Reforming Subchapter K: Contributions and Distributions

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I. INTRODUCTION

The ability to transfer assets to and from a partnership without recognition of gain or loss by partners or the partnership is one of the greatest attractions of subchapter K. It is also the source of many of the problems that bedevil the area. Nonrecognition of gain or loss on contributions and distributions sometimes makes it possible to shift gain and loss on assets and to exchange assets tax free among partners.

Many of the more complex provisions in subchapter K deal with the resulting problems. Some are recent additions to subchapter K. In 1984, Congress amended § 704(c) amended to make mandatory what had been a permissive election to allocate to a partner who contributes a gain or loss asset the precontribution gain or loss on disposition of the asset by the partnership.1 The § 704(b) regulations, issued in proposed form in 1983,2 try to prevent gain or loss shifting when an interest in partnership assets with built-in gain or loss is altered because of a contribution or distribution.3 In 1984, Congress enacted § 707(a)(2)(B) enacted to codify a long-standing principle that contributions and distributions that are in effect sales or exchanges be taxed as such.4 Lengthy regulations to implement part of this statute were recently issued.5 And in 1989, Congress amended § 704(c) to recognize precontribution gain or loss on certain asset distributions.6 These changes supplement older provisions addressing related problems. By treating some distributions as deemed exchanges of assets, § 751(b) ensures that the character of gain or loss as ordinary is preserved when distributions alter a partner’s interests in ordinary and capital assets. Section 734(b) offers elective basis adjustments

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3 See notes 40-42 and accompanying text.
5 Reg. § 1.707-3 to -9.
so that partners can avoid certain anomalous consequences that may result when the basis of an asset changes in a distribution, or when gain or loss is recognized on a distribution.

Further reforms in this area can be expected. Recently enacted legislation would tax precontribution gain on certain asset distributions when the value of the assets distributed exceeds a partner's basis in his interest.7 Elsewhere in this issue, Professor William Andrews proposes other incremental reforms.8 He would make the § 734(b) basis adjustments mandatory and would deny nonrecognition treatment to certain asset distributions, such as distributions of publicly traded stock.

These efforts to limit the problems that result from the general nonrecognition rules have greatly complicated subchapter K without satisfactorily solving the problems they are meant to address. These measures are incomplete, taken alone or together, and some, particularly the disguised sale rule in § 707(a)(2)(B), are of uncertain effect. Little thought has been given to how these various rules may interact. If writing on a clean slate, no rational person would create anything like the current system governing contributions and distributions.

This article proposes a more coherent system that accomplishes what I consider to be the proper objectives of nonrecognition on partnership contributions and distributions while avoiding the problems of the current system. The proper objectives are to ensure that partnership earnings are taxed only once and to limit the strong disincentive to doing business in partnership form that would result if small shifts in economic interests in partnership assets resulted in recognition of all gain in those assets. I propose that, on distributions that are not out of their share of profits or their share of the proceeds of partnership borrowings, partners recognize gain to the extent of the unrecognized gain on their investment in the partnership. This unrecognized gain would be measured by sub-

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7 New § 737 requires a partner to recognize precontribution gain during the five years following the contribution to the extent of property distributed to him exceeds the basis in his partnership interest. Comprehensive National Energy Policy Act of 1992, Pub. L. No. 102-486, § 1937, — Stat. —. Section 737 was enacted after this article was completed. Changes have been made to reflect this legislation. Section 737 has a limited effect. It affects only cases with precontribution gain and then only in-kind distributions since cash in excess of basis would be taxed in any event. Furthermore, the distribution must occur within five years of contribution. Even in cases covered by § 737, the parties defer tax on gain or any interest element until the distribution, which is often better than they can achieve under a deferred sale.

Legislation has also been proposed that would require large partnerships (those with 250 or more partners) to use the deferred sale approach in dealing with precontribution gain and loss. H.R. 2777 and S. 1394, 102d Cong., 1st Sess. § 201 (1991), proposed to add § 774(b) to the Code. See Staff of Joint Comm. on Tax’n, 102d Cong., 1st Sess., Technical Explanation of H.R. 2777 and S. 1394, at 13-25 (Comm. Print 1991) [hereinafter Explanation].

tracting a partner's basis in his interest from his capital account. I call this the "accounts based system." I also propose that a distribution of an asset be treated as a sale of that asset by the partnership. Finally, I propose that gain or loss on assets provisionally be allocated to partners whenever proportionate interests in assets change because of contributions or distributions. These proposals ensure that already-taxed earnings may be distributed tax free. They also permit the formation and normal operation of partnerships with gain assets without recognition of that gain.

The proposals are complicated, particularly on first impression. But the rules are entirely mechanical in their application, and the information that must be collected and the adjustments that must be made are similar to the information that already must be collected and the adjustments that already must be made under §704(c), the §704(b) regulations and §751(b). They eliminate the need for the disguised sale rule (§707(a)(2)(B)) and the hot asset rule for distributions (§751(b)). They supplement an expanded §704(c) and supplant §734(b). The proposals are similar to a deferred sale approach in some respects, but they provide a different (and I think better) mechanism for dealing with distributions in partial liquidation of a partner's interest. The proposals are meant to work in conjunction with my previous proposal to abolish special allocations and require that all items be allocated to partners in accordance with the relative balances in their capital accounts.\footnote{Mark P. Gergen, Reforming Subchapter K: Special Allocations, 46 Tax L. Rev. 1 (1990) [hereinafter Allocations].}

That proposal helps to ensure that capital accounts accurately measure the value of an interest in a partnership, which is important to the proposals made here.

Section II briefly outlines how the nonrecognition rules that apply to contributions and distributions result in gain and loss-shifting and tax-free exchanges of assets among partners. This is familiar terrain. Section III shows that the reforms of the last several years do not adequately solve the resulting problems. Section IV briefly outlines the accounts-based system and compares it to Professors Andrews' and Berger's proposals in this issue.\footnote{I do not consider the possibility of completely abolishing nonrecognition on contributions. See Philip F. Postlewaite, Thomas E. Dutton & Kurt R. Magette, A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners, 75 Geo. L.J. 423, 470-73 (1986), for a detailed proposal of such a system. See also David R. Keyser, A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation, 5 Am. J. Tax Pol'y 269 (1986).} Section V works out the accounts-based system in more detail.
II. GAIN AND LOSS-SHIFTING, ASSET EXCHANGES AND SOME RELATED PROBLEMS

It is well understood that the nonrecognition rules that apply to virtually all contributions to partnerships and many distributions from partnerships sometimes shift gain and loss or result in tax-free exchanges of gain assets among partners. It is widely recognized that this often is troubling. Thus, the description of these problems can be brief. This section also explains how the current rules can be used to avoid tax on compensation and to create artificial losses.

Nonrecognition on contributions and distributions makes possible the tax-free exchange of assets among partners:

Example 1: A contributes Alpha stock to XYZ Partnership, a large investment partnership which is not considered an investment partnership under $721(b). Later, Beta stock is distributed to A in liquidation of his interest.

If sufficient time passes between the contribution and the distribution (five years or more if the Alpha stock had precontribution gain, two or more if it did not), this probably will not be treated as a disguised sale. If it is not a sale, A exchanges Alpha stock for Beta stock without recognizing gain, something that is otherwise impossible under the Code.

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11 IRC § 721(a).
12 Noncash distributions are not taxed, even though the value of the property received exceeds a partner's basis in her interest. IRC § 731. Cash distributions in excess of a partner's basis in her interest may result in taxable gain. IRC § 731(a). But if cash and property are distributed together, cash is treated as distributed first, so the possibility of gain recognition is minimized. Reg. § 1.731-1(a)(1). Distributions result in gain under § 751 if they alter partners' interests in hot assets.
14 Gain is recognized on contributions to investment partnerships. These are partnerships in which more than 80% of the assets are readily marketable (that is, are traded on an exchange or are quoted regularly on the over-the-counter market) and are held for investment. Reg. § 1.351-1(c)(1)(ii), (3).
15 Reg. § 1.707-3(c); see notes 45-47 and accompanying text.
16 The like-kind exchange rule does not apply to stock or securities. IRC § 1031(a)(2). If the deferred sale approach is adopted for large partnerships, A would recognize the gain on the Alpha stock when he receives the Beta stock in liquidation of his interest. See note 113 and
The problem with tax-free exchanges, of course, is that income in the form of asset appreciation goes untaxed, perhaps forever if an asset is held until death.

This simple pattern is replicated in several recent corporate transactions. Consider the May Department Stores deal. May contributed stock of a real estate subsidiary worth $550 million to a partnership and PruSimon contributed $550 million cash, which was used to purchase May stock. The plan was to eventually distribute the May stock to May and the real estate subsidiary to PruSimon. If this plan works (measures taken and proposed since the deal was announced may tax gain when a partner's own stock is distributed to it on liquidation of the partnership), May disposes of its subsidiary for cash without recognizing gain and PruSimon takes a basis in the subsidiary equal to its cash contribution. Or consider the Sealed Power Technologies ("SPX") and Goldman Sachs joint venture. SPX contributed assets worth $261 million to a joint venture and Goldman Sachs contributed $15 million, with each taking a 50% interest. The venture borrowed $246 million and distributed this to SPX with the hope that all or at least some of the cash distribution to SPX will be untaxed, though it represents gain on SPX's assets.

Nonrecognition on contributions and distributions makes possible gain and loss shifting:

Example 2: CD Partnership owns a single asset, Blackacre, which is worth $100 and has a basis of $40. E contributes $50 for a one-third interest. Blackacre is carried on the partnership's books at a value of $40, and it is not revalued on the admission of E. However, the partnership enters into a contract to make a guaranteed payment of $10 each to C and D accompanying text. Under § 704(c), A will recognize gain on the Alpha stock if it is distributed to another partner while he remains a partner (if this occurs within five years of the contribution) or if it is sold by the partnership.

17 This transaction is described in Lee A. Sheppard, May Department Stores and the Use of Partnerships to Avoid Asset Gain Recognition, 45 Tax Notes 23 (Oct. 2, 1989). See also Menachem Rosenberg, Use of Partnerships to Circumvent General Utilities Repeal Limited by IRS, 71 J. Tax'n 370 (1989).

18 The Treasury has moved to block this under § 311(b) (see IRS Notice 89-37, 1989-1 C.B. 679), by treating the distribution of May stock to May in the liquidation as a taxable redemption by May of stock for property (the property being the partnership interest). The transaction also is affected by the amendments to § 704(c) and new § 737.

19 This transaction is described in Louis S. Freeman & Thomas M. Stephens, Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities, 68 Taxes 962, 963 (1990).

As described, the transaction may run afoul of the disguised sale rule because the debt is incurred to fund the distribution to SPX.
The $60 built-in gain on Blackacre may not have to be allocated to C and D on the sale of Blackacre under the § 704(b) regulations. If it is not, and the gain is shared among the partners equally, C and D temporarily

The guaranteed payment obligation offsets the $20 gain allocated to E on the sale of Blackacre. There are other ways to offset the gain. For example, $20 income might be preferentially allocated to C and D at some future point. Such an income offset may have a better chance of surviving scrutiny under the § 704(b) regulations because it might be subject to greater uncertainty than the guaranteed payment.

