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# Collapsible Partnerships

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# COLLAPSIBLE PARTNERSHIPS

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## *PROFILE OF SECTION 751*

Since a partnership interest is considered a capital asset under Section 741, its disposition generally results in capital gain or loss treatment. But what if the partnership owns appreciated assets whose sale or other realization would cause tax to the partners at ordinary income rates? Should the magic of tax law allow a partner to completely avoid future ordinary income by merely selling his partnership interest before its realization? The Congressional approach to preventing such alchemy was to create a "collapsible partnership" concept somewhat similar to that in the corporate area, except that certain mechanical standards were substituted for subjective tests. Under Section 751 an ordinary income aspect was created in transactions which would otherwise have been taxed as capital gains and losses if viewed solely as the sale of a partnership interest.

Section 751 was enacted in 1954 and during the early years of its existence comparatively few published rulings and court decisions dealt with its provisions. However, the relatively recent interest in tax shelters, coupled with the widespread use of partnerships as vehicles for such investments, has focused attention on the area. As a result, recent years have seen an accelerating number of official interpretations of Section 751, which have made a start in defining the parameters of its effect, although much greater clarification is needed.

Section 751 applies to both sales and exchanges of partnership interests (Section 751(a)) and certain disproportionate property distributions (Section 751(b)). A distribution is deemed disproportionate if the recipient receives either more or less than his share of collapsible partnership assets. In the event of a transaction described in either subsections (a) or (b), a selling or distributee partner must look to the underlying partnership assets at the time to determine tax consequences. Under the law, ordinary income taxation could result due to the existence of unrealized receivables or inventory items which have substantially appreciated in value.[1] These two categories are variously referred to as Section 751 property, collapsible partnership property or tainted assets.

## *UNREALIZED RECEIVABLES*

The term unrealized receivables involves the rights to income not yet taxed arising from goods delivered or to be delivered (other than capital assets) and services rendered or to be rendered. Through 1975, this category also included recapture property (i.e. Sections 1245, 1250, 1251, and 1252) and certain mining property (defined in Section 617(f)(2)) to the extent their disposition would result in ordinary income. The Tax Reform Act of 1976 broadened the definition of unre-

[1] Section 751(a) and 751(b).

alized receivables to encompass stock in a DISC (Section 992(a)); stock in certain foreign corporations (Section 1248); franchises, trademarks or trade names (Section 1253(a)) and oil and gas properties (Section 1254(a)(1)).[2]

Under the regulations, a partnership is deemed to have a right to service income, even though payment is not enforceable until a later date, so long as applicable contracts or agreements are in existence as of the date of sale or distribution.[3] Within this definition, a construction partnership reporting income under a long-term contract method presumably has an unrealized receivable to the extent it has entered into contracts for work it will begin in the future. In such case, however, consideration would be given both to the estimated costs to complete the contract, and the time between the event triggering the unrealized receivable (i.e., sale or distribution) and the expected payment date.[4] This present value concept is an interesting one and, although not yet litigated, could permit significant discounts in the value of a right to future income in periods of high inflation. Also, as will be discussed later, much emphasis would be placed on the values given the contract by both the buyer and seller.

The courts have generally adopted quite a broad view of contracts falling within the purview of Section 751. In *Frank A. Logan*[5] the petitioner sold his interest in a cash basis law partnership and received, in part, payment for unbilled work in progress. The taxpayer argued these accounts were not unrealized receivables since there were no expressed agreements with respect to their payment between the partnership and its clients. The court, however, concluded Section 751 encompassed implied agreements as well as expressed agreements and in holding against the taxpayer observed in what was, perhaps, hyperbolic overkill, "The fruit petitioner left on the partnership tree may not have been ripe, but it was nonetheless fruit."

Nor will the creation of multiple partnership tiers circumvent the unrealized income principle, as shown by *Herman M. Hale*.[6] Mesa Co. was a land development and home construction partnership which issued a partnership interest to yet another partnership, Hale Co., in exchange for future services to be rendered to it. When a limited partner in Hale withdrew from the partnership and received cash and a note in exchange for his interest in Hale's assets, Section 751 was found to be applicable. The Tax Court held Hale's interest in Mesa amounted to a right to services rendered and to be rendered by Hale Co., since Hale's interest was acquired "solely by reason of its contribution of services thereto." Again, the court was unimpressed with the taxpayer's argument that there was no guarantee whatever of receiving any income from Mesa Co.

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[2] Section 751(c).

[3] Regs. 1.751(c)(1)(ii).

[4] Reg. 1.751-1(c)(3).

[5] 51 TC 482 (1968).

[6] 24 TCM 1497 (1965).

The right to income doctrine was given a new dimension in *U. S. v. Woolsey*[7] where the Court held a contractual right to sell insurance in a specific area constituted an unrealized receivable even though no future income would be forthcoming unless the partnership actually sold insurance. Perhaps the ultimate scope of Section 751 was defined in *Roth v. Commissioner*[8] where, in an alternative conclusion, the right to income under a motion picture distribution arrangement was stamped as an unrealized receivable. What surprises the reader of Roth is that such income is more in the nature of rents than services or goods.

