Constructive Cash Distributions

John W. Lee
William & Mary Law School, jwleex@wm.edu

Repository Citation
http://scholarship.law.wm.edu/tax/463

Copyright c 1976 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
CONSTRUCTIVE CASH DISTRIBUTIONS

JOHN W. LEE, III

1. What are Constructive Cash Distributions?

In drafting subchapter K of the Internal Revenue Code of 1954, which deals with partners and partnerships, the draftsmen frequently utilized the technique of devising a mechanical rule to accomplish a particular objective. The complexities of constructive cash distributions arise from the interplay between several families of mechanical rules; principally Section 752 providing for treatment of certain liabilities, Section 731(a) which mandates the extent to which gain or loss on partnership distributions is recognized, and Section 751(b) which treats certain distributions involving unrealized receivables and certain inventory items as sales or exchanges.

Section 752 consists of a series of mechanical rules which incorporate the Crane doctrine. In Crane v. Commissioner, the Supreme Court held that the amount of a mortgage pre-existing or placed on property at acquisition, whether recourse or nonrecourse, is included both in basis and in the amount realized upon a subsequent sale or exchange of the property. Section 752(a) provides that any increase in a partner's share of the partnership liabilities or any increase in his individual liabilities by reason of his assumption of partnership liabilities will be considered as a contribution of money by the partner to the partnership. This may be viewed as a “constructive cash contribution”. Section 722 in turn provides for a basis increase in the contributing partner’s partnership interest for the amount of money contributed by him. Unlike the analogous corporate provision, there is no requirement that the partner alone or in conjunction with other transferors be in control of the partnership or that the contribution be made in the initial organization of the partnership. The rationale for adding a partner's share of liabilities to his basis is that he has in effect extended his credit as if he personally borrowed funds and contributed them to the partnership.


3 Where a partner acquires his interest by purchase, apparently his share of partnership liabilities are included in his basis directly under the Crane doctrine and not through constructive cash contributions. See I.R.C. §§742 and 752(d). The liabilities are not counted twice. Cf. Treas. Reg. §1.752-1(f).

4 See I.R.C. §§351(c) and 368(c).

Section 752(c) provides that liabilities to which property is subject will, to the extent of the fair market value of the property, be considered as a liability of the owner of the property. This too incorporates an aspect of the *Crane* doctrine. Here the theory is that property owned by a partnership subject to a liability renders that liability in effect a liability of all members of the partnership or venture "because it is an economic obligation which the venturers will service and retire in order to protect and enhance their present investment or equity." 6 In summary, Sections 752(a) and (c) speak to the basis aspect of *Crane*. The "amount realized" aspect is handled differently. Section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities are to be treated in the same manner as liabilities in connection with a sale or exchange of property not associated with the partnership. In short, on a sale or exchange of a partnership interest the *Crane* doctrine applies directly (and we do not have "constructive cash distributions"). Thus, in the case of a sale or exchange, liabilities assumed, or taken subject to, are included in the amount realized by the selling partner. 7

On the surface, the above rules appear to be all that would be necessary to codify the *Crane* doctrine for the partnership provisions. But the partnership provisions go a step further and in effect provide for a decrease in a partner's basis where there is a decrease in the partnership liabilities. Specifically, Section 752(b) provides that any decrease in a partner's share of partnership liabilities or any decrease in his individual liabilities by reason of the partnership's assumption of his liabilities is deemed a distribution of money to the partner by the partnership, i.e., a "constructive cash distribution". Section 733 provides that a distribution of money or constructive cash to a partner by a partnership, other than in liquidation of his interest, will reduce the adjusted basis of his partnership interest (but not below zero) by the amount of the money or constructive cash. 8 The decrease in basis is not the only possible result of a constructive cash distribution; other mechanical partnership rules can produce in some instances unexpected and even disastrous tax consequences.

2. What are the Tax Consequences of Constructive Cash Distributions?

Generally, gain is not recognized to a partner upon a partnership distribution to him. However, to the extent that any money distributed, including a constructive cash distribution, exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, gain is recognized by the partner and considered as gain from the sale or exchange of (part of) the partnership interest of

---

6 Id. at 85, 142.
7 Frank A. Logan, 51 T.C. 482 (1968).
the distributee partner.\(^9\) In turn Section 741 provides that gain or loss recognized in the case of a sale or exchange of an interest in the partnership is considered as capital gain or loss.\(^10\) This rule may be better understood against the background of the workings of Section 705 which determines the basis of a partner's interest. Section 705(a) sets forth an "earnings and profit" formula, "the basic approach of which is aggregating the partner's capital contribution and his share of partnership income and reduce the amount so determined by distributions to the partner and his share of partnership losses."\(^11\) As in a corporate distribution, a partnership distribution (here limited to money) in excess of earnings and profits and the partner's original basis generally is treated as a capital gain.\(^12\)

Section 731(a) and constructive cash distributions in excess of basis do not tell the whole story. Section 731(c) states that Section 731 does not apply to the extent otherwise provided by Sections 736 and 751. Section 751 deals with unrealized receivables, as defined in Section 751(c), and certain inventory items. For purposes of this paper the focus will be on potential partnership depreciation recapture, i.e., recapture which would be determined at the partnership level under Sections 1245 and 1250 if the partnership sold the depreciable property, which is defined as an unrealized receivable.

Section 751(a) treats the amount received by a partner in exchange for all or a part of his partnership interest attributable to partnership unrealized receivables or substantially appreciated inventory items (Hot Assets) as an amount realized from the sale or exchange of ordinary income property. Section 751(b) provides that to the extent a partner receives a distribution of partnership non-section 751 property (including money) in exchange for all or a part of his interest in Hot Assets, such transaction is restructured as a taxable sale or exchange between the distributee partner and the partnership. Treasury Regulation Section 1.751-1(b)(3) restructures the entire transaction, in which a distribution of non-Hot Assets is received in exchange for an interest in Hot Assets, as a proportionate distribution to the partner of his share of Hot Assets and non-Hot Assets followed by a sale or exchange by the distributee partner of the constructively received Hot Assets back to the partnership for an amount of non-Hot Assets equal to the fair market value of Hot Assets. Thus, when a partner receives solely a cash distribution and at the same time relinquishes an interest in potential partnership recapture, the cash distribution is restruc-

---

\(^9\) I.R.C. §731(a).

\(^10\) Section 741 is a manifestation of the "entity" approach to partnership taxation, under which the partnership is considered a separate entity. The alternate approach is the "aggregate approach" under which the partnership is treated as a collection of individuals and the partnership is looked through. Section 751 constitutes an aggregate approach exception or carve out from the entity approach of Section 741. See Pusey, The Partnership as an "Entity": Implications of Bayse, 54 TAXES 143, 156 (1976).