See notes 40-42 and accompanying text. The § 704(b) regulations require that § 704(c)-type allocations of built-in gain be made when partnership assets are revalued on a contribution or distribution. Typically, partners will want to revalue assets when interests shift so as not to transfer wealth in the form of unrealized gain to other partners. Thus, in Example 2, not revaluing Blackacre on the admission of C with a one-third interest means that the value of E's interest will be overstated by $20 when Blackacre is sold since C will be credited with one-third of the built-in gain on Blackacre. The $20 guaranteed payment obligation running from E to C and D offsets this overstatement.

The Service might try to challenge this transaction under the special allocation rules, but it may not prevail in reallocating the gain to C and D. The Service could argue that the guaranteed payment prevents the allocation of gain to E from having substantial economic effect because the income is offset by a later deduction. The allocation of income and the offsetting guaranteed payment could violate the general substantiality rule because they increase one partner's expected after-tax return without decreasing any other partner's expected after-tax return. Reg. § 1.704-1(b)(2)(iii)(a). This would be true, for example, if E is tax exempt and C or D is not because allocating part of the gain to E reduces aggregate taxes. The $20 guaranteed payment has precisely the same economic effect as revaluing Blackacre on the admission of E and allocating the $20 built-in gain to C and D: Under either arrangement C and D jointly realize a $20 gain on Blackacre and any change in Blackacre's value from $100 is shared one-third by each partner.

One problem with this argument is that even if the arrangement is found to lack substantial economic effect, the remedy is to allocate the gain in accordance with the partner's interest in the partnership. Reg. § 1.704-1(b)(1)(i). Partners' interests are presumed to be equal, which leads to equal sharing of gain on the sale of Blackacre. Reg. § 1.704-1(b)(3)(i). There is an express exception for allocations of built-in gain, see Reg. § 1.704-1(b)(3)(ii) (last sentence), but this exception only applies when property is carried on partnership books with a value different from its tax basis. Reg. § 1.704-1(b)(4)(i). If Blackacre is not revalued on the admission of E, this condition is not met.

In addition, the partners could argue that this arrangement conforms better with the principles underlying § 704(b) than would the allocation that would be required if Blackacre was revalued on the admission of E. If the guaranteed payment was made simultaneously with the sale of Blackacre, it would avoid the defects in the ceiling rule, and would ensure a better fit between tax and economic results. Under the ceiling rule, if Blackacre is sold for $90, a $25 gain would be allocated each to C and D. Economically, C and D each have reaperted a $27.33 net gain and E has reaperted a $3.33 loss. Allocating the gain on the sale of Blackacre equally among the partners and then making a $20 guaranteed payment from E to C and D produces this tax result. For an argument that it is appropriate to use guaranteed payments or curative allocations to circumvent the ceiling rule, see Marich & McKee, note 13, at 644-52. One flaw in applying this argument to this case is that the guaranteed payment is not made simultaneously with the sale, so the tax consequences do not follow the economic consequences precisely.

20 The guaranteed payment obligation offsets the $20 gain allocated to E on the sale of Blackacre. There are other ways to offset the gain. For example, $20 income might be preferentially allocated to C and D at some future point. Such an income offset may have a better chance of surviving scrutiny under the § 704(b) regulations because it might be subject to greater uncertainty than the guaranteed payment.

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shift $20 gain to E. Such gain and loss shifting is problematic if partners have different tax rates.

Distributions that alter interests in assets may also temporarily shift gain and loss among partners, or even permit one partner to defer gain at no expense to other partners, depending on whether a § 754 election has been made. Consider:

Example 3: H contributes Blackacre (basis $0, worth $100) to FG Partnership. The only asset of FG Partnership is Omega stock (basis $200, worth $200). More than five years later, H receives half the Omega stock (basis $100, worth $100) in liquidation of his interest.

H defers recognition of gain until he disposes of the stock. This deferral may be at the expense of F and G. If FG Partnership sells Blackacre and no § 754 election is made, F and G temporarily will recognize H’s $100 gain on Blackacre (that is, until they sell or liquidate their interest in the partnership). If, however, F and G make a § 754 election, the partnership would increase Blackacre’s basis to $100 on the distribution of the stock to H under § 734(b). F and G would avoid gain on the sale of Blackacre, and H would defer gain at no expense to them. Conversely, the § 734(b) adjustments are disadvantageous if a high basis asset is distributed to a partner with a low basis in his interest since the partnership must reduce the basis of its remaining assets.

The nonrecognition rule for distributions can be used to avoid tax on compensation paid a service provider:

Example 4: Techco employs S to develop software for a personal computer it manufactures. S and Techco establish ST Partnership to which Techco contributes Techco stock and cash. In return for performing services for the partnership, S is given a profits interest which entitles him to any appreciation in the value of the Techco stock. This is in addition to cash compensation paid to S. The rights to the software S develops belong to the partnership. If the Techco stock appreciates in value, the partnership will distribute to S Techco stock equal to the value of his interest (that is, the amount of the appreciation in the value of Techco stock). Techco will take the rights to the

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22 Thus, in Example 3, if F withdrew from the partnership and took Blackacre, without an election, he would be able to step up the basis of Blackacre to $100 (F’s basis in the partnership) without the partnership having to take a corresponding reduction in the basis of the Omega stock. With an election, the partnership would have to reduce the basis of the stock by $100.
software and any remaining stock and cash when the partnership liquidates.

$S$ may have taxable income when he receives the profits interest (if it is not subject to forfeiture), but the interest will be of slight value when it is received.\(^2\) Under this plan, $S$ eventually gets Techco stock without including most of its value in income,\(^2\) something that otherwise can be accomplished only through qualified stock options.\(^2\) Tax on this gain is deferred and may be avoided entirely if $A$ holds the stock until death.

The rules on distributions also may be manipulated to create artificial losses. Consider a recent well-publicized tax shelter which takes advantage of the § 453 regulations on basis recovery on contingent-price installment sales.\(^2\)

**Example 5:** $K$ invests $90, $L, $9, and $M, $1, in KLM Partnership. Gain and loss are allocated in these shares. The partnership buys a security for $100 and resells it for an installment obligation requiring that $90 be paid in the first year and $10 times LIBOR in the third year. Under the § 453 regulations,\(^2\) the $100 basis in the obligation can be recovered ratably over the three years. Thus, the partnership has a gain of $56.66 in year one and offsetting losses in years two and three. $K$ is allocated 90% of this gain in year one. Immediately thereafter, $K$'s interest is liquidated for an amount equal to its restated value.\(^2\) This produces a loss for $K$ to offset the gain in year one. $L$ and $M$ have artificial losses in years two and three.

\(^2\) Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991); Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974). On the taxation of profits interests received for services, see Laura Cunningham, Taxing Partnership Interests Exchanged for Services, 47 Tax L. Rev. 247 (1991); Mark P. Gergen, Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital, 44 Tax L. Rev. 519, 525-34 (1989).

\(^2\) IRC § 731(a).

\(^2\) The right to the appreciation in the Techco stock is essentially a stock option. If an option is not publicly traded and it is not a qualified stock option, a person given the option as compensation for services is taxed on the value of the option (the difference between the stock price and the strike price) at the time of its exercise. Reg. § 1.83-7(a). Qualified stock options are not taxed when granted or exercised, but they are subject to significant limitations. IRC § 422. For example, qualified stock options exercised by an individual in one year cannot exceed $100,000. IRC § 422(d).

\(^2\) Lee A. Sheppard, Tax Shelter Partnerships For the Big Boys, 45 Tax Notes 1087 (Aug. 27, 1990).


\(^2\) The published report on this transaction states that $K$'s interest is liquidated for the amount in its capital account. Sheppard, note 26, at 1088. This will not work unless $K$'s capital account is revalued upon the liquidation of its interest, since its capital account is overstated at the end of year one due to the gain allocated to it. In **Example 5**, $K$ would have a $140.99 capital account at the end of year one ($90 + $50.99). The value of $K$'s interest is $90 plus the return earned on that amount in one year. The allocation of 90% of the gain in year
Ideally, in this transaction, \( K \) either would be tax exempt or have expiring net operating losses. But even if \( K \) has the same tax rate as \( L \) and \( M \), there may be a net tax advantage to the partners since the short period over which \( K \) pays additional tax (no more than a year) is more than offset by the long period (until the partnership is dissolved) over which \( L \) and \( M \) can defer tax because of the losses they incur in years two and three.

*Example 5* may seem unlike more straightforward cases of gain and loss shifting, but the problem is essentially the same. Over the three years, gain and loss on the installment obligation net out, but the liquidation of \( K \)'s interest at the end of year one shifts the loss in years two and three—which ought to be allocated to \( K \) because of its gain in year one—from \( K \) to \( L \) and \( M \). This is done without cost to \( K \) (other than taxes, if any, paid on the artificial gain for one year) because it reaps the loss on liquidation of its interest.

**III. Recent Solutions**

Sections 704(c) and 707(a)(2)(B) are the most significant responses to the problems of gain and loss shifting and tax-free asset exchanges through contributions and distributions. This section of the article shows that § 704(c), while perhaps well conceived in principle, is underinclusive. Section 707(a)(2)(B) is poorly conceived because it requires distinguishing between normal contributions and distributions that incidentally shift interests in assets and transfers that are disguised sales. There is no good way to distinguish the two. Section 707(a)(2)(B) is also underinclusive.

Sections 704(c) and 707(a)(2)(B) are the most recent responses to the problems that result from nonrecognition on contributions and distributions. Related problems are addressed by § 751(b), which treats a distribution as a deemed sale of assets to the extent the distribution alters interests in ordinary income (or hot) assets. The purpose of this section and of § 751(a) (which addresses related problems when partnership interests are sold) is to preserve the character of gain or loss. Section 751(b) prevents a partner from transmuting ordinary gain into capital gain by exiting a partnership while taking capital assets and leaving ordinary assets. It does this by treating the distribution as a deemed ex-

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one to \( K \) might be challenged under the § 704(b) regulations if the distribution to it on liquidation of its interest did not respect its capital account. Reg. § 1.704-1(b)(2)(ii)(b)(2). This problem can be avoided by decreasing \( K \)'s capital account to reflect the real value of the installment obligation when \( K \)'s interest is liquidated. The regulations countenance such revaluation, though a seed of doubt is sowed by the requirement that the revaluation be for a "substantial non-tax business purpose." Reg. § 1.704-1(b)(2)(iv)(f)(5).
change of the ordinary assets left in the partnership for the capital assets received on the distribution.

Section 751(b) indirectly helps to check gain and loss shifting and disguised sales in some cases, but its scope is limited. It applies only if interests in ordinary income assets are exchanged for interests in capital assets. It does not affect exchanges of assets of similar character. Moreover, § 751(b) applies only when partners reduce their interest in ordinary income assets through distributions. Thus, § 751(b) does not apply if an asset with ordinary gain is contributed to a partnership that holds other assets with capital gain, though this, too, potentially transmutes ordinary gain into capital gain. The exclusive focus of § 751(b) on a shift in interests in assets connected with distributions is ironic, for the current spate of statutory reforms focuses exclusively on such shifts connected with contributions. Why different generations have focused on different parts of a single problem is puzzling.

