deductibility.

Under the recommendations of the advisory group, the statutory designation of specific items to be separately accounted for and assigned individually to each partner would be expanded and supplemented by the adoption of a general rule that the character of any item of income, gain, loss, deduction or credit which is included in a partner's share of partnership income should be determined as if such item were realized from the same source as realized by the partnership or incurred in the same manner as by the partnership.[7]

In justification of the adoption of this general rule the advisory group quite properly points out that were it not for the broad approach taken by the regulations, a partner could have been deprived of the retirement income credit if the only retirement types of income which he received were received through participation in partnership.[8]

Under the advisory group's recommendation, for example, it would be possible to determine the nature of an asset as capital or ordinary only by reference to the status the asset would have in the hands of each of the individual partners. Thus a sale of property by a partnership conceivably could produce capital gain to some partners and ordinary income to other partners who might be dealers in that property. The advisory group does point out, however, that it would be possible for a partner who on his individual account is a dealer in a particular type of property to have a segregated investment account in that property from which sales would result in capital gain or loss. A common illustration of this might be the case of an individual dealer in securities engaged in a partnership which carries on an unrelated business, but which has incidental transactions in investment securities.

7. *Revised Report, supra* note 2, at 7.
8. *Revised Report, supra* note 2, at 7.

Another example where the application of the advisory group's recommendation would have some significance is in the case of income from foreign sources. Under the advisory group's recommendation the source of income would retain its character in the hands of the individual partners and income from specific foreign sources would be aggregated with other income from the same sources derived directly by the individual partners for purposes of determining the entire amount of foreign income necessary in the computation of foreign tax credits and the limitations thereon.

It should be pointed out that this particular recommendation of the advisory group would fundamentally codify the approach that has been adopted in the regulations promulgated by the Commissioner under section 702.

Partnership organizational expenditures:

One of the potentially most beneficial recommendations of the advisory group relates to organizational expenditures of a partnership. Basically the advisory group would permit the deduction by a partnership over a period of 60 months of organizational expenditures paid or incurred after the enactment of its recommendations.[9] However, the recommendations of the advisory group with respect to partnership organizational expenditures differ in material respects from the present provisions of the Code relating to organizational expenditures of corporations.[10] The major differences are as follows:

1. The period of amortization of organizational expenditures for partnerships would be fixed at 60 months, whereas corporations may elect to amortize organizational expenses over a period of not less than 60 months.
2. A void in existing partnership law would be filled by a specific provision making organizational expenditures not previously deductible by the partnership eligible for deduction in the taxable year of the termination of the partnership.
3. The organizational expenses of a partnership would be deductible beginning with the month after such expenses were paid or incurred, whereas in the case of corporate organizational expenditures deduction is

9. *Revised Report, supra* note 2, at 9-11.
10. INT. REV. CODE OF 1954, § 248. See also Reg. § 1.248-1.

over the period beginning with the month in which the corporation begins business.

4. A specific definition of organizational expenses would be provided which would include expenses associated with the creation of a new partnership, the preparation of a partnership agreement for an existing partnership, the amendment of an existing partnership agreement, or the preparation or amendment of any agreement relating to the purchase or retirement of the interest of a partner.

While not recommending it as such, the advisory group also suggests that consideration should be given to providing for the amortization of organizational expenses which do not qualify under the recommendation above over a period of 60 months, following the effective date of the amendment recommended above.[11] It should be noted that this would represent a material departure from the rule applied to organizational expenses of a corporation, and if this recommended change were adopted it would almost certainly have to be in conjunction with a similar change applicable to corporate organizational expenditures.

Close of partnership taxable year:

One long-standing problem which has been the source of considerable controversy in the partnership area has been the determination of events which might cause a termination of the partnership, particularly in view of the widely differing provisions of local law. Prior to the passage of the 1954 Code the Internal Revenue Service at one time took the position that the dissolution of a partnership under local law, such as by death or by change in the membership of the partnership, automatically terminated the partnership and closed its taxable year.[12] Court cases involving this problem generally distinguished between the *dissolution* of a partnership, as under local law, from its *termination* for federal income tax purposes,[13] and the Commissioner ultimately yielded and held that changes in membership resulting from death or the substitu-

11. *Revised Report, supra* note 2, at 11.