These cases, particularly Woolsey, are distressing since there is an obvious movement afoot to designate as unrealized receivables items which had previously been comfortably classified as goodwill. Under present accounting theory at least some portion of this right to sell insurance would have to be regarded as goodwill. The courts, however, have warned us they will not be bound by such accounting dictates when ruling in the Section 751 area.

By now it should be apparent that the right to future income involves considerably more than the simplistic instance of accounts receivable in cash basis partnership. Consider, for example, a proposed sale of a partnership which owns and operates an apartment building. Under the existing regulations and the courts' general view of their meaning (i.e. *Roth*), are not rental leases unrealized receivables? How, then, should the present value of this future income be defined?

The answer, I suspect, is in the regulations themselves, which state: "In determining the amount of the sale price attributable to such unrealized receivables . . . any arms length agreement between the buyer and the seller . . . will generally establish the amount of value".[9] In view of the weight put by the regulations on an arms length agreement, it would be appropriate to attempt to face this issue in the sale agreement, rather than leaving it to the courts to decipher the Section 751 possibilities of a transaction.

As mentioned above, unrealized receivables also include potential recapture income, the most notable being those defined in Sections 1245 and 1250. Here, again, an arms length agreement between the parties carries much weight as to the property values and, hence, recapture possibilities.[10] The interesting aspect of the depreciation recapture portion of Section 751 is that each item of Section 1245 and Section 1250 property in the partnership must be separately analyzed. Assume, for example, the sale of a partnership interest which holds three separate items of depreciable property used in the trade business. According to the sale agreement, one is worth more than book value and two less. Section 751 income would result with respect to

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[7] 326 F. 2d 287 (5th Cir. 1963).
[8] 321 F. 2d 607 (9th Cir. 1963).
[9] Regs. 1.751-1(c)(3).
[10] Regs. 1.751-1(c)(4)(iii).

the appreciated asset. The "loss" on the other two properties would be capital in nature, being considered part of the sale of a partnership interest under Section 741.[11]

This requirement to analyze each item of depreciable property in determining recapture is a harsh one. If the partner had not sold his interest but, instead, convinced his other partners to sell the three pieces of property, the entity would have generated one Section 1245 gain and two Section 1231 loss items. Accordingly, each partner might have been able to treat the net Section 1231 loss as an ordinary loss in his personal return.[12] These depreciation recapture rules appear to overshoot the general aim of the collapsible partnership provisions, which is to treat the disposition of a partnership interest as a disposition of all its underlying properties.

## *APPRECIATED INVENTORY*

For Section 751 purposes, inventory items comprise properties considered stock in the taxpayer's trade (or held primarily for sale to customers in the ordinary course of business), property not within the definition of a capital asset or a Section 1231 asset and certain foreign investment company stock as defined in Section 1246(a). Included assets will not, however, be considered Section 751 property unless they have substantially appreciated in value. The substantial appreciation doctrine removes from the tainted category inventory items whose fair market value does not exceed both 120% of their bases to the partnership and 10% of the fair market value of all partnership property other than money.[13]

Unlike the treatment of Section 1245 and Section 1250 property discussed above, all inventory items are aggregated into one group for the purpose of measuring the 120% and 10% tests.[14] If all inventory items, lumped together, do not violate these two percentage tests, then none will be treated as a collapsible asset. Accordingly, it is possible to distribute some items which are significantly appreciated without triggering Section 751 so long as all inventory, as a group, is not tainted property.

For many taxpayers, this appreciated inventory concept will not prove particularly troublesome. As an example, consider the following balance sheet:

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[11] Regs. 1.751-1(c)(4)(i).

[12] See, generally, Section 1231.

[13] Section 751 (d).

[14] Reg. 1.751-1(d)(1).

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 26,000 | $ 26,000 |
| Trade Accounts Receivable | 50,000 | 50,000 |
| Inventory | 110,000 | 140,000 |
| | $186,000 | $216,000 |
| Liabilities | $ 10,000 | $ 10,000 |
| Capital, A | 88,000 | 103,000 |
| Capital, B | 88,000 | 103,000 |
| | $186,000 | $216,000 |

Should one of the partners contemplate a sale of his interest at fair market value, his $15,000 profit will all be considered a capital gain in spite of the substantial appreciation in the inventory. This follows because the regulations also include as an inventory item for this purpose any other property which, to the partnership, is neither a capital asset nor a Section 1231 asset.[15] Since trade receivables are not within the definition of either of these two categories,[16] they are viewed as inventory items for Section 751 purposes. Accordingly, appreciated inventory does not exist here since the fair market value of all inventory items ($190,000) is less than 120% of tax basis ($160,000). Unfortunately, the opposite could occur; that is, the existence of unrealized receivables could tip the inventory items beyond the 120% and 10% guidelines.