\(^12\) Compare I.R.C. §§301(c)(1), 301(c)(3) and 316 with Id. §§705 and 731(a).
tured as a distribution of potential partnership recapture and cash. The partner is deemed to have sold the potential recapture back to the partnership for its fair market value. Since potential recapture has a zero basis to the partnership under Treasury Regulation Section 1.751-1(c)(5) and the distributee partner takes over the partnership's basis of zero under the Treasury Regulation Section 1.751-1(b)(3)(iii) and Code Section 732(a)(1) [unless a Section 732(d) election is available], the result is that the distributee partner has ordinary income to the extent of the constructively received potential partnership recapture which is constructively exchanged for the cash distribution. Due to the above zero basis provision for the potential partnership recapture, arguably under Section 751(b) a distributee partner can realize ordinary income even where the cash distribution is not in excess of his basis; however, the Service in Revenue Ruling 73-30014 ruled that, in the case of cash distributions, Section 751(b) applied only where the money distributed was in excess of the partner's basis. This result of gain where disproportionate distributions do not exceed basis should also obtain where, instead of an actual distribution of money, there is a constructive cash distribution. Yet, this tax trap is not widely recognized, not surprisingly since it arises from a constructive cash distribution under Section 752(b) coupled with constructive proportionate distributions under Section 751(b) followed by a constructive sale where there is an actual disproportionate distribution, in this case of constructive cash. Piling technical rule with constructive transactions upon technical rule with constructive transactions, to say the least, is confusing even to the tax sophisticate.15

Indeed, even the courts and commentators frequently appear to have improperly analyzed the interrelationship of Sections 731 and 751. As stated above, Section 731(a) mandates that in the case of a (constructive) cash distribution in excess of basis, any gain will be considered as a gain (or loss) from the sale or exchange or an interest in a partnership as

---

13 Section 732(d), a partnership analogue to Section 334(b)(2), provides that where the partnership has failed to make a section 754 election and a non-cash distribution is made to a partner within 2 years after his interest was transferred to him, he may elect to treat as the partnership's "inside" basis, i.e., the partnership's basis in its assets, the inside basis the partnership would have had if a section 743(b) adjustment had been in effect. The latter provision in effect steps up or down the partnership's inside basis—but only as to the transferee partner—to such partner's outside basis in his partnership interest (determined under section 1011 et seq., I.R.C. §742). See generally, Lawson, Partnership Optional Basis Adjustment Rules, 62 A.B.A.J. 1356 (1976). This constructive proportionate distribution of Hot Assets is subject to any section 732(d) election, according to Treasury Regulation Section 1.751-1(a)(3)(iii).


15 In such circumstances the overlooking of technical rules, such as the availability of Section 732(d), by experts can be understood (although perhaps not forgiven). Compare, Treas. Reg. §1.751-1(a)(2) with Chrissie H. Woodhall, 28 T.C.M. 1438, 1445 (1969), aff'd, 454 F.2d 226 (9th Cir. 1972).
arising from the sale or exchange of a capital asset—the “entity” approach.\textsuperscript{16} However, Section 741 contains an exception where Section 751 applies, which constitutes a manifestation of the “aggregate” approach.\textsuperscript{17} The reference in Section 741 seems to be to Section 751 (a).\textsuperscript{18} Conversely, on its surface, Section 731(c) does not indicate whether it refers to Section 751(a) or 751(b) or both. Yet, which provision applies is significant. For example, if Section 751(a) were the appropriate section, then apparently it would not apply until the distribution was in excess of basis thereby triggering Section 741 and in turn Section 751(a) as an exception to Section 741. Moreover, the partnership would not obtain a stepped up “inside” basis in the Hot Assets, potential recapture in this instance, for the ordinary gain taxed to the distributee partner unless an election were in effect under Section 754 and an adjustment to basis of partnership property could be made under Section 734(b)—arguably since Section 751(a) would be the operative section, the adjustments should be under Section 743(b). Conversely, if Section 751(b) is the appropriate section, then ordinary income arguably can result to the distributee partner even where the distribution of constructive cash is not in excess of basis,\textsuperscript{19} and the partnership in the constructive purchase back of the potential recapture after the restructured proportionate distribution would obtain a stepped up “inside” basis in the potential recapture\textsuperscript{20} so that upon any subsequent sale of the partnership assets there will not be a second tax.\textsuperscript{21} On the one hand, the Tax Court in Francis E. Holman\textsuperscript{22} seems to have reasoned that the exception of Section 731 for Section 751 is speaking to Section 751(a).\textsuperscript{23} On the other hand, the Tax Court in Julian E. Jacobs\textsuperscript{24} just as clearly read the exception in Section 731 (c) as speaking to Section 751(b). The legislative history, as well, appears to support the latter construction.

Senate Report No. 1622,\textsuperscript{25} in describing the effect of Section 731(c), stated that “[i]t will be observed that Section 751(b) provides

\textsuperscript{16} See Note 10, supra.

\textsuperscript{17} See generally, Pusey, supra Note 10 at 156.

\textsuperscript{18} See Treas. Reg. §1.741-1(a) (“[w]here the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange...”).


\textsuperscript{20} See Treas. Reg. §1.751-1(e)(1) (partnership in section 751(b) transaction obtains new cost basis in Hot Assets deemed distributed proportionately to distributee partner and then constructively purchased from him).

\textsuperscript{21} See generally Horwie & Klingman, Strong Potential for Double Taxation Exists When Partner Sells His Interest, 44 J. TAXATION 290 (1976).

\textsuperscript{22} 66 T.C. No. 74 (July 29, 1976).

\textsuperscript{23} “The other exception in Section 731(c)—section 751...” is equally detrimental to petitioners' position. Section 751(a) provides that the amount... attributable to unrealized receivables... “shall be... taxed as ordinary income.” 66 T.C. 809.

\textsuperscript{24} 33 T.C.M. 843, 856 (1974) (“Section 731(c) states, however, that section 731(a) ‘shall not apply to the extent otherwise provided * * * section 751 * * *!’ Section 741 (b) provides...’”)