12. O. D. 228 (CB 1919 190).

13. See, for example, Heiner v. Mellon, 302 U. S. 271 (1938); Rossmoore v. Comm., 76 F. 2d 520 (2d Cir., 1935); Mary D. Walsh, 7 T. C. 205 (1946); Anne Jacobs, 7 T. C. 1481 (1946).

tion of partners did not terminate the partnership for federal income tax purposes.[14]

This solution to the problem was generally adopted in the 1954 Code[15] and specific rules were provided for the first time citing the circumstances which would cause a termination of a partnership. These rules, particularly as they operate upon the death of a partner, have not proved entirely satisfactory and offer an illustration of a pitfall which could cause extremely unfortunate tax consequences to the unwary taxpayer.

Under the 1954 Code the death of a partner does not in itself close the partnership taxable year, either as to the deceased partner or to the partnership.[16] It is only upon the sale, exchange or liquidation of a deceased partner's interest that the partnership taxable year is closed, and then, under the usual circumstances, it is closed only with respect to the partner who disposed of his interest.[17]

It is not unusual on the death of a partner for his interest in the partnership to pass into his estate. Under these circumstances the operation of the partnership provisions of the Code would be such that the taxable year of the partnership would not close insofar as the deceased partner was concerned, and the estate would step into the deceased partner's shoes insofar as the interest in the partnership is concerned. Upon the close of the normal taxable year of the partnership, the estate would be required to report its share of the entire income of the partnership for the full taxable year then ended, irrespective of the fact that the estate may have acquired its interest in the partnership upon the death of the partner toward the end of the partnership taxable year.[18]

The final taxable year of the deceased partner would reflect no income from the partnership if the partner was not a member of the partnership at the time the partnership's regular taxable year closed. Thus if the partner were a married individual whose sole source of income was from his interest in the partnership, the effect of this rule would be to place the full year's partnership income into the hands of the estate, where it would not be eligible for the split-income provisions

14. Rev. Rul. 144 (CB 1953-2 212).
15. INT. REV. CODE OF 1954, §§ 706(c), 708(b).
16. INT. REV. CODE OF 1954, § 706(cxi); Reg. § 1.706-1(c)(3).
17. INT. REV. CODE OF 1954, §§ 706(c)(2), 708(b); Reg. § 1.706-1(c)(2).
18. See examples at Reg. § 1.706(c)(3)(vi).

by filing a joint return. A further unfortunate consequence might arise in the event the partner, during the period of the partnership's taxable year prior to his death, had made deductible expenditures for medical expenses, contributions and other personal items which would be deductible on his and his wife's joint return, but which in the absence of any income, would be entirely wasted and produce no tax benefit.

The Subchapter K advisory group was fully cognizant of this problem and suggested as a solution that, as a general rule, the partnership taxable year be deemed to close at the date of death insofar as the deceased alone is concerned. The group recommended also, however, that the successor in interest of the deceased partner (*i.e.* the estate or the heirs) be given the option to continue the year with respect to the deceased partner's distributive share of the partnership income to the normal ending of the partnership year, as long as there had been no sale or exchange or liquidation of the interest before that date which would constitute a termination of the partnership year insofar as that particular interest was concerned.[19]

If this recommendation were adopted it would afford considerable flexibility. In a case in which the partner dies midway during the partnership taxable year it would, in effect, make possible a multiple splitting of the partnership income for that year. First the year's income could be split between the deceased partner and the estate, and second, the share of the partnership income for the year prior to death might be available for income splitting if the deceased partner and his surviving spouse filed a joint return for the year of death. Thus it can be seen that the recommendation of the advisory group would afford a desirable solution to this problem.

However, it must be recognized that the advisory group's recommendation is not presently the law, and existing partnership agreements should be reviewed carefully to take appropriate steps to avoid this possible pitfall. Where under either the partnership agreement or the will of an individual partner the interest of a partner upon death would pass to his estate, some provision should be made for a prompt distribution of the partnership interest from the estate to the heirs of the partner, especially if the designated heir is the surviving spouse of the partner. Under the present Code, if

19. *Revised Report, supra* note 2, at 15-16.

the estate receives the partnership interest upon the death of the partner and distributes it to the surviving spouse before the close of the partnership taxable year, the estate will have no income with respect to the partnership, but the entire income for the full partnership taxable year will be reported by the survivor of the deceased partner who holds the partnership interest at the close of the partnership taxable year. In this way, it would be possible to secure both the benefits from splitting of income, where the heir of the deceased partner was the surviving spouse, as well as bringing into the final return of the deceased partner and the surviving spouse sufficient income to produce tax benefits from deductible expenditures which may have been made by the taxpayer and the spouse before death.