A. § 704(c) and the § 704(b) Regulations

Section 704(c) requires that when a partner contributes a gain or loss asset to a partnership, precontribution gain or loss be allocated to him on sale of the asset.

Example 6: A contributes Blackacre (basis $0, worth $100) to AB Partnership for a half interest. Later Blackacre is sold for $120. Gain of $110 is allocated to A for tax purposes (the $100 built-in gain plus one half the remaining $20 gain).

Corresponding allocations of depreciation deductions are required to eliminate any precontribution gain or loss on depreciable assets.

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29 Consider the following:

Example: A contributes inventory worth $100 with a basis of $50 to AB Partnership for a half interest. The partnership's other asset is stock worth $100 with a basis of $100. Two years and one day later, A receives the stock in liquidation of this interest. This is treated as a deemed exchange by A of a half interest in the inventory for a half interest in the stock. Thus, A recognizes $25 ordinary income and takes a $50 basis in half the stock. He takes a $25 basis (his remaining outside basis) in the other half of the stock considered distributed to him in liquidation of his interest. A has $25 capital gain on the sale of the stock.

30 The interaction of the hot asset rules and § 704(c), § 707(a)(2)(B) and the § 704(b) regulations raises complex questions which Treasury has not even begun to try to resolve. I touch on one such issue—how basis is allocated on assets with built-in gain or loss to determine the consequences of a deemed exchanges under § 751(b)—in note 65.

31 See Reg. § 1.704-1(c)(2)(i) Ex. 2; cf. Reg. § 1.704-1(b)(5) Ex. 18 (regarding newly admitted partner to partnership already containing gain or loss assets); William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners §§ 10.04[1] (2d ed. 1990). The other partners are allocated depreciation deductions equal to the economic depreciation of their interests in the asset with built-in gain.
Section 704(c) was amended in 1989 to treat a distribution of an asset with precontribution gain or loss as a sale of the asset at its fair market value for purposes of recognizing such gain or loss if the distribution occurs within five years of the asset’s contribution to the partnership.\textsuperscript{32}

\textit{Example 7:} A contributes \textit{Blackacre} (basis $0, worth $100) to \textit{AB Partnership} for a half interest. \textit{Blackacre} is distributed to B when it is worth $120. A has $100 gain on the distribution.

This prevents partners from circumventing the rule allocating precontribution gain on sales by distributing gain or loss assets.\textsuperscript{33}

Section 704(c) does not always work perfectly even in the cases where it applies because of the “ceiling rule.” Under this rule, the aggregate gain, loss or other deductions allocated to partners cannot exceed the amount of such items realized by the partnership or the deductions allowable to it.\textsuperscript{34}

\textit{Example 8:} A contributes securities (basis $8, worth $12) to \textit{AB Partnership}. B contributes $12. The securities decrease in value to $10 and are sold by the partnership. Section 704(c) allocates the gain on the sale of the securities to A, but under the ceiling rule only $2 gain—the amount realized by the partnership—can be allocated.

Here the ceiling rule shifts gain from A to B. Economically, A has realized a $3 gain (since A bears only $1 of the loss in the value of the securities) and B has realized a $1 loss. But A only recognizes a $2 gain and B recognizes no loss.

An argument for the ceiling rule is that without such constraint, partners might overstate the value of assets contributed to a partnership to generate extra losses (or depreciation deductions) for the other partners.\textsuperscript{35}

\textit{Example:} A contributes a machine (basis $50, worth $100) to \textit{AB Partnership} for a half interest. B contributes $100 cash. The machine has a five-year useful life, earns $26 per year, and is depreciable on a straight-line basis over five years. Each year, the machine earns $6 economic income and $16 taxable income net of depreciation. Under § 704(c), the entire $10 depreciation deduction on the machine is allocated to B. Thus, A will have $13 and B $3 income each year.

It is as if B purchases a half-interest in the machine for $50 and recovers $10 depreciation each year on a straight-line basis on his half interest. This is equivalent to allocating the built-in gain on sale of the machine to A. At the end of five years when the machine is worthless, $50 gain over and above his $3 economic income per year will have been allocated to A, eliminating the built-in gain.


\textsuperscript{34} Reg. § 1.704-1(c)(2)(i). This rule is incorporated in the § 704(b) regulations. See Reg. § 1.704-1(b)(5) Ex. 14(ii).
at the expense of the contributing partner, who will have an equivalent amount of gain (or income).\textsuperscript{35} In a system, such as ours, where capital accounts are not always binding, this may be a risk. But this should not be as much of a problem if, as I have proposed elsewhere, capital accounts are made the basis for all allocations.\textsuperscript{36} This would make misvaluation of assets unattractive, since it affects the allocation of all items of income, gain or loss.\textsuperscript{37}

Section 704(c) is too limited in scope. First, it does not ensure that precontribution gain or loss is properly allocated to a partner in every case where a gain or loss asset is contributed to a partnership. Precontribution gain or loss is not recognized by the contributing partner if an asset is distributed more than five years after its contribution. Presumably the time limit was included to prevent § 704(c) from making too great an encroachment on § 721 and § 731. New § 737 prevents avoidance of § 704(c) by redeeming the interest of a contributing partner before the contributed asset is sold or distributed by taxing precontribution gain on redemptions within five years of a contribution. Under prior law, § 704(c) could be avoided in this manner.\textsuperscript{38}

\textsuperscript{35} Berger & Wiedenbeck, note 13, at 150-51. The authors suggest that the ceiling rule also produces the right result when property contributed with built-in gain declines in value before it is sold, by limiting the gain allocated to the contributor to the actual gain on the sale. Id. at 151 n.48. Their mistake can best be seen with an example:

\textit{Example:} A contributes \textit{Alpha} stock (value $100, basis $40) and B contributes $100 cash to AB Partnership. The Alpha stock drops in value to $80 and is sold by the partnership.

At the time, the partnership still holds $100 cash. A and B are equal partners. The authors argue that the ceiling rule properly limits A's gain on the sale of the Alpha stock to $40, not taxing him on the lost precontribution gain. In fact, A should have $50 gain, for he has disposed of the Alpha stock and is left with a partnership interest worth $90. Abolishing the ceiling rule produces that result: A would have a $60 gain on the sale of the stock plus a $10 loss (half the partnership's $20 loss).

Marich and McKee suggest that the ceiling rule is merely an artifact of the entity approach. Marich & McKee, note 13, at 635-36. If so, this is yet another illustration of the perniciousness of allowing constructs of a partnership as an entity or an aggregate of partners to influence tax policy.

\textsuperscript{36} Gergen, Allocations, note 9.

\textsuperscript{37} Consider the following:

\textit{Example:} A contributes securities worth $8 and B contributes securities worth $10 to a partnership. If B consents to valuing A's contribution at $10 so their capital accounts are equal, B would be forced to give A half of all income, gain or loss of the partnership. This will be at least a $1 loss to B and the loss could be greater. If the securities are immediately sold, B has a $1 loss. If the securities are never sold and instead are held for dividends, the present value of the income stream lost to B ought to be $1. If A withdraws before the securities are sold or revalued, B's loss is $2 since A is entitled to the $10 in his capital account, leaving B assets worth $8.

\textsuperscript{38} See note 7; see also N.Y. St. B. Ass'n, Tax Section, Report on Certain Provisions of the Revenue Reconciliation Act of 1989, reprinted in 44 Tax Notes 1543, 1557 (Sept. 25, 1989) [hereinafter NYSBA report]. If a corporate partner receives its own stock on the distribution, as would be the case in the May Stores transaction, the transaction would be taxed as a redemption of stock. See text accompanying notes 17-18.
Second, § 704(c) does not apply when interests shift in gain or loss assets already owned by a partnership because of admission of a new partner (Example 2) or because of a distribution that reduces the interest of an old partner. The § 704(b) regulations handle such cases. Under those regulations, if a partnership adjusts capital accounts to reflect appreciation or depreciation of assets upon a contribution or distribution, it must allocate that gain or loss to the existing partners under § 704(c).

Thus, if a partner joins a partnership that owns appreciated assets and the capital accounts of the original partners are increased to reflect this appreciation, the gain must be allocated to the original partners when the property is sold.

There are several problems with the § 704(b) solution. It requires a sale of assets with built-in gain while the partner allocated the gain is still a partner. Thus, the rule may be avoided by distributing assets with built-in gain.

*Example 9:* AB Partnership owns Blackacre (basis $0, worth $100). Blackacre is carried on partnership books as worth $0 and A’s and B’s capital accounts are $0. C contributes $100 cash for a half interest in the partnership. Blackacre is revalued at $100 and A’s and B’s capital accounts are increased to $50. Under the § 704(b) regulations, if Blackacre is later sold for $100 or more, $100 gain would be allocated to A and B. If, however, Blackacre is distributed to C, A and B recognize no gain. C takes a $100 basis in Blackacre on the distribution.

The § 704(b) regulations have not caught up with the 1989 amendments to § 704(c) in this respect.

The allocations required by § 704(b) also are avoided if a partner completely liquidates his interest before an asset with built-in gain or loss is sold, just as § 704(c) can be so avoided. Thus, the regulations do not impair the plan in Example 5. K cannot be allocated the built-in loss on

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39 Example: A and B are equal partners in a partnership that owns stock (value $100, basis $100) and undeveloped land (value $100, basis $0). A receives a distribution of $50 in stock, reducing his interest to one-third and his basis in the partnership to zero. The land is sold. A shifts $16 gain to B. A has realized a $50 increase in wealth because of appreciation of the land, and has converted that increase in wealth into stock and a right to cash, but he recognizes only a $33 gain.

40 Reg. §§ 1.704-1(b)(2)(iv)(g) and (4)(i). See also Reg. § 1.704-1(b)(5) Ex. 14(i). If the allocation is not made, the partnership does not properly maintain capital accounts (Reg. § 1.704-1(b)(2)(iv)(g)), which means that its allocations do not have substantial economic effect (Reg. § 1.704-1(b)(2)(iv)(a)). Thus, the items are reallocated in accordance with the partners’ interests in the partnership (the default rule, Reg. § 1.704-1(b)(1)(f)). Section 1.704-1(b)(3)(ii) of the regulations, which provides factors to be considered in determining a partner’s interest in a partnership, refers to § 1.704-1(b)(4)(f) of the regulations, which requires § 704(c)-type allocations to make up the disparity between book and tax accounts.
the installment obligation because it is no longer a partner when that loss is realized.

Finally, § 704(c)-type allocations are not mandatory under the § 704(b) regulations. They are not required if capital accounts are not adjusted on a contribution or a distribution. In theory, a failure to adjust capital accounts is risky because it misstates the value of those accounts, and so shifts wealth among partners. In Example 9, for instance, A's and B's capital accounts would be understated by $50 if their accounts were not booked up on the admission of C. If Blackacre is sold for $100 and the gain is allocated 25-25-50 pursuant to the partners' interests, C would have a capital account of $150 and would be entitled to that amount on liquidation. A and B would have given $50 to C.