The mechanical exercise in computing appreciated inventory is considerably easier than defining what is an inventory item. Problems will frequently arise in real estate partnerships which attempt to distinguish between investment property and that held for sale. Presumably, one should be guided by the extensive body of case law which profiles the meaning of Section 1221(i), a subject which is not peculiar to partnerships and clearly beyond the scope of this discussion.

In an apparent attempt to ensure against tax avoidance by a dealer doing business in a partnership entity, the Statute requires that the character of income test be examined both at the partnership and selling or distributee partner levels.[17] Frankly, in view of the judicial doctrine that a dealer may also own investment property, one is strained to appreciate the purpose of this two-tiered approach.

[15] Reg. 1.751-1(d)(2)(ii) Under this definition "inventory" would also encompass a depreciable asset held for less than six months whose value exceeds tax basis.

[16] See Section 1221 defining capital assets.

[17] Section 751(d)(2)(D).

## *TAINTED TRANSACTIONS—IN GENERAL*

As noted previously, the collapsible partnership provisions are triggered by sales and exchanges of partnership interests and certain disproportionate property distributions. For these purposes, if a partner receives untainted partnership property (including money) in exchange for all or part of his interest in collapsible assets, a transaction within the scope of Section 751 has occurred. Similarly, Section 751 is applicable when a partner receives collapsible property in exchange for his interest in other partnership property. Since these proceedings are considered sales between the distributee partner and the partnership, each side realizes gain or loss measured by the adjusted tax basis of surrendered assets and the fair market value of acquired assets.

While the regulations suggest an ordinary loss could occur through Section 751, it is difficult to see how. Inventory qualifies as a tainted asset only if substantially appreciated and a decline in value would be taxed in the Section 741 "pool". With the exception of recapture items, unrealized receivables generally represent "accounting type" profits not yet taxed; accordingly, there should be no justification for claiming a reduction in value below tax basis. As for recapture property, we have previously noted an item is included as a Section 751 asset only if its fair market value exceeds tax basis.

Where a fair market value depreciation of ordinary income assets has occurred, tax planning can achieve the goal of a recognized ordinary loss so long as all parties are cooperative. For instance, if a partner is being redeemed the entity could sell the distressed assets before liquidation and realize the ordinary loss at the partnership level. Another possibility would be to distribute deflated assets to the redeemed party as a prelude to a personal sale outside the partnership. If the distributed assets are inventory items to the partnership, they would retain their character as ordinary income assets for a period of five years after the distribution, regardless of whether or not the assets are deemed capital items in the partner's hands.[18]

These general rules, of course, merely state the case in a vacuum. They can be given life only through an examination of the ways in which they become operative. Since we have already alluded to some judicial doctrines defining collapsible assets, an examination of transactions suggesting Section 751 applications, with their frequently curious results, is in order.

## *TRANSFERS BY SALE OR EXCHANGE*

In calculating the tax results of a sale of a partnership interest, the seller must allocate proceeds between his interest in Section 751

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[18] Under Section 735 (a)(2) inventory retains its character as an ordinary income asset for five years after the distribution. Interestingly, the five-year rule is applicable to all inventory, regardless of whether or not appreciation exists.

property and his interest in other properties.[19] This highlights one of the most disturbing aspects of the collapsible partnership provisions— it is possible for a selling partner to be forced into recognition of ordinary income when he has an overall loss on the transaction. The following example dramatizes this unfortunate result:

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 10,000 | $ 10,000 |
| Inventory | 30,000 | 50,000 |
| Land (investment) | 50,000 | 20,000 |
| | $ 90,000 | $ 80,000 |
| Capital, G | $ 45,000 | $ 40,000 |
| Capital, H | 45,000 | 40,000 |
| | $ 90,000 | $ 80,000 |

Should either partner sell his interest at its fair market value, he would realize a loss of $5,000. However, the sales proceeds of $40,000 must be allocated between Section 751 property ($50,000 ÷ 2) and other property. Since the inventory's basis to each partner is $15,000, the seller must recognize $10,000 of ordinary income. The basis to him of other assets is $30,000, resulting in a capital loss of $15,000. While the true economic loss of $5,000 does prevail, its elements may cause nightmarishly surprising tax results to the seller.

The importance of allocating relative fair market values among the underlying property should be obvious from this example. As noted earlier, the Service will accept an arms length valuation set by the sale agreement. This concession presumably exists as the seller will attempt to underestimate the values of Section 751 property, while the buyer will be interested in valuing such assets as high as possible since he may then recognize a lower gain upon their subsequent sale should a Section 754 election be in effect.

An important fact to be extrapolated from this example is that the selling partner's basis in each underlying property element is intertwined with the partnership's basis. The regulations require these various bases to be determined as if the selling partner has received the property in a current distribution immediately before the sale.[20] This basis allocation considers the impact of Section 732(d) as well as Section 754. Under these provisions, detrimental results might follow if the original acquisition was for less than the partnership's tax bases

[19] Regs. 1.751-1(a)(2).