One other special problem should be given attention in the drafting and review of partnership agreements. This problem arises where under the agreement a deceased partner's interest is to be sold pursuant to the provisions of a buy-and-sell agreement to one or more of the remaining partners. If the sale under such an agreement is effective on the date of death, then the partnership year as to the deceased closes upon his death.[20] This could prove costly in the normal case where one partnership taxable year has previously ended during a deceased partner's taxable year. The event of death would cause the bunching of more than one year's partnership income in the final tax return of the deceased partner.

This problem may be avoided by making the sale pursuant to the partnership agreement effective after death. For example, the sale might be made effective only upon payment for the decedent's interest in the partnership. If this is done and the payment is made to the deceased partner's estate, the final tax return of the deceased partner will not include his share of the partnership income for the taxable year of the partnership up to the date of death. This share of partnership income will be reported by the estate and will not be "bunched" into the final return of the deceased partner. Under the recommendations of the advisory group this problem would be solved by permitting the successor in interest to the deceased partner to elect to have the partnership year close with respect to the deceased partner on the day following death.[21]

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20. Reg. § 1.706-1(c) (3) (iv).
21. *Revised Report, supra* note 2, at 16.

Collapsible partnerships:

Among the more intricate of the present partnership provisions of the 1954 Code are those relating to "collapsible" partnerships, which have as their objective preventing the conversion of what otherwise would be ordinary income into capital gains.[22] Essentially the approach adopted by the present rules is to tax as ordinary income to the partners any gain resulting from the sale or exchange of an interest in a partnership, to the extent attributable to certain assets, or any gain resulting from the imputed sale or exchange of an interest in certain assets held by a partnership arising out of distributions by the partnership to a partner. These rules are buttressed by a provision which denies capital gain treatment on the sale or other disposition of certain "unrealized receivables" and appreciated inventory assets distributed by a partnership to its partners, except in the cases of inventory items distributed by the partnership which are sold or exchanged by a partner more than five years from the date of distribution.

The present partnership provisions limit the denial of capital gain treatment to gains attributable to two broad classes of items, namely unrealized receivables and appreciated inventories. Inventory items are defined quite broadly to include items the sale or exchange of which by the partnership would produce ordinary income.[23]

Under the advisory group's recommendations, this complicated approach to the problem of collapsible partnerships would be abandoned in favor of a simpler, more direct approach.[24] Rather than seeking to define the assets which cause a partnership to fall within the category of a "collapsible" partnership in terms of unrealized receivables and substantially appreciated inventory, the advisory group would identify and define a group of assets to be known as "Section 751 assets." These assets would consist of any property of the partnership except property which, if sold or exchanged by the partnership, would produce long-term capital gains. Based upon this definition of collapsible partnership assets, the general rule would be stated that any gain realized on a sale or exchange of an interest in a partnership to the extent

22. INT. REV. CODE OF 1954, §§ 732, 735, 736, 751.
23. Sec. 751(d). INT. REV. CODE OF 1954, § 751(d).
24. *Revised Report, supra* note 2, at 37-43.

the gain was attributable to section 751 assets of the partnership would be considered as ordinary income. A limitation would be provided, however, that the general rule would not apply unless the amount of gain attributable to the Section 751 assets exceeded the smaller of $1,000 or 15% of the amount realized minus the allocable share of the liabilities of the partnership.

Under the advisory group's recommendation, the collapsible partnership rules would not apply, as they do under the present Code, to a distribution of assets by a partnership to its partners. In order to prevent avoidance of the collapsible partnership rule by asset distributions a corresponding change is recommended by the advisory group in the present provision denying capital gain treatment upon the subsequent sale by a partner of property received in a distribution from a partnership. Under the present Code, a partner is denied forever capital gain treatment on the sale or other disposition of unrealized receivables received in a distribution from a partnership, but long-term capital gain treatment may be achieved in the case of substantially appreciated inventory if the inventory is held for more than five years after the distribution to the partner.[25] The advisory group recommendation would eliminate this five-year limitation in the case of appreciated inventory, and would substitute a rule which would require ordinary income treatment on the subsequent sale or other disposition of any section 751 assets received by a partner in a distribution from the partnership, regardless of the partner's holding period.

Limitation on partners' losses:

A new concept of limiting partner's share of losses was introduced by the Internal Revenue Code of 1954. In the event a partner's distributive share of the partnership losses exceeds the basis for his interest before deducting such losses, such excess is denied as a deduction for that partner.[26] The deduction is not lost, however, since it becomes deductible in the first subsequent taxable year in which the partner makes up his capital deficiency. The deficiency may be offset by additional capital contributions by the partner or by the retention of subsequent earnings of the partnership.