But the effect of undervaluation of capital accounts can be overcome with special allocations or guaranteed payments. In Example 9, this can be done by allocating what otherwise would be C's share of income from the $100 investment contributed by him to A and B until they receive $50 each (bringing their capital accounts up to where they would have been with an adjustment). If Blackacre is sold in the meantime, A and B temporarily shift income to C that is later made up by the special allocation of income from the investment of the cash to them.

B. § 707(a)(2)(B)

Section 707(a)(2)(B) was enacted in 1984 to codify a long-standing principle that contributions and distributions that are essentially sales

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41 See Reg. § 1.704-1(b)(5) Ex. 14(iv).
42 The § 704(b) regulations imply that a failure to allocate built-in gain to A and B in these circumstances might be challenged on assignment of income grounds. Reg. § 1.704-1(b)(2)(iv)(f) states that if capital accounts are not adjusted on an admission of a new partner "paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied. . . ." See also Reg. § 1.704-1(b)(5) Ex. 14(iv) (stating the same thing). Paragraph (b)(1)(iii) invokes the assignment of income principle, among other principles, as a check on special allocations.
43 See, e.g., Rev. Rul. 57-200, 1957-1 C.B. 205 (holding that a contribution of stock that is immediately distributed to another partner is a sale). The 1984 amendments were intended to reverse the results in Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980), and Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980) [hereinafter Comsat]. Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 225 (Comm. Print 1984) [hereinafter 1984 Bluebook]. In Otey, the taxpayer contributed appreciated property to a partnership which immediately took out a loan on the property and distributed the proceeds to the taxpayer. This was held not to be a taxable exchange of the property. In Comsat, partners in a satellite project were compensated for the dilution of their interests upon the admission of new partners by a distribution of cash contributed by the new partners. This was held a tax-free distribution and not a sale of the original partners' interests.

Disguised sales have been found in some later cases arising under prior law. In Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793 (1988), a transaction structured as the admission of new general partners was held to be a sale where the new partners assumed the
or exchanges are taxed as such. Generally, three factors are thought to
distinguish normal contributions and distributions from disguised sales:
time, risk and the source of a distribution out of capital or profits. The
archetypal disguised sale is a contribution of property quickly followed
by a liquidating distribution of other property. Time is short, there is no
risk on payment and the distribution is a recovery of capital. The arche-
typal valid contribution and distribution is a contribution of property to
a partnership that develops the property in a risky venture where the
contributor of the property takes out only his share of profits. Time is
long, the risk on payment is great and distributions are out of profits.

The central problem with the disguised sale rule is that these factors of
time, risk and source of distribution do not distinguish “abusive” contri-
butions and distributions from commonplace partnership transactions in
many cases. Not all partnerships are long lived. Joint ventures may be
formed for single projects which may be accomplished quickly. Con-
versely, just because a partnership is long lived does not mean that a sale
is impossible. In particular, special allocations may be used to shift the
benefits and burdens of ownership of assets among continuing partners.
Not all partnerships are risky. Large investment partnerships may not be
risky; indeed, diversification to avoid risk is their point. Conversely, risk
does not always mean that there has not been a sale. For example, a
partner who contributes land to a real estate development partnership
can give in return for most of his partnership share the right to
income, gain and loss on junk bonds purchased by the partnership for
that purpose. Junk bonds are risky, but presumably the partner is com-
pensated for that risk by a greater potential return. For similar reasons,
the source of a distribution out of capital or profits cannot be determina-
tive. A partner who gets an interest in junk bonds through a partnership
in return for other property may leave his capital in the partnership and
take out only profits. Conversely, a partner in a short lived joint venture
receives a distribution out of capital when it ends. This cannot mean that
all such joint ventures are sales.

contribution obligation of the old general partner (the old partner was a corporation and the
new partners were its shareholders). The court emphasized that the new general partners
stepped into the old general partner's shoes by assuming the debt of the old general partner,
without any change in the partnership or in the interests of the other partners. In Jacobson v.
Commissioner, 96 T.C. 577 (1991), a transfer of property to a partnership that was immedi-
ately followed by a distribution of cash equal to 75% of the value of the equity in the property
was held a sale of a 75% interest in the property to the partner who contributed the cash. The
taxpayers contributed property worth $15,000,000 subject to $6,963,689 in mortgages to the
partnership. The other partner contributed $6,027,233 of which $5,944,010 immediately was
distributed to the taxpayers. This amount plus prepaid rents retained by the taxpayers and
accrued interest on the mortgages equaled $6,027,233, the value of a 75% interest in the equity
in the property.
A standard which required equality among partners, applied in conjunction with a time, risk and source standard, might help to distinguish ordinary partnership transactions from abusive cases. A true partner would be one who is in a venture for the same period, who faces the same risks and who receives distributions from the same sources as other partners. This principle would distinguish the nonabusive case of the investment partnership where all partners have an interest in bonds from the abusive case of the real estate development partnership where one partner's interest is uniquely in bonds. The risk on bonds may be the same in both cases, but in the latter case it is not the same risk that is borne by the other partners. Equality, however, cannot be the standard, for the legislative history of § 707(a)(2)(B) provides that partners need not be equals in condoning priorities and preferences.44 And, once absolute equality is unnecessary, it is difficult to say what variation in risk, time and source of distribution makes one no longer a partner.

The regulations define disguised sales about as well as they can. Time, risk and source of distribution are treated as relevant, but not conclusive. Time is reflected in presumptions that contributions and related distributions within two years are disguised sales45 and those outside two years are not.46 These are only presumptions that can be overcome by facts and circumstances “clearly” to the contrary.47

Risk is reflected in the rule that a distribution is not part of a disguised sale if it is subject to “the entrepreneurial risks of partnership operations.”48 Risk is also the major concern of the ten facts and circumstances listed as evidencing a sale.49 The first factor is “reasonable certainty” as to the time and amount of the subsequent distribution50 and six of the other factors go to facts creating such certainty (for example,
whether other partners are obligated to make contributions if necessary to ensure a distribution).\textsuperscript{51}

The source of the distribution appears most prominently in a rule that presumes a distribution within two years is not part of a sale if it is an “operating cash flow distribution.” This rule ensures that normal distributions of profits are not subject to sale treatment.\textsuperscript{52} Related rules which protect reasonable guaranteed payments and reasonable preferred returns also are concerned with the source of the distribution, since a defining characteristic of both is that the payment be out of profits or for the use of capital and not be a recovery of capital.\textsuperscript{53}

\textsuperscript{51} These factors include the following: a legally enforceable right to the subsequent transfer; security for the transfer; an obligation by another person to make a contribution to fund the distribution; a loan commitment by another person that will fund the distribution; a debt incurred (or to be incurred) by another to fund the distribution; and the existence of excess liquid assets. Reg. § 1.707-3(b)(2)(ii)-(vii).

The three other listed factors are more specialized. One is that “distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property.” Reg. § 1.707-3(b)(2)(viii). This is most obviously directed at arrangements that try to replicate disguised sales through special allocations. For example, A contributes Blackacre and B Whiteacre and each is allocated 90% of the income, gain and loss of the property contributed by the other. See Reg. § 1.707-3(f) Ex. 8.

Another factor is that the distribution is disproportionate in relation to the partner’s continuing interest. Reg. § 1.707-3(b)(2)(ix). This may mean that a small distribution to equalize capital accounts is not treated as a sale.

The final factor is that a partner has no obligation to restore the distribution or that the obligation is so remote as to be of little value. Reg. § 1.707-3(b)(2)(x). This suggests, by implication, that a distribution that creates a capital account deficit may not be part of a disguised sale unless that deficit will not be made up until some distant time. This is consistent with the legislative history. 1984 Bluebook, note 43, at 232.

\textsuperscript{52} Reg. § 1.707-4(b)(1). An operating cash flow distribution is defined as a partner’s share of cash flow, as determined by multiplying net cash flow by the lesser of the partner’s interest in overall profits for the year and his interest in overall profits for the life of the partnership. Net cash flow is taxable income or loss increased by deductions (such as depreciation) that are not matched by a cash charge and decreased by expenditures (such as debt repayments and capital expenditures) that are not matched by a deduction. Reg. § 1.707-4(b)(2). Some problems created by the use of book rather than tax income as the basis for profits are explored in notes 154-59 and accompanying text.

\textsuperscript{53} A preferred return is a preferential distribution out of cash flow that is matched, to the extent possible, by the allocation of income or gain. Reg. § 1.707-4(a)(2). Guaranteed payments, by definition, are for capital and not of capital. Reg. § 1.707-4(a)(1)(i). This point is driven home by example two of Reg. § 1.707-4(a)(4). There, a guaranteed payment is structured to reduce gradually the payee’s capital account (this is done by allocating to the payee part of the deduction for the payment while requiring the other partner to make any contributions needed to fund the payment). To the extent of the reduction in capital, the payments are held proceeds of a sale instead of a guaranteed payment. That preferred returns and guaranteed payments cannot be a recovery of capital is also ensured by the rule that either (or the two together) must be reasonable in amount. Reg. § 1.707-4(a)(3)(i). There is a safe harbor return rate of 150% of the highest applicable federal rate in effect during the existence of the right to the return or payment. The safe harbor rate applies to unreturned capital (that is, distributions that are not themselves guaranteed payments, preferred returns, or operating cash flow distributions or to the weighted average balance of a partner’s capital account for the year). Reg. § 1.707-4(a)(3)(ii).
The difficulty of distinguishing normal contributions and distributions from disguised sales is reflected in the uncertainty of the regulatory standards. The rules on operating cash-flow distributions, guaranteed payments and reasonable preferred returns have fairly clear boundaries, but they are designed only to apply in fairly easy cases, where distributions are not a recovery of capital. Even then, these rules are only presumptions or are subject to exception.

The two-year presumption is also clear, but it is weak, at least as a formal matter. The greatest significance of the two-year presumption lies in the rule that the Service must be given notice of distributions within two years unless the distribution comes within the special rules for preferred returns and the like. A cynic (or scofflaw) might think that distributions outside two years are safe as a practical matter because the Service is not likely to connect them to a contribution. If this is how it works out in practice, a partnership can evade the disguised sale fairly easily by delaying distributions while using special allocations or other measures to provide interim security.

The formal significance of the two-year presumption is not that great. The presumption holds only if the facts are not "clearly" to the contrary. The weakness of the presumption is illustrated by several examples in the regulations that seem to give it little weight. The examples consider a contribution of land worth $1 million with a basis of $500,000 to a real estate development partnership. In example three, the partner who contributes the land receives a distribution of $900,000 on completion of the building within two years of formation of the partnership. This is presumptively a sale, but the example notes that sale treatment may be avoided if the distribution is made out of financing that can be obtained only upon lease-up, if the lease-up is subject to a significant risk.