\textsuperscript{25} 83d Cong. 2d Sess. (1954).
for the recognition of ordinary income to the distributee to the extent that money or property is received from the partnership in exchange for his interest in the unrealized receivable or inventory items in the partnership. Consequently, under the construction of Sections 731(a) and 751(b) as applying to constructive cash distributions, any constructive cash distribution must first be tested under Section 751(b) before it will be treated as gain from the sale or exchange to the extent in excess of basis under Section 731(a). In short, any part of the constructive cash distribution which is not regarded as having been received for Section 751(c) property under Section 751(b) (and hence sold back to the partnership) will be subject to Section 731. Any such excess distribution will be capital gain under Section 731 to the extent it exceeds the partner's adjusted basis remaining after the allocation of basis to the Section 751(b) transaction, if any, and if the constructive distribution is part of a liquidating distribution in which nothing but cash, unrealized receivable and/or inventory items are distributed, any loss resulting from an allocation of Section 751 property will be a capital loss.26

3. When Do Constructive Cash Distributions Occur?

Constructive cash distributions arise in the following circumstances: a change in the partnership profit and loss ratio by an internal shift or admission of a new partner; a partner's withdrawal from the partnership or his abandonment of his partnership interest; gift of a partnership interest to a charity or to a relative; contribution of encumbered property to a partnership; termination of the partnership by a more than 50% change in profit or loss and capital within a 12 month period; forgiveness of partnership indebtedness or foreclosure of partnership property; and where encumbered partnership properties are sold. The following discussion analyzes these types of transactions.

(a) Change in Partnership Profits and Loss Ratio—Treasury Regulation Section 1.752-1(e) provides that a partner's share of partnership liabilities for purposes of Section 752 is determined in accordance with his ratio of sharing losses under the partnership, and that a limited partner's share of the partnership liabilities for this purpose will not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. In fact, this is but the correlative of the rule that the partner's share of liabilities is determined in accordance with his ratio for sharing losses. While the "loss ratio" of the partnership may allocate losses to limited part-

26 The reading of sections 731(c) and 731(e) as calling for 751(b) applying prior to section 741 rather than section 751(a) after section 741 is supported by the legislative history of section 731(a): "Gain or loss recognized under subsection [731] (a) will be treated as gain or loss from the sale or exchange of the distributee's partnership interest, that is, capital gain or loss." S.Rep. No. 1622, 83d Cong. 2d Sess. (1954).
ners, in fact, under the Uniform Limited Partnership Act a limited partner is liable to creditors for partnership liabilities only to the extent of the difference between the contribution actually credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement (and the certificate of partnership filed on public record). Conversely, where none of the partners have any personal liability as to the partnership liability (such as a nonrecourse partnership liability) then all of the partners, including limited partners, are considered as sharing such liabilities under Section 752(c), which provides that a liability to which property is subject shall to the extent of the fair market value be considered as a liability of the owners of the property in the same proportion as they share in profits. This rule does not appear to be restricted to limited partnerships, but would appear to extend to a general partnership in which liabilities were nonrecourse. The rationale of the nonrecourse liability rule is that these liabilities will be paid, if at all, out of the profits earned by the partnership, or will be satisfied by foreclosure on the partnership property which will reduce all partners’ future profits, and accordingly such liabilities should be allocated in the profit sharing ratio. It should be noted that this is a mechanical rule and that the actual potential sharing of liabilities by the partners, such as would arise from a guarantee by limited partners of recourse liabilities, does not give rise to basis. An open question is whether the total contribution which a limited partner is required to make under the limited partnership agreement includes a contingent liability, for example, a liability to contribute to the partnership triggered by a failure of the partnership to meet payments under a recourse liability. It should be noted that the question of “sharing” liabilities for basis purposes is different than personal liability under the new “at risk” provisions.

Regardless of whether the liabilities are recourse or nonrecourse, a decrease in a partner’s profits and loss ratio will result in a constructive cash distribution to him in proportion to his decrease in the profits and loss ratio. Such a decrease can occur when a new partner is admitted to the partnership or where there is an intra-partnership shift in the profits and loss ratio, such as a “flip-flop”, e.g., the limiteds’ share of profits and losses shifts from 95% to 50%.

28 See McKee, supra at 8-9.
29 Comment, Adjustment to Partner’s Basis Caused by Partnership Liabilities: Internal Revenue Code Section 752 in Action, 10 St. Louis L.J. 261, 264 (1965).
31 See Long, Tax Shelter in Real Estate Partnership: An Analysis of Tax Hazards That Still Exist, 36 J. TAXATION 312, 314 (1972); Staff of the Joint Committee on Internal Revenue Taxation, Tax Shelters 83 (1976).
32 Under section 465 and section 704(d) a limited partners may use amounts “at risk” due to guarantees of recourse liabilities that will not increase basis. See S.Rep. No. 94-938, 94th Cong. 2d Sess. (1976).
The old ploy of splitting the profits and loss ratio so that the profit ratio remains constant at some fixed percent while the loss ratio shifts from 95% to 50% at the crossover point in order to avoid constructive cash distributions through shifts in profit ratios where the partnership has nonrecourse liabilities may no longer be available after the Tax Reform Act of 1976. It would appear that Section 210(d) of the Act, amending Code Section 704(b), is broad enough to encompass a general allocation of losses and a general allocation of profits.33

Many commentators have pointed out the danger of constructive cash distributions in excess of basis when a new partner is admitted if the existing partners have substantial deficits in their capital account and in particular when there is a flip-flop.34 But, few commentators have focused on the possibility of a Section 751(b) disproportionate distribution where there is an internal shift in the profit and loss ratio or admission of a new partner.35

The appropriate Section 751(b) question is not whether there should be a distinction between actual money distributions and constructive cash distributions in application of Section 751(b),36 but rather whether there is a distinction between liquidating distributions and nonliquidating distributions.37 Treasury Regulation Section 1.751-1(g) Example (5) applies Section 751(b) to a current distribution. There a partner agreed to reduce his interest in capital and profits from 33-1/3% to 20% in exchange for a current distribution of cash and accounts receivable. At the same time his share of partnership liabilities was also reduced from 33-1/3% to 20%. The example treated the reduction in liabilities as an additional distribution of money in excess of the partner's pro rata share of the partnership cash for purposes of applying Section 751(b). A leading commentator on Subchapter K has pointed out that where a partner's interest in profits and losses is reduced, for example, from 50% to 25%, in a partnership with $12,000 in unrealized receivables and $2,000 in liabilities, his interest in Hot Assets also is reduced from $6,000 to $3,000 and under Section 752 he receives a constructive cash distribution of $500. The commentator argued that absent the reduction the partner would have been taxed on 50% of the partnership income used to pay the nondeductible partnership liabilities of $2,000 without the receipt of cash, and that with his reduction to a 25% interest in partnership prof-

33 Id. at 99-100.
35 For exceptions (See Aronsohn, Admission of a New Partner for Cash, Property or Service, 23 Tax Lawyer 325, 337 Example II(b) (1970); Bloom, Making the Deal and Creating the Partnership, 35 (PLRJA 2488 1973); Parker & Lee, Constructive Cash Distributions in a Partnership: How and When They Occur, 41 J. Tax. 88, 93 (1974).
36 Parker & Lee, supra, at 93.
its and losses, he would be taxed only on $500 of the partnership income used to pay the same liability, the reduced partner could properly by viewed as realizing under Section 751(b) the $500 constructive cash distribution as in "anticipation of that portion of the receivables that will be used to satisfy part of his [formerly 50%] share of the liability."38

The application of Section 751(b) to a constructive cash distribution arising from a reduction in a partner's profit and loss ratio coupled with a reduction in his share of the partnership's Hot Assets will extend far beyond the tax shelter interpartner shifts in profit and loss ratio, e.g., flip-flop, or admission of new partners in tax shelter syndications. The same result could obtain in a law or accounting partnership upon the admission of a new partner if he shares in accounts receivable or in income from services performed but not billed prior to his admission as long as he also becomes responsible for a portion of the partnership liabilities.