[20] Regs. 1.751-1(a)(2), 1.732-1 and 1.732-2.

in assets since a partner's basis in distributed property is limited to the basis of his partnership interest.

A fairly common problem arises when the sale agreement is silent on allocation of proceeds and the selling partner's interest in profits differs from his interest in capital. Sadly, the regulations do not discuss this most practical situation and taxpayers are left on their own to muddle through to a conclusion. Some commentators have suggested a capital interest be used to determine a partner's share of the basis of partnership assets while the profit interest be used to assess his share of the change in value of the assets. This appears to be the most logical approach since it views the transaction as if the partnership itself had sold all its underlying properties.

To illustrate the theory, assume the following fact pattern where partners share profits equally:

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 9,000 | $ 9,000 |
| Unrealized receivables | 21,000 | 30,000 |
| Inventory | 30,000 | 39,000 |
| Other property | 60,000 | 72,000 |
| | $120,000 | $150,000 |
| Liabilities | 30,000 | |
| Capital, A | 20,000 | |
| Capital, B | 50,000 | |
| Capital, C | 20,000 | |
| | $120,000 | |

The inventory items are considered collapsible property since this category has appreciated in value by more than 20% and comprises more than 10% of the value of all partnership property, exclusive of cash. Viewed with the unrealized receivables, the ordinary income potential of a sale by any partner is affected by the increase of $18,000 in the worth of tainted assets.

Partner B is approached by an individual willing to purchase his interest for $60,000 of cash. Because partnership liabilities are deemed capital contributions in accordance with the profit and loss ratio,[21] B's basis for his interest is $60,000 (i.e. $50,000 + $30,000/3).

[21] Section 752(a) and Regs. 1.752-1(e).

Therefore, the seller has a 33-1/3% interest in profits and a 50% interest in partnership property.

Pursuing this concept, the sales proceeds would be apportioned as follows:[22]

| | B's share of assets at 50% | B's share of appreciation at 33-1/3% | Total |
|---|---|---|---|
| Cash | $ 4,500 | - 0 - | $ 4,500 |
| Unrealized receivables | 10,500 | $ 3,000 | 13,500 |
| Inventory | 15,000 | 3,000 | 18,000 |
| Other property | 30,000 | 4,000 | 34,000 |
| | $ 60,000 | $ 10,000 | $ 70,000 |

The result of this exercisė in columnar dexterity leaves B with an ordinary gain of $6,000 and a capital gain of $4,000.

While few in number, some published dicta do exist offering insight into transactions considered within the realm of Section 751. In Rev. Rul. 60-352,[23] the taxpayer donated his entire limited partnership interest to a charitable organization. The partnership was a real estate dealer consistently using the installment method, and having unrealized receivables at the date of gift. The Service concluded the donor must recognize ordinary income on the installment obligations not yet taxed, although a corresponding contribution deduction, subject to the limitations of Section 170, was permitted in the ruling. While the text in the advice specifically suggests taxation under Section 453(d) (i.e., gain or loss on disposition of installment obligations), language in the ruling implies Section 751 is also applicable.

Query: would the same result be obtained if the receivables were potential depreciation recapture property, or is the ruling meant to apply only to installment obligations? The question posed is by no means purely academic since a gift of a partnership interest containing such assets would leave the donor in the position of having disposed of ordinary income property. While at first blush Section 751 appears operative in the latter instance, we are faced with the hard fact that a gift of property with depreciation recapture potential is generally not a taxable event under the Statute.[24] Therefore, should the partnership interest be viewed purely in terms of its underlying

[22] Under Regs. 1.752-1(d), B's share of liabilities relinquished are considered proceeds of the sale.

[23] CB 1960-2.

[24] Sections 1245(b)(1) and 1250(d)(1).

assets, the transfer should not be interpreted as a Section 751 transaction, unless it is considered a disproportionate distribution, a subject discussed later. Ordinary income should result, however, where the donor partner had a so called "negative basis" (i.e. his basis in the partnership interest was less than his share of liabilities) at the point of gift.[25]

Support for the non-applicability of Section 751 on the gift of a partnership interest containing recapture property and having a "positive basis" can be found in Rev. Rul. 72-172,[26] where the Service's conclusion was based upon the results which would have been obtained had a partnership interest not been at issue. Factually, a husband and wife sold their partnership interests to a wholly owned corporation. At the sale date, the only partnership assets were land and an apartment house. Section 1239 mandates ordinary income on such a sale if the assets had been held individually, but there is no provision in the collapsible partnership Statute designating potential Section 1239 income as an unrealized receivable. Accordingly, the Service ignored Section 751 and held for ordinary income under Section 1239. Similar reasoning was applied in Rev. Rul. 58-394.[27]

These rulings suggest an interesting philosophical question. If the Service examines a transaction and concludes solely on the basis of the results of the individual ownership, why is Section 751 needed? Of what moment are the terms appreciated inventory and unrealized receivables if the Statute triggering their consequences is to be ignored? Further, *Holbrook* (see the following) rejected the individual ownership approach and the Service similarly rejected it in Rev. Rul. 73-300, discussed below in the context of disproportionate distributions.