In examples five and six, the partner receives a distribution of $1 million 25 months after the contribution. Example five notes that this is presumed not to be a sale. This conclusion, however, is based on the premise that the distribution will be made only to the extent permanent loan proceeds plus other capital contributed exceed the construction cost of the building, which in turn is assumed to be risky because a sufficient loan will be made only if occupancy levels are high. Example six drives the relevance of this risk home by holding that the result would be otherwise in

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54 Reg. § 1.707-3(c)(2).  
55 Reg. § 1.707-3(f) Exs. 3, 5, 6 and 7.  
56 Reg. § 1.707-3(f) Ex. 3(iii).  
57 Reg. § 1.707-3(f) Ex. 5(iii).
example five if sufficient funds were secured by a loan commitment.58

From these examples, one can only conclude that risk is more important than time, since the crucial question in every case seems to be whether the distribution depends upon a speculative outcome. The emphasis on risk over time is inevitable since a time standard is over- and under-broad and can be evaded. But a risk standard is indefinite in two ways: (1) There is no clear definition of how much risk is enough, and (2) it is hard to know the degree of risk in individual cases. Thus, a rule that finally turns on risk must be uncertain.

One way to illustrate the problems with the regulations is to consider a single hard case closely. The example goes to the heart of the flaw in the statute and the regulations because it involves the use of preferences to reduce risk on a contribution.

*Example 10:* A contributes *Blackacre* (basis $50, worth $100) to *AB Partnership*. B contributes $100 cash, which is used to improve *Blackacre*. The partners' shares of gain, profits and losses are determined by the relative size of their capital accounts. A is allocated 100% of all cash distributions until his capital account is reduced to $20.

If *Blackacre*'s improved value remains constant at $200 per year and it earns $20 per year, and if all profits are currently distributed, A will receive $20 per year for six years and $5 in year seven, after which his capital account will have been reduced to $20.59 The present value of this (using a 10% discount rate) is $100, the same amount B would pay for *Blackacre* in cash. Assuming A's remaining partnership interest is liquidated in year seven, the result under the plan is equivalent to an installment sale under which B pays A six $20 annual installments and one $25 installment for *Blackacre*.

<table>
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<th>Year</th>
<th>Beginning Capital Accounts</th>
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<th>Cash Distributed</th>
<th>End Capital Accounts</th>
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<td>$17.73</td>
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</tbody>
</table>

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58 Reg. § 1.707-3(f) Ex. 6. Example seven adds that a loan commitment would not justify overcoming the presumption if there was a risk that construction could not be completed at a low enough cost to ensure funds would be left for the distribution. Reg. § 1.707-3(f) Ex. 7.

59 Partnership accounts of A and B are as follows over the seven years:
Economically, this plan is not significantly different from a sale. Though $A$ retains an interest in Blackacre, any impact on him from changes in the value of Blackacre will be fairly small because his interest in Blackacre is continually diluting and because of the preference on cash distributions. For example, if Blackacre drops 25% in value at the beginning of year four and its earnings drop to $15 per year,\footnote{A's return decreases to $15 per year in years four to seven and to $3.90 in year seven. His end interest will be worth $15. The accounts are as follows starting in year four:} $A$'s loss from the dramatic drop in the value of Blackacre (in present value terms) is only $5.80. $A$ effectively is shielded from the risk of decreases in the value of Blackacre. Conversely, $B$ reaps most of the gain from an increase in the value of Blackacre. For example, if Blackacre increases in value by 50% at the start of year four and its rents increase to $30 per year,\footnote{$A$ receives $30 per year in distributions in years four and five and $7.56 in year six. His end interest will be worth $30. The accounts are as follows starting in year four:} $A$'s profit from the increase in the value of Blackacre is only $10.06 while $B$'s profit is $65.07 (both in present value terms).\footnote{The discounted present value of the cash distributions to $A$ and the end value of his interest, using a 10% discount rate, is $110.06. The discounted present value of the cash distribution to $B$ and the end value of his interest is $165.07.} Furthermore, these risks can be reduced. The partnership may enter into a long-term lease locking in $20 rent per year for Blackacre over the seven years it takes to reduce $A$'s interest. $A$'s only risk then is from the drop in value of his 10% interest in Blackacre at the end.\footnote{In the case where Blackacre drops 25% in value in year four, $A$'s loss would be only $2.63 in present value terms as compared to the $5.70 loss if he also bore the risk of reduced rents.} Alternatively, the venture may maintain capital reserves and the income from the investment of those reserves may be specially allocated to $A$,\footnote{Cf. Reg. § 1.704-1(b)(5) Ex. 7 (countenancing disproportionate allocations of income from capital reserves under certain circumstances).} or $A$ may be

\begin{center}
\begin{tabular}{ |c|c|c|c|c|c|c|c|c| }
\hline
\multicolumn{2}{ |c| }{Beginning} & \multicolumn{2}{ |c| }{Profits} & \multicolumn{2}{ |c| }{Cash} & \multicolumn{2}{ |c| }{End Capital} \\
\multicolumn{2}{ |c| }{Capital Accounts} & \multicolumn{2}{ |c| }{Allocated} & \multicolumn{2}{ |c| }{Distributed} & \multicolumn{2}{ |c| }{Accounts} \\
\hline
\hline
4 & $66.90$ & $133.10$ & $5.01$ & $9.99$ & $15.00$ & $0.00$ & $56.91$ & $143.09$ \\
5 & $56.91$ & $143.09$ & $4.20$ & $10.74$ & $15.00$ & $0.00$ & $46.17$ & $153.83$ \\
6 & $46.17$ & $153.83$ & $3.46$ & $11.54$ & $15.00$ & $0.00$ & $34.63$ & $155.37$ \\
7 & $34.63$ & $155.37$ & $2.60$ & $12.40$ & $15.00$ & $0.00$ & $22.23$ & $177.77$ \\
8 & $22.23$ & $177.77$ & $1.67$ & $13.33$ & $3.90$ & $11.10$ & $20.00$ & $180.00$ \\
\hline
\end{tabular}
\end{center}

The present value of these cash flows, using a 10% discount rate, is $94.20.

\begin{center}
\begin{tabular}{ |c|c|c|c|c|c|c|c|c|c| }
\hline
\multicolumn{2}{ |c| }{Beginning} & \multicolumn{2}{ |c| }{Profits} & \multicolumn{2}{ |c| }{Cash} & \multicolumn{2}{ |c| }{End Capital} \\
\multicolumn{2}{ |c| }{Capital Accounts} & \multicolumn{2}{ |c| }{Allocated} & \multicolumn{2}{ |c| }{Distributed} & \multicolumn{2}{ |c| }{Accounts} \\
\hline
\hline
4 & $66.90$ & $133.10$ & $10.03$ & $19.97$ & $30.00$ & $0.00$ & $46.93$ & $153.07$ \\
5 & $46.93$ & $153.07$ & $7.04$ & $22.96$ & $30.00$ & $0.00$ & $23.97$ & $176.03$ \\
6 & $23.97$ & $176.03$ & $3.59$ & $26.41$ & $7.56$ & $22.44$ & $20.00$ & $180.00$ \\
\hline
\end{tabular}
\end{center}

$A$'s return decreases to $15 per year in years four to seven and to $3.90 in year seven. His end interest will be worth $15. The accounts are as follows starting in year four:

In the case where Blackacre drops 25% in value in year four, $A$'s loss would be only $2.63 in present value terms as compared to the $5.70 loss if he also bore the risk of reduced rents.
given a preference on *Blackacre*’s profits until he earns a 10% return on his capital account.

The tax advantage of this plan over an installment sale is that it defers gain recognition. On an installment sale (assuming that the sale qualifies for installment treatment)\(^{65}\) gain is prorated over all principal payments,\(^{66}\) and part of each payment is taxed as interest.\(^{67}\) Distributions from a partnership are treated first as a recovery of basis.\(^{68}\) Under the plan, if all goes as expected, A will receive $20 per year for six years and $25 in year seven when his interest is liquidated. If this were taxed as an installment sale, $10 of the $20 A receives in year one would be taxed as interest (this assumes an interest rate of 10% on outstanding principal) and $5 of the remaining $10 would be taxed as gain. Under the partnership rules, A is taxed only on his share of profits—$10 in year one—and

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\(^{65}\) In recent years, Congress has substantially restricted availability of the installment method, denying it to sales of inventory (IRC § 453(b)(2)(B)), sales by dealers of real or personal property (IRC § 453(b)(2)(A), (I)), and sales of property with depreciation recapture (IRC § 453(i)). It also has required those who sell real or intangible property used in a trade or business on an installment method, and who hold a large amount of installment notes, to pay interest on the deferred tax liability. IRC § 453A.

If a sale of *Blackacre* does not qualify for installment treatment, the advantages of the plan are even greater, though the results under the plan will be different because the § 751 hot asset rules may apply. Many of the assets denied installment treatment are considered hot assets, most importantly substantially appreciated inventory. See generally IRC §§ 453(a), (b)(2), (I), 751(d)(1). Generally, if a partner gets cash or nonhot property for an interest in a hot asset, it is treated as if he receives the hot asset in a distribution and sells it back to the partnership for the cash or the property. Consider the implications of the hot asset rules in *Example 10* if *Blackacre* is inventory. When A receives a $20 cash distribution in year one and reduces his interest in the partnership (and so in *Blackacre*) from 50% to 45% ($90 of $200), it is treated as a distribution of a 5% interest in *Blackacre* (worth $5) to A and resale of that interest by A back to the partnership. There are two possible outcomes depending on whether any of *Blackacre*’s $50 basis is allocated to the interest distributed to A. Under the general rules of § 732, A would take a $2.50 basis in the $5 interest deemed distributed to him and he would have $2.50 gain on the deemed sale. IRC § 732(a)(1). The Service might argue instead that under § 704(c), the basis of *Blackacre* is allocated entirely to B and so A has a zero basis in the part of *Blackacre* deemed distributed to him and $5 gain on the sale.

It is not clear under current law whether the basis of the part interest in *Blackacre* hypothetically distributed to A must be reduced. The § 704(c) regulations authorize offsetting allocations only of “depreciation, depletion, or gain or loss with respect to contributed property,” Reg. § 1.704-1(e)(2)(f), and so such a reduction may not be required. On the other hand, the § 751 regulations state that § 704(e) is taken into account in determining the distributee’s basis in the assets deemed distributed. Reg. § 1.751-1(a)(2). McKee, Nelson and Whitmire suggest that § 704(c) requires that the partner who contributes an appreciated hot asset be allocated its entire basis in applying § 751. McKee et al., note 31, ¶ 16.02[4]. This is wrong. The contributing partner (A in the example) should be allocated basis only in excess of basis that must be allocated to the other partners to provide them a fair market value basis in their share of the hot assets. In any event, under either approach, A is better off under the plan than he would be if he sold *Blackacre* outright for a six-year note since, if installment treatment is denied, he has $50 gain taxed at the time of the sale.

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\(^{66}\) IRC § 453(a), (c).

\(^{67}\) IRC §§ 483, 1274.

\(^{68}\) IRC § 731.
the remaining $10 is treated as basis recovery. The advantage of the plan over an installment sale is even greater in year two. Under either approach, $A$ pays tax on $9, the interest or his share of profits (the example is designed so the two are equal). But $5.50 of the remaining $11 is taxed under an installment sale while none of it is taxed under the plan. $A$ begins to pay tax on recovered capital in year five when his capital account is reduced below $50 and he has a zero basis in the partnership.69 Debt may be used to delay even further the recognition of gain.70

This arrangement does not violate the general norms of subchapter K.71 Cash preferences are fairly common in partnerships and have been upheld in several cases,72 though they usually involve a greater risk to the investor and the investor’s interest after the preference is satisfied is usually more substantial than in Example 10.73 Cash preferences also are

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69 Id.