A possible solution to the constructive cash distribution—Section 751(b) transaction arising from the admission of a new partner or upon an interpartnership shift in profits and losses is to provide for a special allocation under Section 704 to the old partner of his share of the preadmission or pre-shift Hot Assets, particularly potential partnership recapture.39 If a partner is going to continue to be liable for his former share of Hot Asset gain, then it is difficult to say that there has been a relinquishment of a portion of his share of unrealized receivables or Hot Assets in exchange for non-Hot Assets.

(b) Abandonment of Partnership Interest or Withdrawal from Partnership. Where no unrealized receivables or inventory items (or goodwill) are involved and a withdrawing partner has been paid his distributive share of partnership income, Revenue Ruling 74-40 confirms that liabilities in excess of basis of the withdrawing partner give rise to gain realized and recognized under Section 731(a). The starting point is that the decrease in liabilities arising from a partner withdrawing from a partnership does give rise to a constructive cash distribution under Section 752(b). Section 731(c) provides that Section 731 does not apply to the extent otherwise provided by Section 736 relating to payments to a retiring partner or to a deceased partner's successor in interest. However, Section 736(b) in turn provides that payments made in liquidation of the interest of a retiring or deceased partner ("Section 736(b) distributions") are considered as a distribution by the partnership to the extent otherwise provided by Section 736 relating to payments to a retiring partner or to a deceased partner's successor in interest. However, Section 736(b)

38 Cowan, Unpublished Manuscript on Section 752.
in turn provides that payments made in liquidation of the interest of a retiring or deceased partner ("Section 736(b) distributions") are considered as a distribution by the partnership to the extent that such payments are made in exchange for a withdrawing partner's interest in partnership property. Treasury Regulation Section 1.736-1(b)(1) agrees that Section 736(b) distributions are recognized by the distributee partner to the extent provided in Section 731. Accordingly, the constructive cash distribution that arises from a partner withdrawing from a partnership constitutes a capital gain under Section 731(a) to the extent in excess of basis, provided that the constructive cash distribution is made in exchange for the partner's interest in the partnership property and does not constitute a distributive share of partnership income or guaranteed payment and is not attributable to Hot Assets.

Where a partner withdraws from a partnership with a deficit in his capital account and the withdrawal is structured as a sale of the withdrawing partner's partnership interest to his remaining partner or partners in consideration of release from liability for repayment of the deficit (and possibly other consideration), the authorities conflict as to the proper treatment of the transaction. In Revenue Ruling 57-31841 the Service concluded that an earlier withdrawal of capital from a partnership under an obligation to repay it did not constitute, at the time of withdrawal, a distribution subject to Section 731 but instead the withdrawal constituted a loan governed by Section 707(a). Accordingly, when the obligation was cancelled at the time of the sale of the partnership interest, the debtor-withdrawing partner was considered to have then received a distribution of the money at the time of the cancellation taxable under Section 731(a)—there were no Hot Assets. On the other hand, in Arthur F. Fixel,42 a withdrawing partner with a substantial deficit in his capital account (whether from withdrawals or losses is not apparent) exchanged and conveyed his share of the partnership's assets to his equal partner in exchange for the latter's agreement to assume the withdrawing partner's share of the partnership liabilities. The withdrawing partner received no cash in connection with the exchange, nor were any partnership assets distributed to him. The taxpayer argued that Sections 741 and 752 were qualified by Section 61 so that his gain from the other partner's assumption of his share of partnership liabilities was limited to the amount of his solvency on the day on which the other partners assumed the partner's shift in liabilities.43 The Tax Court found that the taxpayer failed to show that he was insolvent, but in any event it analyzed the transaction as one in which Section 741 applied so that Section 752(d), which treats a liability in a sale or exchange as being subject directly to the Crane rule, as discussed above, and not Section 752(b) was the applicable provision.

While the result in the case and ruling cited apparently would not change as to the withdrawing partner regardless of whether Section 731 or Section 741 were the applicable provision, in a continuing partnership a significant difference could arise. If the cancellation of the deficit in the capital account, which appears to have happened in both instances, is treated as a Section 731 distribution and a Section 754 election is in effect, then the partnership will make an adjustment to undistributed property pursuant to Section 734(b) which will benefit all of the remaining partners. On the other hand, if the transaction is treated as a 741 sale to one or more of the remaining partners when a Section 754 election is in effect, then the adjustment under Section 743(b) applies only as to the transferee partner. Thus, subsequent partners would not receive benefits from such adjustment. Furthermore, if the author's analysis of Section 731(c) as relating only to Section 751(b) is correct, then in the event that the cancelled deficit in the capital account is treated as a distribution and there are Hot Assets, the applicable provision would be Section 751(b) which affects the partnership by stepping up its basis in the "repurchased" Hot Assets. On the other hand, if the transaction is treated as a Section 741 sale or exchange, then the applicable provision as to Hot Assets would be Section 751(a), which would result in adjustments by the partnership only if there were a Section 754 election in effect and under Section 743(b) would have an effect only as to the transferee partner.

In short, significantly different tax consequences attach according to whether a partner's withdrawal constitutes a sale or a liquidation of his interest. In somewhat dissimilar as well as similar circumstances the Tax Court has held that whether a sale or liquidation occurs, even in a two man partnership, is determined by the intent of the parties. If the transaction is intended to be a liquidation, then the result (if there are no Hot Assets) where a partner's share of partnership liabilities are "assumed" by the partnership or the other partner is a constructive cash distribution equal to the amount assumed under Section 752 and if in exchange for the partner's interest in the partnership, a capital gain to the extent in excess of his basis in that interest under Section 736(b) and Section 731(a). To the extent that there is a loss, it is capital.