In *Holbrook v. Commissioner*,[28] limited partners in an oil and gas venture sold their interests to the general partner at original cost. As of the sale date, cumulative net losses from the enterprise had been deducted by the sellers. While the Commissioner did not argue for treatment under the unrealized receivables or appreciated inventory doctrines, he did press for ordinary income under tax benefit principles. In the Service's view the general partner was merely reimbursing the limited partners for prior losses. The Court held the sale should be viewed solely within the context of the collapsible provisions and ruled for capital gain income since no tainted assets existed under the Statute's definitions. While the results should now be different under the Tax Reform Act of 1976, the decision is interesting in affirming the mandate of Section 751(a).

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[25] Ordinary income should occur in the reduction of his share of partnership liabilities, treated as a cash distribution to him. Sections 731(a)(1) and 731(c). See also, Rev. Rul. 74-40, CB 1974-1.

[26] CB 1972-2.

[27] CB 1958-2.

[28] 34 TCM 294 (1975).

An imaginative argument was made by the taxpayers in *Wilford E. Thatcher*.[29] The issue involved the incorporation of a cash basis partnership whose liabilities, when including accounts payable, exceeded its assets' tax bases. The Service sought to invoke Section 357(c) to tax the partnership on excess liabilities transferred, without reducing such excess by untaxed accounts receivable.

The taxpayers advanced a novel argument in defense. Under the regulations,[30] the basis for unrealized receivables must be adjusted for related costs, including those not previously taken into account under the partnership's tax accounting method. Seizing upon this provision, the taxpayers contended there was no real excess of liabilities over assets, within the meaning of Section 357(c), since the regulations attributed basis to accounts receivable to the extent of related costs (in this instance, the accounts payable). In other words, if untaxed accounts payable were to be considered in Section 357(c) computations, Section 751 required accounts receivables to be likewise considered. The Court rejected this approach, arguing the cited regulation applied only to Section 751(a) and (b) transactions, and not to those contemplated by Section 351.

## *DISPROPORTIONATE DISTRIBUTIONS*

It has been observed that Section 751(b) treats certain disproportionate distributions as sales of collapsible partnership property between the partner and the partnership. At the outset it should be noted this provision is inapplicable unless one of the parties relinquishes his right to either unrealized receivables or appreciated inventory. For these purposes, the relinquishing party is treated as the seller of the tainted assets, although both parties are likely to recognize gain or loss as a result of the distribution.

While the thrust of this provision is to prevent shifting potential ordinary income among the partners, attentiveness can nevertheless accomplish the same result with the blessings of the regulations. Strangely, a distribution will not be deemed disproportionate so long as the recipient partner receives his share of the fair market value of all Section 751 assets,[31] even though an immediately subsequent sale by him would cause more or less taxable income than his share had the partnership disposed of all its properties. This principle can be seen by the following illustration:

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[29] 61 TC 4 (1973).
[30] Regs 1.751-1(c)(2).
[31] Regs. 1.751-1(b)(1)(ii).

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 60,000 | $ 60,000 |
| Inventory | 30,000 | 45,000 |
| Investment Real Estate | 45,000 | 60,000 |
| | $135,000 | $165,000 |
| Capital, A | $ 45,000 | $ 55,000 |
| Capital, B | 45,000 | 55,000 |
| Capital, C | 45,000 | 55,000 |
| | $135,000 | $165,000 |

Inventory items, as a group, constitute Section 751 property since they comprise more than 10% of total partnership assets, exclusive of cash, and their collective value exceeds 120% of tax basis. In the event all partnership assets are sold, each partner would recognize $5,000 of ordinary income ($45,000 - $30,000 = $15,000/3). If it is deemed desirable to have A liquidated with minimal ordinary income potential, such a result can be achieved through a distribution of $15,000 of inventory which has not appreciated in value and a 2/3 interest in the realty. Since A has received his share of inventory items, no disproportionate distribution within the meaning of the statute has occurred.[32]

Now let us assume A sells the properties shortly thereafter, when their values are equal to those at distribution. Since the adjusted basis of the properties received is equal to the basis of the liquidated partnership interest,[33] A will recognize a gain of $10,000:

| | |
|---|---|
| Sale of inventory | $ 15,000 |
| Sale of realty (2/3 x 60,000) | 40,000 |
| Total proceeds | $ 55,000 |
| Basis of properties to A | 45,000 |
| Net Gain | $ 10,000 |

To determine what portion of the gain is taxed at ordinary income rates, A must determine his tax basis in each property. In a liqui-

32 Regs. 1.751-1(d)(1).

33 Section 752(b).

dating distribution, basis is first allocated to Section 751 property in an amount not exceeding the adjusted basis of such property to the partnership, with the excess attributable proportionately to the other distributed properties.[34] Since the inventory items had a basis equal to their fair market value at distribution, A's entire profit is considered a capital gain:

| | Proceeds | Basis | Gain |
|---|---|---|---|
| Inventory | $ 15,000 | $ 15,000 | $ -0- |
| Realty | 40,000 | 30,000 | 10,000 |
| | $ 55,000 | $ 45,000 | $ 10,000 |

In substance, therefore, by having his interest redeemed in this manner, A has completely relieved himself of a potential $5,000 ordinary income recognition. Upon sale of the remaining inventory by the partnership, partners B & C will be taxed on the full appreciation of $15,000, and ordinary income has quite effectively been shifted among the partners.