70 For example, $AB Partnership$ might borrow $100 after its formation and invest the proceeds in a money market account or similarly secure instrument with the interest on that investment used to repay the debt. $A$ and $B$ are allocated basis from the debt in accordance with the losses they would bear if all of the assets of the partnership suddenly became valueless. Reg. § 1.752-2(b)(1). This is the amount of the deficit in their capital account once the losses are charged against the account. Initially, $A$ and $B$ each derive $50 basis from the debt since their initial capital accounts are $100 and each would be charged with a $150 loss if the partnership’s $300 in assets became valueless. At the end of year one, $A$’s share of the debt is reduced to $45 (his capital account is $90 and a $135 loss (45% of $300) would be charged to $A$ if partnership assets became valueless). $A$’s basis in the partnership at the end of year one is $85 ($100 original basis — $10 capital distributed — $5 reduction in debt). Under this plan, $A$ does not have gain on distributions of capital until year six rather than in year five. At the end of year five, $A$’s share of the debt is reduced to $19.42 (his capital account is $38.85 and a $58.27 loss (19.4% of $300) would be charged to $A$ if the assets became valueless). $A$’s basis in the partnership at the end of year five is $8.27 ($100 original basis — $61.15 capital distributed — $30.58 reduction in debt).

71 Section 704(c) does not apply because $Blackacre$ is never sold and it is distributed to $B$ only after $A$ has fully recognized gain. If $Blackacre$ is depreciable, § 704(c) would tax $A$ on part of the built-in gain by allocating a greater share of the depreciation deductions on $Blackacre$ to $B$. Reg. § 1.704-1(c)(3)(i) Ex. 1, (b)(5) Ex. 18. For example, if $Blackacre$ is a building with a 30-year useful life which is depreciated on a straight-line basis over thirty years and which earns $10.61 each year net of expenses excluding depreciation, the regulations require that the entire depreciation deduction for $Blackacre$, $1.67, be allocated to $B$. The result is that $A$ has $5.30 and $B$ $3.64 taxable income from $Blackacre$ each year although their economic interests are equal. If $Blackacre$ were held by $A$ and $B$ for 30 years, this would eliminate the built-in gain, but in seven years this effect is slight. Indeed, the § 704(c) allocation merely shields $B$ from any adverse effects from $A$’s deferral of the gain recognition (assuming there is sufficient basis to give $B$ full depreciation so the ceiling rule does not apply). The § 704(c) allocation requires $A$ to bear the cost of $Blackacre$’s low basis to the extent of depreciation, but $A$ may otherwise defer the recognition of gain.


73 The typical case involves a speculative project in which an investor is allocated all expenses and income until he recovers his expenses and all cash distributions until he recovers his investment (plus sometimes a specified rate of return). Thereafter the investor and the other partners share profits and losses evenly.
countenanced in the legislative history of § 707(a)(2)(B), although in qualified terms.

How does this plan fare under the proposed regulations? It does not come within the nonsale presumptions for preferred returns and cash-flow distributions since both require that distributions be made out of income allocated to the partner. Half of the distributions to A are income allocated to B. Preferred returns must be reasonable in amount, with a safe harbor rate of 150% of the applicable federal rate (AFR). To reduce A's equity interest, the distribution to A presumably must be at a higher rate.

Thus, the general rule covers this plan. The first two years' distributions are presumed to be part of a sale while later distributions are not. The other facts and circumstances are ambiguous. The timing and amount of the distributions may be determined with reasonable certainty at the time of the contribution, which is treated as evidence of a sale. But most of the other negative factors are absent. A cannot look outside the partnership to B or to a lender to secure the distribution, and the partnership does not have other liquid assets securing the distribution.

Factor eight gives the most pause. It defines as evidence of a sale "[t]hat partnership distributions, allocations or control of partnership operations is [sic] designed to effect an exchange of the burdens and benefits of ownership of property." This is the factor most directly concerned with the possibility of using special allocations to disguise sales. Read uncharitably, the factor is nonsensical. All contributions of property to a partnership are "designed to effect an exchange of the burdens and benefits of ownership of property" since part of future gain or loss on the contributed property is borne by the other partners and they share in the control of the property. Of course, the concern is with special alloca-

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74 1984 Bluebook, note 43, at 232 ("Congress did not intend to prohibit a partner from receiving a partnership interest in return for contributing property which interest entitles him to priorities or preferences as to distributions (such as a preference in nature of interest on contributed property), but which transaction is not in substance a disguised sale.").
75 Reg. § 1.707-4(a)(2), (b)(2)(i).
76 The part of the distribution that is out of A's share of operating cash flow is presumed not to be proceeds on a sale even though these are excess distributions. This is a potential source of confusion since these operating cash flow distributions take the place of interest that otherwise would be imputed on the deferred payments for the property. It would be a mistake to impute interest anew on the payments in reduction of capital. The solution probably is to treat this as a case where the facts "clearly" merit treating distributions out of cash flow as part of a sale. There is no provision in the rules on guaranteed payments and preferred returns for bifurcating payments that are unreasonable in total amount so that the part that would be reasonable is within those presumptions. See Reg. § 1.707-4(a)(1)(iii), (2). Thus, this problem does not arise under those rules.
77 Reg. § 1.707-3(b)(2)(i).
78 Reg. § 1.707-3(b)(2)(iii), (iv)
79 Reg. § 1.707-3(b)(2)(vii).
80 Reg. § 1.707-3(b)(2)(viii).
tions, extraordinary distributions or unusual control arrangements which serve to shift ownership of property. This only raises the question of how much variation of risk from the norm in the partnership is allowed before preferences or other arrangements that reduce a partner's risk turn a contribution into a sale. The only guidance on this crucial question is found in example eight. In the example, I contributes an office building to a partnership and other partners contribute government securities. Income, gain and loss on the securities are allocated 90% to I and income, gain and loss on the building are allocated 10% to I. This is treated as a disguised sale. Of course, Example 10 in this article is distinguishable from example eight in the regulations. A looks only to the property for income (albeit property improved with B's cash). In example 8 in the regulations I looks to the government securities which the partnership will not need to draw on to pay its expected expenses. At least in the first several years, A retains a stake in the property commensurate with his initial capital contribution. At all times A's stake in the property is commensurate with his partnership share. Thus, example eight, and by implication factor eight, does not require treating Example 10 as a disguised sale.

The approach of the regulations is similar to the common law approach to applying general standards in that indeterminate standards are given meaning by their application in specific cases. In a very real sense, then, the heart of the regulations is in the examples. Indeed, example eight was probably drawn in response to a much publicized plan for using special allocations to evade the disguised sale rule. The Service probably will deal with other difficult cases, such as the one I hypothesize, in similar fashion by revenue rulings. Over time, a clearer line between contributions and distributions and disguised sales will emerge as more hard cases are resolved.

But an approach that uses indeterminate standards that are given meaning over time through rulings and cases is a terrible way to administer the tax system. It puts most of the strain on the weakest part of the system, the agents in the field, who are too few in number, poorly trained and unsophisticated. It invites abuse by those who want to take advantage of the system. Penalties are imposed for positions taken without substantial authority, but whether there is substantial authority for a

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81 Reg. § 1.707-3(g) Ex. 8.
82 See NYSBA Report, note 38, at 1558.
83 The regulations temper this by requiring notice of distributions within two years unless they are reasonable guaranteed payments, reasonable preferred returns or distributions out of operating cash flow. Reg. § 1.707-4(a), (b).
84 The position must also result in a substantial understatement. IRC § 6661(a). There is no penalty for a position without substantial authority if it is disclosed. IRC § 6661(b)(2)(B)(ii).
position depends on the weight of the authority against it, and so weak arguments may seem substantial under standards that initially leave much in doubt. At the same time, doubt is costly to those who want to comply with the law, since they must employ attorneys who can plumb the mysteries of the law to tell them what is safe. And they may finally learn that little is definitely safe under these rules.

In some situations, these problems may be inescapable. If there were an important difference between sales and contributions and distributions requiring disparate treatment, a case-by-case approach elaborating general standards might be the best way to draw the line. But, as I argue later, nothing important need depend on such a distinction. The real policies that justify nonrecognition on contributions and distributions may be served in a way that largely avoids these problems.

There are two other more technical problems with the disguised sale rule. One relates to when it is applied. This can be illustrated with a variation of the May Stores transaction. Assume A contributes Blackacre to AB Partnership and B, a large publicly held corporation, contributes its stock. Five years later, the partnership is liquidated. A takes the stock and B takes Blackacre. Assuming this is a disguised sale (although it is not obvious that it would be), the regulations require A to treat this as a sale of Blackacre in year one and to impute interest on the sale. Thus, A has interest income over the five years. While it is not clear from the regulations, it seems that A must pay interest on the resulting tax deficiencies in each of those years.

This must be the rule or otherwise taxpayers would have an incentive to structure deferred payment sales as partnership contributions and distributions since, even if the transaction is recharacterized, they defer paying tax in the interim. But this look-back rule often will conflict with the three-year statute of limitations on assessments. The Service may compel taxpayers to correct their past mistakes, but only for three years. This means, for example, that if the issue of whether the distribution is part of a disguised sale is not raised until year six after the contribution,
interest imputed in years one and two (and maybe year three depending on the timing) may escape tax completely. If the sale does not qualify for installment treatment, the gain also may escape tax completely. If the disguised sale rule is to be retained, an exception needs to be made to the statute of limitations.

The other problem has to do with the scope of the rule, which applies only if interests in assets shift because of related contributions and distributions. Thus, the rule does not reach an exchange of assets in liquidation of a partnership where the funds for the liquidation come from the partnership. Many may think this is appropriate. Partners, they may argue, should be able to divide their assets however they want without recognizing gain. But some divisions are troubling:

Example 11: Bicycle Partnership owns a bicycle factory. Total partnership capital is worth $1 million and the partnership has a cash flow in excess of expenses of $150,000 per year. Debt is negligible. A’s basis in his partnership interest is $100,000 and his share of capital is $250,000. To liquidate A’s partnership interest, the partnership agrees to purchase three single-premium insurance policies over the next three years for $100,000, using part of its cash flow. The policies are on A’s life with A’s heirs as beneficiaries. The policies are distributed to A in liquidation of his interest.

The other partners are purchasing A’s interest in the partnership by diverting their share of its cash flow to him. A is never taxed on his gain in the partnership as his heirs receive the insurance proceeds tax free. If the partnership has made a § 754 election, the other partners are able to step up the basis of the partnership’s assets to reflect the gain that A should have recognized (an amount equal to the decrease in the basis of the policies on the distribution to A). The disguised sale rule does not apply in this situation.