Taxpayers have argued, however, that abandonment of a partnership interest gives rise to an ordinary loss under Section 165, based upon two leading pre-1954 Code cases: Palmer Hutcheson and Gaius G. Gannon. These cases, however probably are inapplicable

---

44 See generally Lawson, supra.
45 David Foxman, 41 T.C. 535 (1964), aff'd, 352 F.2d 466 (3rd Cir. 1965).
47 Id.
48 17 T.C. 14 (1951).
49 16 T.C. 1134 (1951).
under subchapter K and certainly are inapplicable whenever partner-
ship liabilities are involved so that constructive cash distributions
arise upon the liquidation of a partnership interest.\textsuperscript{50}

(c) Gift. Some commentators had suggested that the deficit in the
capital account problems in real estate tax shelters that have become
"profitable" or crossed over could be avoided by making a gift of the
partnership interest to a tax-exempt organization or to a lower brac-
et taxpayer.\textsuperscript{51} But the Service in Revenue Ruling 75-194\textsuperscript{52} con-
cluded that where a limited partner with an adjusted basis in his part-
nership interest less than his proportionate share in partnership lia-
bilities made a contribution of his interest in the limited partnership
to a charitable organization, the entire transaction constituted a "bar-
gain sale" by the limited partner to the charity. The ruling reasoned
that (i) Section 752(d) provided that where there is a sale or exchange
of an interest in a partnership, liabilities are to be treated in the same
manner as liabilities in connection with a sale or exchange not asso-
ciated with partnerships would be treated, \textit{i.e.}, the \textit{Crane} rule applies
directly, and that (ii) under Section 1011(b) if property is transferred
to a charitable organization subject to an indebtedness, the amount
of the indebtedness must be treated as an amount realized for pur-
poses of determining whether there is a sale or exchange to which
Section 1011(b) applies, even though the transferee does not agree to
assume or pay the indebtedness. The ruling utilized Section 741, and
presumably where there were Hot Assets would use Section 751(a).

The ruling, however, rests on a bootstrap premise. Section 752(d)
treats partnership liabilities in the same manner as if there were a
sale or exchange of property not associated with a partnership, \textit{i.e.},
as if the liabilities were outside the partnership, only where there is
a sale or exchange of an interest in the partnership. Yet, it is the lia-
bilities themselves that give rise to the "bargain sale" aspect in a
contribution to a charitable organization. Thus, the bargain sale de-
PENDS upon the partnership liabilities being treated as though there
were no partnership, and yet such treatment as if there were no part-
nership is itself dependent upon there being a "sale" of the partner-
ship interest. If a gift does not constitute a sale or exchange by itself,
the entire edifice built by the Service in Revenue Ruling 75-194 col-
lapses of its own weight.

Additionally, the Sixth Circuit in \textit{Johnson v. Commissioner}\textsuperscript{53} ex-
pressed dissatisfaction with an analogous part-gift part-sale analysis

\begin{itemize}
\item \textsuperscript{50} Rodman v. Commissioner, 76-2 U.S.T.C. \textsection{} 9710 (2d Cir. September 17, 1976); Edward F. Neubecker, 65 T.C. No. 51 (Dec. 18, 1965); Edward H. Peitz, 59 T.C. 207, 219 (1972); Andrew O. Stillwell, 46 T.C. 247, 251-52 (1966).
\item \textsuperscript{52} 1975-1 Cum. Bull. 80.
\item \textsuperscript{53} 495 F.2d 1079 (6th Cir. 1974), \textit{cert. denied}, 419 U.S. 1040 (1974).
\end{itemize}
in a similar context and instead treated a gift of incumbered property, with liabilities in excess of basis, as giving rise to income under a "shedding of debt" analysis based on analogy to Crane. Such analysis in turn is also analogous to the constructive cash distributions under Section 752(b), which may trigger income under either Sections 731 or 751(b). It is submitted that a gift of a partnership interest where there are partnership liabilities involved should be treated as a constructive cash distribution under Section 752(b) and not as a bargain sale Section 752(d) situation. Not only are there different consequences vis-a-vis inside partnership basis where there are Hot Assets, and hence Section 751(b) applies, but in addition such approach presents a more accurate result even where the donor partner does not have a deficit in his capital account. In such circumstances under a part-gift part-sale analysis, if the gift is not to a charitable organization, allocation of the donor-seller's entire basis to the sales portion under Treasury Regulation Section 1.1001-1(e)(1) and other authorities would result in an ordinary gain equal to Hot Assets and a capital loss of an equal amount.

On the other hand, if there is potential recapture involved, under Section 751(b) there would be ordinary gain to the donor; but no capital loss, rather the donee would have a greater basis as to the gift element. It must be admitted, however, that where there are no Hot Assets so that Section 751(b) would not apply, the bargain sale approach is more apt in a contribution of a partnership interest with "excess" liabilities to a charitable organization to result in taxable gain to the donor partner than the constructive cash distribution analysis. This is because in a bargain sale, basis is allocated between the sale and gift portions under Section 1011(b), while under a constructive cash distribution (where there is no Section 751(b) problem) gain arises only when the constructive cash distribution is in excess of the partner's entire basis in his partnership interest. In short, the effect under a constructive cash distribution approach where there are no Hot Assets present, is the same as allocating basis first entirely to the sale portion.

(d) Contribution of Encumbered Property to a Partnership by a Partner. Section 721 flatly states that no gain or loss will be recognized to a partnership or to any other partner upon a contribution of property to the partnership in exchange for an interest in the partnership. There is no partnership statutory analogue to Section 357 which provides that, as a general rule, assumption of liabilities in a transfer under Section 351 (as well as other corporate sections) will not be treated as money or other property, with one exception being where the liabilities are in excess of basis. The regulations under

54 495 F.2d 1083.
55 See also Malone v. United States, 326 F.Supp. 106 (D.Miss. 1971), aff'd per curiam, 455 F.2d 502 (5th Cir. 1972).
Section 721, however, provide that where the transfer of property by
the partner to the partnership results in the receipt by the partner of
other consideration, i.e., boot, the transaction will be treated (in part)
as a sale or exchange under Section 707, rather than as a contribution
under Section 721. When it is recalled that Section 357 was enacted
to overturn the Supreme Court's 1938 decision in United States v. 
Hendler, which held that the assumption of liabilities upon incor-
poration constituted boot, one might expect to see that the transfer of
encumbered property to a partnership would result in recognition not
as a constructive cash distribution but as a sale or exchange with boot
under Section 707. However, that is not the case. Rather, the regula-
tions under Section 1.721-1(a) refer to Section 752 for the rules gov-
erning the treatment of liabilities to which contributed property is
subject. Reading together Treasury Regulation Sections 1.752-1(b)(2)
and 1.752-1(c), the rules where property is contributed subject to a
liability are as follows:

The amount of the liability in excess of the contributing partner's
share under the partnership agreement for such liability (as deter-
mined under Treasury Regulation Section 1.752-1(e)) constitutes a
constructive cash distribution. To the extent that the constructive cash
distribution is in excess of the contributing partner's basis in his part-
nership interest (which under Section 723 is the same as the basis of
the property contributed by the partner to the partnership), the dis-
tribution is taxable under Section 731(a), assuming that no potential
recapture exists as to the property.