25. INT. REV. CODE OF 1954, § 735.
26. INT. REV. CODE OF 1954, § 704(d).

This provision in the 1954 Code not only imposes certain hardships on partners by denying them the deduction of losses currently, even though they may have other income outside of the partnership area against which such losses may be offset, but it also affords a certain degree of flexibility in the timing of losses from a partnership to offset other income of the individual partner. Thus a partner who has entered into a partnership which has incurred losses his share of which is in excess of the basis of his partnership interest has an opportunity to claim such losses at his will by making an additional capital contribution to the partnership or by permitting his share of subsequent partnership income to remain unwithdrawn. Interestingly enough, these losses may be made available without any positive contribution by the partner himself. Under the Code any increase in the partner's share of the partnership liabilities is considered as an additional capital contribution by that partner,[27] and therefore any borrowing by the partnership itself will be tantamount to a capital contribution by the partner, qualifying the losses for immediate deduction.

The Subchapter K advisory group would liberalize the rule limiting the deductibility of partnership losses somewhat to take into consideration the possibility that an individual partner may have a liability to the partnership.[28] Under the present Code, such liability has no effect on the partner's basis for his interest and therefore cannot be used to qualify a partner's share of a partnership loss for deduction. The advisory group recommends that where a partner is or becomes fully obligated to pay a liability to the partnership on account of his share of losses or otherwise, such liability should be recognized in determining his basis for his interest and be considered tantamount to a capital contribution. If this rule were adopted, an obligation imposed on a partner by the partnership agreement to make up deficiencies in his capital account by reason of partnership losses would not only remove some of the flexibility now permitted by the Code in the timing of the deduction of losses by partners, but also would make it unnecessary to take artificial steps to secure deduction for the partner's share of partnership losses.

An interesting sidelight effect of the present provision in the Code whereby a partner's distributive share of partner-

27. INT. REV. CODE OF 1954, § 752 (a).
28. *Revised Report*, *supra* note 2, at 43-44.

ship losses is limited to the adjusted basis of his partnership interest is caused by a provision in the regulations requiring the segregation of loss items from other deductions and credits.[29] These other deductions and credits, such as for charitable contributions, are applied first in the reduction of basis. This rule was apparently adopted in the regulations to reduce the basis of a partner's interest in a partnership by deductible items such as charitable contributions before determining the amount of a partnership's operating loss which is deductible. On the surface it might appear that this rule would work against the taxpayer, but under appropriate circumstances it may actually work to his benefit.

For example, assume that a 50% partner has a basis for his interest in the partnership of $100 and the partnership return showed a charitable contribution of $200 and a net loss from operation (exclusive of contributions) of $1,000. The partner's share of the partnership contribution ($100) would be deductible by him and would reduce the basis of his partnership interest to zero. Therefore he could not deduct any portion of his operating loss. His $500 share of the operating loss would have to be carried forward and deducted in the subsequent year in which his basis was made sufficient to absorb the loss either by earnings or by an additional capital contribution to the partnership.

Suppose, however, that the partnership charitable contributions had been $600 rather than $200. Under these circumstances the partner could have deducted his share ($300) of the partnership contributions, since this deduction is technically not a "loss" and may be deducted irrespective of the level of the partner's basis of his partnership interest. Even though $300 of charitable contributions may have been deducted, only $100 would be applied in reduction of basis, since the basis of a partner's share in the partnership may not be reduced below zero. Accordingly, the partner under these circumstances could obtain benefit from the $200 deduction in excess of his partnership basis twice — once as part of his contributions, and again by virtue of his undiminished basis if he later sells his partnership interest. Under the second set of facts assumed above, the partner would still have available his $1,000 share of the operating loss of the partnership at such time as he restores his deficit in basis by the retention of

29. Reg. § 1.704-1(d)(2).

earnings or by additional capital contribution to the partnership.

This latter problem was not touched upon by the advisory group.

The brief analysis above does not represent an exhaustive discussion of the partnership taxation problems considered by the Subchapter K advisory group. Certainly no evaluation of what problems are the more important can be made in the abstract, because a taxpayer facing a peculiar set of circumstances may find that the facts which he faces make certain other problems much more important than those discussed here. Because of this, it is essential that tax advisors make themselves thoroughly familiar with the problems described by the advisory group and the solutions that are recommended. While the advisory group's recommendations may not be adopted in full, there is little doubt that the work which it has done will have a significant effect on future legislation in the partnership area.