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90 This could be justified by either an aggregate or an entity theory. The entity theory could be invoked to claim that one cannot pierce the veil of the partnership to determine each partner's share in its individual assets; each partner has a stake in the undivided whole and should be able to take any part of the whole. Or, one might invoke the aggregate theory to claim that there is no exchange on a distribution of a partnership asset since a partner merely takes what was always his.

91 IRC § 101(a)(1).

92 The rule might apply if the other partners made cash contributions that were used to purchase the insurance policies. This might be recast as a sale by A of his partnership interest for the cash. The issue of disguised sales of partnership interests is reserved in the regulations. Reg. § 1.707-7.

The regulations deal expressly with a related issue: a distribution by a partnership to a partner of property subject to a recently incurred debt.
IV. AN INTRODUCTION TO AN ACCOUNTS-BASED SYSTEM AND A COMPARISON WITH SOME ALTERNATIVES

A good reason for not taxing some partnership distributions is that earnings should be distributed tax free since they already are taxed at the partnership level. Another possible reason for nonrecognition is to facilitate the transfer of assets to and from partnerships. At one level, it is difficult to justify nonrecognition on the latter ground. An income tax must tax a gain-seeking exchange—the tax is imposed on gain and administrative reasons often necessitate that the tax be imposed on an exchange. But in a system where unrealized gains generally are not taxed, it would be a mistake to require partnerships and partners to recognize gain on all assets whenever interests in assets shift because of a contribution or distribution. Under this system, a partnership holding appreciated assets would recognize the gain on those assets if it admitted a new partner, no matter how small the new partner’s interest. And a person who contributed a gain asset to a partnership would recognize that gain, no matter how small the interests of the other partners. Gen-

Example: A, B and C are equal one-third partners in ABC Partnership, which owns Blackacre (basis $0, worth $300). The partnership incurs a $200 debt, secured by Blackacre, and uses the proceeds of the debt to purchase bonds. Blackacre is distributed to C subject to the debt. This probably would be recast as a sale by the partnership of Blackacre to A. Reg. § 1.707-6(b)(1), (d) Ex. 2. The lesson is that if sale treatment is to be avoided when liquidations alter interests in assets, it is best if the cash funding the liquidation comes from within the partnership.


94 See IRC § 1001.

95 Philip Postlewaite, Thomas Dutton and Kurt Magette have proposed what may be described as a system of total recognition. They would abolish § 721 to recognize gain and loss on contributions of assets. Postlewaite et al., note 10, at 470-73, 606-11. They would require existing partners to recognize gain or loss on partnership assets when a new partner joins the partnership. Id. at 470.

Example: AB Partnership owns Blackacre (worth $100 with a basis of $50). C contributes Whiteacre (worth $50 with a basis of $40) for a one-third interest. A and B would each report $25 gain; C reports $10 gain. The bases of Blackacre and Whiteacre are stepped up to their values. They would also treat a liquidating distribution as an exchange of an interest in the partnership’s remaining assets for the assets the distributee receives. Id. at 598-606.

Example: ABC Partnership owns two assets: Alpha stock (worth $120 with a basis of $60) and Beta stock (worth $60 with a basis of $15). Each partner has a $25 basis in his interest. C receives the Beta stock in liquidation of his interest. This is treated as an exchange by A and B of a two-thirds interest in the Beta stock (worth $40 with a basis of $10) to C for a one-third interest in the Alpha stock (worth $40 with a basis of $20). A and B each have $15 gain. C has $20 gain. AB’s basis in the Alpha stock becomes $80. C’s basis in the Beta stock becomes $45.

Distributions would be considered liquidating if they are not pro rata. Id. at 606. Nonliquidating distributions would remain tax free. Id. at 606.
erally, it is troubling when significant tax consequences flow from actions of small economic significance, since the tax consequences come to dominate the action.

I propose a system more closely tailored to the two reasons for nonrecognition that largely avoids the problems of the current system. It has three components: First, a partner would recognize gain on his investment in the partnership upon distributions exceeding his share of accumulated earnings or debt. Gain on an investment in a partnership would be measured by the difference between a partner’s basis in his interest and his capital account.96 Second, a distribution of assets would be treated as a taxable disposition by the partnership (except to the extent of the distributee’s predistribution interest in the asset). This would extend the rules in §§ 704(c) and 751(b), which treat some distributions as sales, to all distributions that alter interests in distributed assets.97 Finally, gain or loss on assets provisionally is allocated whenever interests in assets are altered as a result of contributions and distributions. This restates the rules in § 704(c) and the § 704(b) regulations requiring allocations of built-in gain or loss when interests in assets shift, but it eliminates the ceiling rule.98 These rules are worked out in detail in Section V.

The most novel part of the system is the rule requiring recognition of gain on distributions exceeding a partner’s share of earnings or debt. The operation of this rule can be visualized by conceiving of a partnership as a barrel. At the bottom of the barrel are partnership assets. Above this are accumulated earnings and the proceeds of partnership borrowings. A partner is required to recognize gain on his share of partnership assets when a distribution dips below his share of accumulated earnings and the proceeds of partnership borrowings. Rules also are proposed that would permit a partner to withdraw cash he contributes or the cash proceeds from the sale of assets he contributes without recognizing gain. (This may be visualized as another layer in the barrel above a layer of noncash assets.) The rules provide for nonrecognition when an asset contributed by a partner is distributed to him, and provide for nonrecognition to the extent of a partner’s share of gain on a distributed asset. (These rules permit some assets to pass out of the barrel without recognition of gain.)

This system avoids double taxation of partnership earnings by permitting tax-free distributions of accumulated earnings. It reduces the disincentive to place or hold gain assets in a partnership since tax is imposed on that gain only where a distribution is taken out of capital or a gain asset is distributed or sold. Any disincentive is further reduced by per-

96 See Section V.A.
97 See text accompanying notes 165-70.
98 See text accompanying note 171.

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mitting tax-free distributions of the cash a partner contributes and permitting a partner to withdraw assets he contributes and his share of gain on other assets tax free.

This section compares this system with the alternative reforms proposed by William Andrews and Curtis Berger in this issue. My proposal is similar to Professor Berger's. Although my proposed approach is slightly more complicated, it more closely fits the policies justifying non-recognition on distributions. I discuss the problem of complexity last.

A. Professor Andrews' Proposals

Professor Andrews proposes one change that bears significantly on disguised sale and related problems. He would make § 734(b) mandatory, to require a partnership to adjust the basis of its assets where a distribution results in gain or loss to a distributee or where a distribution results in a step up or step down in the basis of a distributed asset.

Mandatory § 734(b) adjustments eliminate some of the problems discussed in Section II. Recall Example 5 where a partnership buys a security and resells it for an installment obligation, creating a gain in the first year and offsetting losses in later years. Mandatory § 734(b) adjustments would eliminate the artificial losses realized by the remaining part-

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99 Andrews, note 8; Curtis Berger, W(h)ither Partnership Taxation, 47 Tax L. Rev. 105 (1991). Steines, note 13, at 658-64, suggests that the residual possibilities for gain and loss-shifting under § 704(c) and the § 704(b) regulations may be dealt with by adopting special rules to prevent corporations with net operating losses, tax-exempt corporations and foreign persons from absorbing built-in gain properly attributed to another partner. As Steines concedes, this limited reform would do nothing to address the larger problem of disguised sales. Further, it assumes that gain and loss shifting is problematic only if partners have different marginal rates. As explained in Section II, gain and loss shifting may provide tax savings even if the interested partners have the same marginal rate if they terminate or sell their interests in the partnership at different times. See notes 11-28 and accompanying text. Furthermore, the Steines proposal assumes something like the current rate structure will remain in effect. Under a more progressive rate structure where individual rates varied significantly, there would be concern with gain and loss shifting among individuals with different rates.

100 Professor Andrews' proposals try to preserve inside and gain and loss on non pro rata distributions of cash or assets by appropriate adjustments to the basis of the remaining partnership assets. For example, he argues that an in kind distribution of an appreciated asset should not be treated as an exchange of the distributed asset for the retained assets. Instead such a distribution should only require a reduction in the basis of retained assets as substitute property for carrying the partnership's unrecognized gain. Andrews, note 8, at 66. Professor Berger and I would both treat many (but not all) in kind distributions as taxable exchanges. Professor Andrews would require a partnership or distributee partner to recognize gain on some in kind distributions. He would require a partnership to recognize gain on an in kind distribution where assets of a similar character remain in the partnership and have insufficient basis to absorb the basis reduction required by § 734(b). Id. at 234-36. Furthermore, Andrews would require a distributee to recognize gain on an in kind distribution that reduces his interest in appreciated depreciable property. Id. at 252.

101 Id. at 221.

102 See text accompanying notes 27-28.
ners when the partner who recognizes most of the first-year gain departs after the first year since the basis of the note would be decreased when the departing partner recognizes a loss on the liquidation of his interest. Such adjustments also make it less attractive for a partnership to distribute assets when the basis steps up in the hands of the distributee, because this will be matched by a reduction in the basis of a partnership's assets. So, for example, a partnership may be reluctant to "sell" a low-basis asset for cash by having the buyer contribute cash to the partnership and later take the low-basis asset in a distribution since the partnership would be stripped of basis in other assets when it makes the distribution.

Mandatory § 734(b) adjustments leave many other problems unsolved. As previously noted, it is in a partner's interest to have such adjustments made when high-basis assets or cash are distributed to a partner with a low-basis in his interest. Example 3 is such a case. Even when the adjustment is not in the partners' interests, it does not completely eliminate the advantage of transferring assets through distributions. For example, if a partnership distributes a low-basis asset to a partner with a high basis in his interest, the partnership will have to reduce the basis in its other assets, but it will not be taxed on the gain. In essence, mandatory § 734(b) adjustments reduce deferral on distributions of low-basis assets, but they do not eliminate it. Under the current system without adjustment, gain is not taxed on a distribution of a low-basis asset until the remaining partners sell their interests in the partnership, which retain their low basis. With mandatory § 734(b) adjustments, the gain may be taxed at the partnership level when the partnership sells its remaining assets since the basis of partnership assets is reduced. Under an accounts-based system, the gain is taxed on the distribution of the asset.