Treasury Regulation Section 1.1245-4(c)(4) Example 3 considers
the tax consequences of a contribution of encumbered Section 1245
property with potential depreciation recapture to a partnership. Code
Section 1245(b)(3) states that if the basis of property in the hands of
a transferee is determined under the transferred basis rules of Sec-
tion 722, then the amount of gain taken into account by the transferor
under the recapture provision is not to exceed the amount of gain
recognized to the transferor on the transfer of the property deter-
mined without regard to Section 1245(b). Therefore, the regulation
concludes that Section 1245(b)(3) limits the recapture gain to be taken
into account to the amount of gain taxable under 731(a) determined
without regard to Section 1245. Note, that there is no indication that
Section 751(b) applies to such transaction.

(e) Termination of Partnership by Reason of 50% Change in Profits
and Losses. Section 708(b)(1)(B) provides that a partnership will be
deemed to have terminated if within a 12-month period there is a sale
or exchange of 50% or more of the total interest in partnership capital
and profits. In turn Treasury Regulation Section 1.708-1(b)(1)(iv)
states that if a partnership is terminated by a sale or exchange of an

57 Treas. Reg. § 1.721-1(a).
58 303 U.S. 564 (1938).
59 Lewis, Handling Problems of Mergers and Acquisitions of Partnerships, Account-
interest the following is deemed to occur: the old partnership distributes its properties to the purchaser and to the other remaining partners in proportion to their respective interests in the partnership properties, and immediately thereafter the purchaser and the other remaining partners contribute their properties to a new partnership. This entire transaction may be dubbed a "liquidation-recontribution".

Those continuing partners in the new partnership generally will recognize no adverse income tax consequences from the liquidation-recontribution alone. On the "liquidation", the continuing partners' shares of old partnership liabilities would decrease and result in constructive cash contributions, but that decrease simultaneously would be offset by the corresponding increase in their individual liabilities. On the "recontribution" a decrease in the continuing partners' individual liabilities would be offset by an increase in their share of the partnership liabilities of the new continuing partnership. Treasury Regulation Section 1.752-1(a)(2) provides that upon distribution of a partnership assets subject to liabilities, a partner's outside basis in his partnership interest is decreased by the partnership's inside basis in the distributed property and by the decrease in the partner's share of the partnership liabilities. However, the regulation continues under Section 752(a) the distributee partner's outside basis in his partnership interest would be increased by the increase in his individual liabilities by reason of Section 752(c), i.e., the rule that a liability is taken subject to is treated as a liability assumed by a partner. In short, the constructive cash distribution upon the old partnership liquidating and having no liabilities is simultaneously offset by the distributee partners' increase in basis due to their own individual liabilities increasing by the liabilities to which the partnership is no longer obligated. On the "recontribution" to the new partnership the decrease in the contributing partners' individual liabilities by reason of the new partnership taking the assets subject to such liabilities and thereby creating a constructive cash distribution is offset by a corresponding increase in their share of the liabilities of the new partnership arising from its taking the property subject to the liabilities.

The adverse tax consequences of a termination are that the new partnership will be a second user for purposes of accelerated depreciation under Treasury Regulation Section 1.167(a)-1(a)(6). Furthermore, if the new partners who purchased the 50% plus interest, thereby causing the termination of the old partnership, paid a premium for the partnership interest of the departing partners, they would have a greater basis in their partnership interest than the departing partners. Accordingly, when under the liquidation provision their outside basis in their partnership interest is transferred to the liquidating distributions and the distributed assets are recontributed to the

60 Parker and Lee, supra, at 89.
61 See Treas. Reg. §1.752-1(b)(2).
62 I.R.C. §742.
second new partnership, it would have a stepped-up inside basis in the assets transferred to it. Unless a special allocation under Section 704(c)(2) were made, all partners in the new partnership would share in this stepped-up basis. Note that in the deemed liquidation of the old partnership, deficits in the capital accounts of the remaining partners will not be recognized. Furthermore, their share of accelerated depreciation will not be recognized upon the liquidation since this is not a disproportionate distribution and since Section 1245 and Section 1250 do not apply to such nonrecognition transactions.

(f) Forgiveness of Partnership Indebtedness and Foreclosure on Partnership Property. Section 752(b) provides that any decrease in a partner's share of partnership liabilities is considered a distribution of money by the partnership to the partner. Accordingly, wherever partnership liabilities are forgiven, a partner is apt to argue that the attendant decrease in liabilities results at most in a constructive cash distribution to him, taxable under Section 731(a) (assuming no unrealized receivables) only to the extent in excess of his basis in his partnership interest (and only to the extent he is solvent thereafter). Conversely, the Commissioner is apt to argue that a forgiveness of indebtedness of the partnership results in ordinary income to the partner, subject only to the exception that if he is insolvent before the forgiveness, the forgiveness results in income only to the extent that he was rendered solvent by it.

In Stackhouse v. United States, the partners argued that the cancellation of indebtedness should not give rise to income under Section 61 except to the extent that the money distributed exceeded the adjusted basis of their interest in the partnership immediately before the distribution as required by Section 731(a). The district court ruled that the partners' reliance under Section 731(a) was misplaced because there was no distribution of partnership assets or of proceeds from the sale or exchange of the partnership assets to a partner. The district court was wrong in that conclusion—it overlooked the constructive cash distribution.

But the Fifth Circuit in catching that error missed the forest. It proceeded to analyze how constructive cash distributions arising from a decrease in a partners' share of outstanding liabilities generated a constructive cash distribution, but only to the extent in excess of basis. The Government equally missed the forest by arguing that cancellation of indebtedness under Code Section 61(a)(12) controlled and that the partnership provisions of subchapter K were inapplicable. "In its view those provisions deal solely with the rights and liabilities of the partners among themselves and do not affect the taxpayer's realization of taxable income from the discharge of their indebtedness to a third party. In particular §731 does not apply because there

---

63 See I.R.C. §§ 732(b) and 723.  
64 I.R.C. §1250(d)(3) and Treas. Regs. §1.1250-3(c)(2)(vii).  
65 Treas. Regs. §1.61-12(b)(1).  
is no distribution of any partnership assets to a partner or sale or exchange of partnership assets with the resulting distribution of the proceeds to the partners.\textsuperscript{67} Presented with the narrow argument of the Government the Fifth Circuit properly read Section 752 and the regulations thereunder as providing for constructive cash distributions and properly concluded that a reduction in the partnership liabilities resulted in a constructive cash distribution. Therefore, it concluded that it necessarily followed that the gain to be recognized to the partners from the forgiveness of indebtedness should be calculated in accordance with the terms of Section 731(a).