Determining the components of gain on a liquidating, disproportionate distribution is clearly one of the most complicated areas of the collapsible partnership provisions. The general rule for evaluating such transactions is deceptively simple—the gain recognized by the partnership and the distributee partner is measured by the basis of property surrendered and the value of property received by each in the distribution. As will be seen below, navigating the interpretative regulations may well prove as rewarding as a fly practicing pirouettes across the threads of a spider's web.

The following fact pattern is suggested by the regulations:[35]

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 15,000 | $ 15,000 |
| Accounts receivable | 9,000 | 9,000 |
| Inventory | 21,000 | 30,000 |
| Buildings—depreciated basis | 42,000 | 48,000 |
| Land | 9,000 | 9,000 |
| | $ 96,000 | $111,000 |

[34] Regs. 1.732-1(c)(1). If however, the basis of the partnership interest is less than the partnership's basis of distributed Section 751 property, any other property distributed will assume a zero basis.

[35] Regs. 1.751-1(g).

| | | |
|---|---|---|
| Current liabilities | $ 15,000 | $ 15,000 |
| Mortgage payable | 21,000 | 21,000 |
| Capital: | | |
| A | 20,000 | 25,000 |
| B | 20,000 | 25,000 |
| C | 20,000 | 25,000 |
| | $ 96,000 | $111,000 |

For this illustration, assume the buildings have been depreciated only under the straight line method, with no depreciation recapture potential. Also, all partners' capital contributions and distributions to date were in the form of cash, so that each one's share of the tax basis of assets is equivalent to the basis of his interest.[36]

Tax consequences will be dependent upon the composition of the liquidating distribution. If, for instance, C is redeemed with a distribution to him of his share of each partnership asset and liability, no gain or loss would result to either party since no disproportionate distribution has occurred. Alternatively, if either the distributee or the partnership receives more than his/its share of tainted assets, a transfer deemed a sale will result, with gains computed accordingly.

Let us suppose C is redeemed with a distribution of $5,000 in cash and $20,000 of inventory having a tax basis of $14,000. Under these circumstances, the partnership, in effect, has "sold" inventory for certain other assets, a transaction clearly within the meaning of the collapsible partnership provisions.[37]

As indicated by the balance sheet, inventory items (including unrealized receivables) are appreciated under the definition of Section 751(d). Since C has a one-third interest in the partnership, his share of inventory items is valued at $13,000 (i.e. $39,000/3). Accordingly, his receipt of $20,000 of such property denotes an excess distribution of $7,000 for which his rights to other properties will be surrendered.

The precise tax consequences to C can vary, depending upon the agreement of the parties. Table I discloses the effect of the transaction where the partners agree that the $7,000 of inventory in excess of the distributee's share is in exchange for a like amount of buildings. Table II constructs the consequences where no such agreement exists.

Under either approach, C realizes a gain of $5,000, which is consistent with his equity in the appreciation of the partnership's assets. This profit must be reflected either in currently recognized gain or as a deferred gain via a reduction in the basis to him of property received. As can be seen from the appended Tables, the larger the

[36] See, generally, Sections 705 and 722.

[37] Section 751(b)(1)(A).

recognized capital gain, the higher is his basis in inventory. Accordingly, he may well wish to be currently burdened at capital gain rates while correspondingly reducing his ordinary income potential upon disposition of the inventory.[38]

This planning potential has not gone unnoticed by the Service, and the regulations have been constructed to lessen its impact. As can be noted in Tables I and II, the Service has effectively reduced immediate capital gain recognition by not treating relinquished liabilities as additional consideration in the deemed sale (see footnote 22).

To illustrate, reference is made to Table II wherein C disposes of his interest in buildings, land and partnership liabilities. There is merit to the theory that the distributee should recognize an immediate capital gain of $1,100:

| | |
|---|---|
| C's partnership investment | $ 20,000 |
| Share of liabilities | 12,000 |
| Basis of partnership interest | $ 32,000 |
| Cash distributed and liabilities assumed[38] | (17,000) |
| | 15,000 |
| Basis of C's share of inventory distributed to him[39] ($13,000 x $21,000/$30,000) | (9,100) |
| Adjusted basis of realty | 5,900 |
| Sale to partnership | 7,000 |
| Capital gain recognition | 1,100 |

While the capital gain recognition might be burdensome, an over all benefit would be achieved since C's basis in the inventory would

[38] Regs. 1.751-1(b)(2)(iii) determines basis in a Section 751(b) transaction as if it were a nonliquidating distribution. Under Regs. 1.732-1(a) the adjusted basis of a partner's interest in a partnership is first reduced by distributed cash. See also Section 752(b) treating reduction of a partner's share of partnership liabilities as a cash distribution to him.