The Fifth Circuit attempted to soften its adverse holding as to the Government by pointing out that after the constructive cash distribution, in computation of gain, the adjusted basis of each partner's interest in the partnership would have to be reduced by the amount of the distribution. Upon the eventual liquidation of the partnership and the distribution of the assets, the \textit{Stackhouse} review court reasoned, the taxpayers would probably realize further gain by reason of the indebtedness, so that gain would be recognized at that time. This analysis also appears in error since generally speaking proportionate distributions in a liquidation are tax free and the partner applies his basis in his partnership interest to the distributed assets. (There are exceptions where unrealized receivables are involved and where payments are for something other than the partner's interest in the partnership.)\textsuperscript{68}

The Government should have argued in \textit{Stackhouse} that cancellation of indebtedness did give rise to income under Section 61 at the partnership level to the extent that the partnership was rendered solvent, and that such "income" increased the basis of the partner's interests in the partnership under Section 705(a)(1)(A)\textsuperscript{69}—arguably the increase in basis is equal to the entire amount of cancelled debt.\textsuperscript{70} The constructive cash distribution at the end of the tax year by reason of the cancellation of debt would result in a decrease in basis equal to the increase from the cancellation of indebtedness income. The net result would be that the partners would recognize ordinary income as to their distributive share of the cancellation of indebtedness income under Section 704 and the constructive cash distribution probably would not exceed basis. While such approach appears the proper

\textsuperscript{67} Stackhouse v. United States, 411 F.2d 465, 468 (5th Cir. 1971).

\textsuperscript{68} I.R.C. §736(b) and 732(b).


\textsuperscript{70} Under Code Section 705(a)(1)(B) a partner's adjusted basis in his partnership interest is also increased by the income of the partnership exempt from taxation. It is arguable that cancellation of indebtedness income that is not recognized to the extent the taxpayer is not rendered solvent falls within this definition. In somewhat analogous situation earnings and profits are increased by the full amount of cancelled debt even though there is no income tax to the debtor.
one, it was not adopted by the Fifth Circuit in *Stackhouse*; nor did the Service in Revenue Ruling 71-301, which considered the effect of forgiveness of indebtedness in a partnership context, adopt such an analysis. Rather the ruling considered the situation in which the cancellation of indebtedness did not render either the partnership or the partners solvent, but the decrease in liabilities resulted in a constructive cash distribution in excess of basis. The ruling considered the question solely from the stance of the partnership provisions and held that no gain was recognized to the partners notwithstanding the fact that the constructive cash distribution arising from the cancellation of indebtedness exceeded the adjusted basis of their partnership interests immediately before the distribution, “since the discharge in bankruptcy did not make the partner or the partnership solvent.” It would appear that Revenue Ruling 71-301, which was promulgated after *Stackhouse*, constitutes a subrosa acquiescence by the Service in the reasoning of *Stackhouse*.

This appearance is, however, belied by Revenue Ruling 72-205 where the Service, in ruling that a partnership could exclude under Section 108 income realized from the discharge of indebtedness by consenting to the Section 1017 basis adjustments, held further that the discharge of partnership debt was deemed under Section 752 a distribution of money to the partners by the partnership.

One taxpayer has ingenuously argued that where a partner assigns and conveys his share of the partnership assets to another partner in exchange for the latter’s right to assume the former’s share of partnership liabilities, that Sections 741 and 752 are qualified by the general provisions of Section 61 so that the gain from the assumption of liabilities, here under Section 752(d), is limited to the amount of solvency on the date of the assumption. The Tax Court did not find it necessary to decide whether a partner’s gain under Sections 741 and 752 was implicitly limited to net worth, without regard to partnership’s liabilities, since the taxpayer failed to meet his burden of proof as to insolvency. Even within the confines of Revenue Ruling 71-301 it is possible that a solvent limited partner will have a Section 731(a) gain to the extent of the Section 752(b) constructive cash distribution in excess of his basis.

The situation in which partnership property is foreclosed with a resultant decrease in partnership liabilities appears on the surface analogous to cancellation of partnership debt with an attendant reduction in partnership liabilities. Following the rationale of *Stackhouse*,

---

71 Hendler, *supra*.
73 But see, Shoptalk, *Reduction of Partnership Liabilities*, 37 J. Tax 136 (August, 1972), which reads Rev. Rul. 71-301 and *Stackhouse* as being in conflict. It may be noted that in Edward H. Pietz, 59 T.C. 207 (1972), the practical effect of the Tax Court’s decision was first to determine gain at the partnership level and then to apply 752(d) and 731, with reference to *Stackhouse* at the partnership level.
it might be argued that the consequence of a foreclosure on partnership property as to partners is determined solely within the confines of Section 752(b) and 731(a) on the grounds that just as in debt cancellation, the essence of foreclosure, at least as to non-recourse mortgages, is a reduction of partnership debt. At the same time, to the extent that a foreclosure resembles a sale or exchange of the partnership assets, it is even clearer that any gain to the partnership as mortgagor on the foreclosure should be determined at the partnership level, followed by the reduction of liabilities consequences at the partner level. In a foreclosure sale, the mortgagor realizes gain or loss in the amount of the difference between the amount of his basis in the mortgaged property and the amount realized by him on the sale. Complications arise, however, where the liability is nonrecourse, if it exceeds the fair market value of the property. Also, where the liability is recourse, commentators differ as to whether the amount realized upon the foreclosure sale is the net proceeds of the sale or the amount of the mortgagee obligation where the mortgagor remains liable for the deficiency, i.e., when the net proceeds of the mortgage sale are less than the amount due on the mortgage.

Where the mortgagor transfers the property in settlement of the mortgage debt, the income tax consequences are even more unsettled. Such a transfer may be characterized as a taxable exchange, cancellation of indebtedness, surrender of burdened property, or adjustment of a purchase money transaction. However, where the mortgagor is insolvent before and after the conveyance in settlement of the debt, the general rule is that he realizes no taxable gain under the general cancellation of indebtedness rule.

To the extent the mortgagor is rendered solvent, there may be a conflict as to whether the income is ordinary from cancellation of indebtedness or capital (under Section 1231) from the sale or exchange aspect arising from the transfer of property and settlement of the debt.