[39] Under Regs. 1.732-1(c)(1) remaining basis—after money distributed—is first allocated to Section 751 property.

be $16,000 (i.e. $9,000 + $7,000). The Service appears to take an unfair position on this point and it remains to be seen whether the Courts will sanction such a construction.

Returning to our primary example, we must next determine the partnership's taxable income caused by the redemption. Regardless of whether or not an agreement exists as to the properties exchanged, the partnership must recognize ordinary income of $2,100 since it has "sold" $7,000 of inventory having a tax basis of $4,900 (i.e. $7,000 x $21,000/$30,000). Remaining partners A and B each has a new basis for his partnership interest of $39,050:

| | |
|---|---|
| Before redemption: | |
| Investment | $ 20,000 |
| Share of liabilities | 12,000 |
| Basis of partnership interest | 32,000 |
| Gain recognized on redemption | |
| (2,100÷2) (40) | 1,050 |
| C's liabilities assumed (12,000÷2) | 6,000 |
| New basis of partnership interest | $ 39,050 |

The statutory scope of Section 751(b) transactions is potentially large. In the interest of equity, however, there is a concession that the Section will not apply to the extent a partner receives property he previously contributed. Similar exclusion is given certain payments to retired partners or to deceased partners' successors.[41]

There have been very few published guidelines defining a disproportionate distribution. The Service did, however, deal with the issue in Rev. Rul. 73-300,[42] although the conclusion reached appears inappropriate. Factually, the taxpayer received cash distributions in excess of the adjusted basis of his interest (as determined under Section 705) from a service partnership using the cash receipts and disbursements method of accounting. It was held that the partner recognized ordinary income to the extent of his share of the firm's unreal-

[40] Section 705(a)(1)(A).

[41] Section 751(b)(2).

[42] CB 1973-2 For a similar conclusion see Rev. Rul. 73-301,CB 1973-2.

ized receivables. While the brevity of the ruling leaves taxpayers in the dark about certain of the circumstances attendant to the distribution, the recipient does not appear to have relinquished any portion of his partnership interest.

Whether this approach is consistent with the Statute is debatable and may well have to be resolved by the courts in the future. By statute the collapsible provisions relate only to those instances in which partnership interests or rights to certain partnership properties are surrendered. In point of fact, the Services own interpretation is that "Section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of Section 751 property or his share of other property".[43] Yet nowhere does the ruling refer to the existence of a disproportionate distribution! Further, must the distributee partner recognize duplicate ordinary income in the subsequent year as the receivables are collected? A basis adjustment under Section 754 to partnership property remaining after the distribution would not solve the problem since such adjustments are limited to capital assets or Section 1231 assets.[44]

This ruling raises the major current definitional problem in the collapsible partnership area—namely, exactly when does a disproportionate distribution occur? It was previously noted that Section 751 (b) applies when a partner receives a distribution of money in exchange for his interest in collapsible assets. Again, in order for the distribution to be disproportionate, the recipient must give up his rights to some partnership property.

The difficulty here arises since a reduction of a partner's share of partnership liabilities is considered a cash distribution to him.[45] We now have the question of whether a constructive distribution (i.e. reduction in the share of liabilities) can cause a Section 751(b) transaction. Since virtually all partnerships must have liabilities of some sort,[46] there appears to be the potential of ordinary income each time there is a shift in profit interests.[47]

To illustrate the point let us assume the following balance sheet:

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[43] Regs. 1.751-1(b)(1)(ii).

[44] See Regs. 1.755(b)(1)(ii).

[45] Section 752(b).

[46] In Rev. Rul. 60-345, CB 1960-2, the Service held liabilities of a cash method partnership are considered in a partner's basis for his interest even though the cash method precludes recording such liabilities on the partnership's books.

[47] Under Regs. Section 1.752-1(e), a partner shares in partnership liabilities in a ratio consistent with his interest in profits and losses. Should his P & L interest be reduced, his share of liabilities drops and he is deemed to have received a cash distribution under Section 752(b).

| | Tax Basis | Fair Market Value |
|---|---|---|
| Cash | $ 10,000 | $ 10,000 |
| Unrealized receivables | -0- | 12,000 |
| Capital Assets | 20,000 | 20,000 |
| | 30,000 | 42,000 |
| Liabilities | $ 12,000 | $ 12,000 |
| Capital, K | 9,000 | 15,000 |
| Capital, L | 9,000 | 15,000 |
| | 30,000 | 42,000 |

New partner M is admitted for a cash contribution of $15,000 in exchange for a one-third interest in profits and capital. K and L now each have an interest in Section 751 assets of $4,000 ($12,000 ÷ 3) whereas such interest before M's admission was $6,000 ($12,000 ÷ 2). Since M has also assumed one-third of the liabilities, both K and L have received a constructive cash distribution of $2,000 and have, in turn, surrendered a portion of their share of partnership assets. In short, they should each have ordinary income upon the admission to the extent of their relinquished unrealized receivables.

These results are not restricted to situations in which a new partner is admitted. Similar consequences would ensue where profit interests shift among the parties, the so called "flip-flop" occurrence. The issue is particularly topical since many tax shelter syndications allocate initial losses to the limited partners, then shift profit and loss ratios when the entity crosses over into a taxable income posture.

The recognition of this problem at the outset might avoid the incidence of a Section 751(b) transaction at the point the profit interests change. While this suggestion has not been litigated as yet, a special allocation of the income realized from collapsible assets in a ratio consistent with the profit and loss interests before the change should avoid Section 751(b) since none of the partners would have given up their rights to tainted assets when their respective shares of partnership liabilities were reduced. To successfully parry the Section 751 (b) problem the special allocation must have substantial economic viability, which is, of course, a fact and circumstances test requiring a fresh analysis in each situation.

The possibilities of disproportionate distributions are virtually endless. As an example, in the previous discussion of Rev. Rul. 60-352, it was observed that the gift of a partnership interest containing depreciation recapture property should not be deemed a constructive sale, and a Section 751 transfer, unless the donor had a "negative basis" for his partnership interest (see footnotes 23 and 24). However, should the view be taken that the transaction is more properly examined under Section 751(b) than Section 751(a), the results would be different. Under the disproportionate distribution theory a donor partner's share of liabilities would be reduced by the gift, as would his interest in other properties. Therefore, even without a "negative basis", there would be a Section 751(b) transfer and ordinary income recognition.

While a literal reading of the Statute would imply ordinary income on the gift, such a conclusion is of highly questionable fairness. If one holds to the view that income recognition should not be modified merely because business is transacted in a partnership setting, the result to the donor is inequitable. In point of fact, the Service has adhered to such a perspective, as exemplified by Rev. Rul 72-172 (cited previously).

## *CONCLUSION*

It has now been almost 25 years since the collapsible provisions became law. While there has been a recent acceleration of rulings and cases dealing with the area, the questions summarized herein suggest an urgent need for greater clarification of issues not originally contemplated by Congress. Since almost all partnerships must come up against Section 751 at least once in their existence, it is dangerous to continue sailing in virtually uncharted seas. Obviously, the courts and the Service will be under more pressure in the future to interpret these provisions. It is hoped such interpretations shall shed light—rather than further confuse an area which now often seems incomprehensible.

TABLE I

| | C's share of value | Distribution | Assets sold by C | Consideration | Tax Basis to C | Section 751 gain | Capital gain |
|---|---|---|---|---|---|---|---|
| Cash | $ 5,000 | $ 5,000 | | | | | |
| Accounts receivable | 3,000 | | | | | | |
| Inventory | 10,000 | 20,000 | | $7,000 | | | |
| Building | 16,000 | | $7,000 | | $6,125(A) | | $875 |
| Land | 3,000 | | | | | | |
| Liabilities | (12,000) | | | | | | |
| | $25,000 | $25,000 | | | | | |

(A) $42,000 ÷ $48,000 = 87.5% x $7,000

| | |
|---|---|
| Basis of inventory to C: | |
| Basis partnership interest | $32,000 |
| Cash distributed and liabilities assumed | (17,000) |
| Basis building deemed distributed | (6,125) |
| Basis of C's share Sect. 751 property | 8,875 |
| Inventory purchased by C | 7,000 |
| Basis of inventory to C | $15,875 |

TABLE II

| | C's share of value | Distribution | Assets sold by C | Consideration | Tax Basis to C | Section 751 gain | Capital gain |
|---|---|---|---|---|---|---|---|
| Cash | $ 5,000 | $ 5,000 | | | | | |
| Accounts receivable | 3,000 | | | | | | |
| Inventory | 10,000 | 20,000 | | $7,000 | | | |
| Building | 16,000 | | $16,000 | | $6,263(A) | | $737 |
| Land | 3,000 | | 3,000 | | | | |
| Liabilities | (12,000) | | (12,000) | | | | |
| | $25,000 | $25,000 | $ 7,000 | $7,000 | | | |

(A) $51,000/57,000 x $7,000 = $6,263

| | |
|---|---|
| Basis of inventory to C: | |
| Basis partnership interest | $32,000 |
| Cash distributed and liabilities assumed | (17,000) |
| Basis building deemed distributed | (6,263) |
| Basis C's share Sect. 751 property | 8,737 |
| Inventory purchased by C | 7,000 |
| Basis of inventory to C | $15,737 |