After the determination at the partnership level of the amount of gain to the partners due to the foreclosure, the amount of gain allocated to each partner would increase his basis—generally the amount of the partnership liabilities over the partnership’s inside basis in the

---

78 See authorities cited in Handler, supra at 228-29.
79 Id. at 234.
80 See e.g., Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934). See discussion in Handler, supra at 237, 180 and 228 v143.
81 Compare Treas. Reg. §1.1017(1)(5) with Handler, supra at 245.
foreclosed property plus any cash received. Then, under Sections 752 and 731 (clearly Section 751(b) does not apply since there would be no relinquishment of unrelieved receivables at this point), the partner would have a gain from a constructive cash distribution to the extent in excess of his basis, i.e., his deficit in his capital account. If the partner was still insolvent after the transaction, conceivably, under Revenue Ruling 71-301 the partner would have no income.

(g) Installment Sale of Partnership Property. When a crossover occurs in a tax shelter partnership, limited partners sometimes seek to dispose of their investment through an installment sale. The goal, obviously, is to defer gain on the disposition over a number of years. The alternatives are for the partnership to sell its property or for the partner to sell his interest on the installment basis. Where a partner has a deficit in his capital account at the time that the partnership sells its encumbered principal property, the partner will realize and recognize income in the year of the installment sale equal to the deficit in his capital account, reduced by his share of any undistributed gain from the sale, in addition to his share of gain otherwise recognized on the sale. Such gain is not deferred through the installment sale.

When the encumbered property is sold, the partner’s share of partnership liabilities is reduced, thereby resulting in a constructive cash distribution. Due to the deficit in his capital account, the distribution is in excess of his basis. There may exist in such an installment sale by the partnership undistributed partnership gain. For in the installment sale, any excess of partnership liabilities, at least in the form of a mortgage, over the partnership’s inside basis in the real property sold is treated as a payment received by the partnership in the year of sale. Thus, such excess of partnership liabilities over inside basis creates a no cash gain to the partner which increases his basis, thereby reducing the deficit in his capital account and the amount of the distribution that is in excess of his tax basis in his partnership interest.

If a partner instead sells his partnership interest and receives periodic payments, the initial question is whether as a practical matter installment reporting will be available for his share of partnership liabilities (even if not in excess of his basis and interest) exceeds 30% of the sales price. A leading partnership commentator, pointing out that Treasury Regulation Section 1.453-4(c) speaks only to “mortgage” assumption and that a partnership interest in personal property with its attendant liabilities is treated in a sale or exchange as not associated with a partnership, reads the leading cases as conflicting as to whether the mortgage assumption of liability rule would

82 Id. at 252.
84 Reporting of gain on sales of realty and casual sales of personally on the installment basis is not available if the payments in the year of sale exceed 30% of the selling price. I.R.C.§453(b)(2)(ii).
apply to a sale of a partnership interest. The commentator clearly implies that the Tax Court would treat any assumption by the buyer of non-mortgage liabilities as payment in the year of sale for purposes of the 30% test. In fact, however, the Tax Court in J. Carl Horneff expressly delineated its conclusion that in the non-mortgage situation, it was only the payment of the seller's liabilities in the year of sale and not the assumption itself that should be treated as a payment in the year of sale. It is unclear whether the Tax Court would treat assumed non-mortgage liabilities, which were in excess of basis but not paid in the year of sale, as year of sale payments. However, the Service since has conceded in Revenue Ruling Section 73-555 that in non-mortgage situations secured and unsecured liabilities assumed and paid by the purchaser in the year of sale do not constitute payments for purposes of determining whether the transaction meets the 30% test, except where "the total of all liabilities assumed exceed the basis of the property." Therefore, if the partner sells his partnership interest and elects to report on the installment basis, when his share of partnership liabilities is in excess of his basis, such excess will constitute gain in the year of sale for reporting purposes and for purposes of the 30% test. The Service recently held in Revenue Ruling 76-483 that in an installment sale of a partnership interest, the purchaser's assumption of partnership liabilities is treated as part of the amount realized by the selling partner and as part of the selling price. It also indicated that only the excess of partnership liabilities over the selling partner's share of his basis in his partnership interest would be considered in determining the payments and total contract price under Section 453. It may be assumed, therefore, that whether the partner sells his interest and elects the installment method of reporting or the partnership sells its property and elects the installment method, the amount of gain and the timing of its recognition will be the same.

The timing of recognition of the types of income (recapture vs. capital gain) may vary, however, according to whether the partnership interest or partnership assets are sold in the installment sale. When the partnership sells its assets on the installment method the rule that installment payments to the extent of the gain portion will all be taxed as ordinary income until all the recapture has been reported, i.e., recapture comes off the top, would only apply as to the profit at the partnership level. The constructive cash distribution portion of the gain would be capital gain, since there would be no

---

85 2 Willis, Partnership Taxation §70.04 (2d ed. 1976) (comparing United States v. Marshall, 357 F.2d 294 (9th Cir. 1966) and Irwin v. Commissioner, 350 F.2d 91 (5th Cir. 1968) with J. Carl Horneff, 50 T.C. 63 (1968).
86 50 T.C. 63, 74 (1968).
88 Treas. Reg. §§1.1245-6(d)(1) and 1.1250-1(c)(6); Dunn Constrin Co. v. United States, 323 F.Supp. 440 (D.Ala. 1971).
TAX CONFERENCE

disproportionate distribution—the partner would not be relinquishing his share of Hot Assets attributable to potential partnership recapture. Where, however, the partnership interest itself is sold on the installment basis and there are Hot Assets consisting of potential partnership recapture, the Service in Revenue Ruling 75-3239 took the position that the income portion of the downpayment and each installment must be allocated among the taxpayer's potential partnership recapture and his interest (in the facts of the ruling) in the partnership non-Section 1245 property.

However, to the extent the gain allocable to Section 1245 property exceeded the potential partnership 1245 recapture, "such excess should be deemed to be 'potential section 1245 income' until all the potential section 1245 income is reported." Assuming that virtually all of the partners gain will be attributable to partnership Section 1245 and 1250 property, the effect of the ruling is to make virtually all of the payments ordinary until all of the Hot Assets gain is reported.

Section 751 constitutes a limited exception to the "entity" approach to partnership taxation. Following the mechanical approach of Section 751(c) and its regulations,90 the potential recapture is treated as a separate asset. The approach of Revenue Ruling 75- is to look through the rest of the partnership interest, which is otherwise treated as a separate sale of a capital asset (the "entity" approach) under Section 741. The ruling therefore, conflicts with the approach of Sections 741 and 751. While the suggested approach would delay the recognition of the recapture as contrasted with a sale by the partnership of Section 1245 and 1250 property, this is not inconsistent with the entity approach.

90 See Treas. Reg. §§1.751-1(a)(1) and (a); 1.751-1(c)(4)(ii).