B. Professor Berger's Proposals: Treating Liquidations as Deemed Sales

Professor Berger and I agree that asset distributions generally should be treated as sales. We differ in that he would require a partner to recognize part of his gain on an investment in a partnership on a distribution that reduces his percentage interest in the partnership, treating a

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103 Andrews, note 8, at 66.
104 See text accompanying note 22.
105 Some of Professor Berger's other proposals would affect the disguised sale problem indirectly. He would deny partners outside basis for their share of partnership liabilities, Berger, note 99, at 116-18, which would eliminate the possibility of creating basis to avoid gain on a distribution through partnership level borrowing. He would permit only bottom line allocations, id. at 131, which would prevent a partnership from shifting economic ownership of assets held by the partnership through special allocations of income, gain and loss on those assets.
distribution in reduction of interest like a stock redemption.\textsuperscript{106} Professor Berger borrows both rules from the corporate area. Subject to limited exceptions, a corporation recognizes gain on a distribution of assets.\textsuperscript{107} Shareholders of an S corporation generally do not recognize gain on a distribution of cash,\textsuperscript{108} but if a distribution is in redemption of stock (and is not treated as a dividend under § 302(b)), gain is recognized on the redemption.\textsuperscript{109} Typically, disproportionate distributions are in redemption of stock because equity interests change on the distribution.\textsuperscript{110}

Professor Berger does not indicate what the partnership level consequences should be where a partner recognizes gain on a disproportionate distribution or how the character of the gain to the distributee partner is to be determined. The logical solution is to treat the distribution as a purchase by the partnership of part of the distributee's interest in partnership assets equal to the percentage reduction in his interest.\textsuperscript{111} Thus, the partnership would step up the basis in its assets by the amount of the

\begin{footnotes}
\textsuperscript{106} Id. at 109.
\textsuperscript{107} IRC § 311(b).
\textsuperscript{108} IRC § 1368(b). A shareholder recognizes gain only to the extent the distribution exceeds the basis of his stock.
\textsuperscript{109} Section 1368 applies to distributions otherwise taxable under § 301(c) as distributions with respect to stock. IRC § 1368(a). Distributions in redemption of stock are taxed under the normal corporate rules. IRC § 1371(a)(1). Under § 302(b), some redemptions are recast as dividends taxable under § 301. The purpose of § 302(b) is to prevent a C corporation from disguising a dividend as a redemption. Thus, § 302(b) has a fairly narrow "safe harbor." A redemption is not recast as a dividend only if after the redemption the shareholder owns less than 50% of all classes of voting stock, IRC § 302(b)(2)(B), and if his percentage interest in voting stock and common stock decreases by 20% or more because of the redemption, IRC § 302(b)(2)(C). Even if a redemption fails this safe harbor, it may be treated as a sale if it is not "essentially equivalent to a dividend." IRC § 302(b)(1). Under that provision, a redemption is treated as a sale if there is a "meaningful" reduction in interest. See Boris Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.06 (5th ed. 1989). Under subchapter S, dividend treatment is favorable since the shareholder's entire basis is recovered before gain is taxed. Thus, taxpayers may be advised to take advantage of the narrowness of the safe harbor to design redemptions so they are taxed as dividends. Deborah H. Schenk, Federal Taxation of S Corporations § 12.03[2] (rev. ed. 1992). If the choice is made to treat reductions in interests in partnerships as deemed sales, the rules should be redrawn to treat any nontrivial disproportionate distribution that is not soon made up by an offsetting distribution as a deemed sale.
\textsuperscript{110} Typically, a shareholder who receives a disproportionate distribution is required to cancel or transfer stock back to the corporation to reflect the proportionate reduction in his equity interest. In closely held corporations, disproportionate distributions sometimes occur without formal changes in stock ownership. Under regulations defining the subchapter S one class of stock provision, shares of stock must have identical distributions rights. Reg. § 1.1361-1(l)(1). Disproportionate distributions may not result in termination of the subchapter S election, but the distributions may be recast as loans or other transactions consistent with their economic effect. See Reg. § 1.1361-1(l)(2)(v) Ex. 2 (suggesting that transaction where shareholders with nominal rights to equal distributions take out equal amounts in different years may be recast as a loan).
\textsuperscript{111} This is similar to the § 751 rules for hot assets and to proposals of Professor Postlewaite, Thomas Dutton and Kurt Magette for taxing liquidating distributions. Postlewaite et al., note 10, at 604-06.
\end{footnotes}
gain recognized by the distributee, and the character of the distributee's gain would be determined by the character of the partnership's assets.

Example 12: A is a 50% partner in AB partnership. The partnership owns land worth $100 with a basis of $40, inventory worth $100 with a basis of $80 and $100 cash. A's capital account is $150 and his basis in his interest is $110. $100 cash is distributed to A, reducing his interest in the partnership from 50% to 25% ($50 capital of a total of $200 capital). A would be treated as having sold a $25 interest in the land with a basis of $10 and a $25 interest in the inventory with a basis of $20 for $50 cash. A would have $15 capital gain and $5 ordinary income. The partnership's basis in the land would become $55 and its basis in the inventory would become $85.

In effect, these rules would treat a percentage reduction in a partnership interest as a deemed sale of the same percentage interest in partnership assets. Because of this characteristic, I call this the deemed-sale approach.

These rules are similar to an augmented version of the deferred-sale approach. Under a deferred-sale approach, a partner who contributes a gain asset to a partnership recognizes that gain when the asset is distributed by the partnership or when his interest in the partnership is reduced. Professor Berger extends this rule to cover gain that accrues while assets are held by a partnership and his proposals define as a

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112 ALI Study, note 13, at 129-31; Jackson et al., note 93, at 120-23; Marich & McKee, note 13, at 682-87. The Tax Simplification Act of 1991 would require large partnerships (generally those with 250 or more partners) to use the deferred-sale approach. S. 1394 and H.R. 2777, 102d Cong., 1st Sess. § 201 (1991) (proposing to add § 774 (b) to the Code). See Explanation, note 7, at 13-25. There are minor differences in the two systems considered by the ALI in 1954 and 1984. In 1954, the ALI considered and rejected what has been described as a "partial" deferred sale approach. In essence, a partner who contributed an asset would be treated as having sold only part of the asset equal to the other partner's shares in the asset after the contribution. In 1984, the ALI considered and rejected a "full" deferred sale approach. This treats a contribution of an asset as a sale at its full fair market value. Marich and McKee advocate the latter approach because of its considerably greater simplicity. Marich & McKee, note 13, at 684.

113 This is in addition to the rule in § 704(c) requiring a partner to recognize precontribution gain where an asset is sold or depreciated by a partnership.

114 In 1984, the ALI reasoned that if a deferred-sale approach were adopted, it would be "desirable" to adopt a parallel rule to cover gains and losses that accrue while assets are owned by partnerships, but concluded that this made the rule too complicated. ALI Project, note 13, at 136-37. McKee and Marich proposed to make the deferred-sale approach elective and would have offered a similar election when a new partner entered a partnership holding gain or loss assets. Marich & McKee, note 13, at 686 n.101. Under the rule proposed in the Tax Simplification Act of 1991, the approach would be required only on contributions of gain or loss assets. S. 1394 and H.R. 2777, 102d Cong., 1st Sess. § 201 (1991).
taxable reduction in interest a reduction in percentage interest in a partnership.115

The deemed-sale approach and the accounts-based approach use different triggers to determine when gain on an investment in a partnership should be taxed on a distribution. The deemed-sale approach taxes a distribution that reduces percentage interests in a partnership; the accounts-based approach taxes a distribution that exceeds earnings or debt.116 This difference points to one advantage to the accounts-based approach: Under the deemed-sale approach earnings may be taxed twice if they are distributed disproportionately.

Example 13: A contributes Blackacre (basis $40, worth $100) to AB partnership and B contributes $100 cash, which is used to improve Blackacre. In the first year $20 income is earned. AB distributes $10 to A and $10 is retained by the partnership. A’s interest in the partnership is reduced from 50% ($110 of $220 capital) to 47.6% ($100 of $210 capital). A would be required to recognize built-in gain on Blackacre ($60) equal to the proportionate reduction in his interest. Under the deemed-sale approach, since A’s interest is reduced by 4.8% (from 50% to 47.6%), A would recognize $2.88 gain (4.8% of $60). Under the accounts-based approach, A would not recognize gain on the distribution of $10 because that is his share of the first year’s earnings. If $20 were distributed to A, $10 would be taxed as gain.

115 The Tax Simplification Act of 1991 (which would adopt a deferred-sale approach for large partnerships) would recognize precontribution gain or loss when and to the extent the value of money or property distributed to a partner exceeds his basis in his interest. S. 1394 and H.R. 2777, 102d Cong., 1st Sess. § 201 (1991).

116 There is a mechanical difference in the two approaches. Under Professor Berger’s system, it is necessary to test the proportionality of distributions since only disproportionate distributions result in recognition of deferred gain. Under an accounts-based system, this is unnecessary since recognition depends on whether a distribution is out of earnings or debt. There is little practical administrative difference in the systems. It is not difficult to measure the proportionality of distributions under the deferred-sale approach. The biggest problem is the possibility that unequal distributions may offset, but this problem may be dealt with by testing proportionality on the basis of aggregate annual distributions. Postlewaite et al., note 10, at 606. Under the originally proposed subchapter S one class of stock regulations, the proportionality of distributions was tested using a three-month period. Prop. Reg. § 1.1361-10(i)(2)(B) (Oct. 1990).

The final regulations eliminate a requirement of strict proportionality over a defined period, and even permit distributions that equalize over years, but also intimate that such arrangements may be recast as loans. Reg. § 1.1361-1(i)(2)(f), (v) Ex. 2. Proportionality is indirectly an issue under the accounts-based system since relative balances in capital accounts, which are a function of the proportionality of distributions, determine the allocation of income and loss. If there is any administrative saving in the accounts-based system over the deferred-sale approach, it is that it avoids the calculation of gain or loss when partners differ in the rate at which they withdraw profits.
Tax may be avoided in this case under a deemed-sale approach by taxing only substantial reductions in interest. For example, rough justice could be achieved by allowing a tax-free percentage reduction in interest equal to a market rate of return, because a distribution of that percentage is likely to be out of earnings.

There is a related advantage to the accounts-based approach: Under the deemed-sale approach, a partial tax-free disposition of an asset still may be achieved if consideration is paid out in equal distributions.

Example 14: AB partnership owns Blackacre, which is worth $400 and has a basis of $200. C contributes $300 to the partnership. Later $100 is distributed to each partner. A and B have effectively sold a half interest in Blackacre to C for cash. If Professor Berger's rules were applied without modification, the $100 distributed to A and B would be treated as basis recovery.

A simplified version of the disguised sale rule might be retained to deal with cases like this.

The accounts-based approach makes it easier to preserve some features of subchapter K that are favorable to taxpayers. Under the rules I propose, a partner can withdraw cash he contributed without recognizing gain because cash contributions are added to the accumulated earnings account. If a partner contributes multiple appreciated assets to a partnership, one of these assets is sold by the partnership, and the sale proceeds are distributed disproportionately to the partner who contributed the asset, that partner would not recognize gain on the distribution because the allocation of built-in gain on the sale increases his accumulated earnings. To eliminate tax on the distribution in these cases under the deemed-sale approach would require special rules that exempt certain distributions from the ordinary rule treating reductions in interest as sales because of the origin of the assets distributed.

The accounts-based approach also provides a mechanism for accounting for debt financed distributions, though at a cost of considerable complexity. Professor Berger's solution to the problem of debt is simple:

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117 The accounts-based approach does not tax a partner's share of gain on an asset that is distributed to him. Gain would not be taxed when a partner contributes a gain asset to a partnership and later receives that asset with the same unrealized gain back in a distribution. Nor would a partner's share of gain that accrues while an asset is held by a partnership be taxed when that asset is distributed to him. Professor Berger would not tax gain when a partner contributes a gain asset and later receives the same asset back in a distribution, but he would tax all gain that accrues while an asset is owned by a partnership on a distribution of the asset. Berger, note 99, at 156.

118 See Section V.C.1.

119 See Section V.A, Example 21.
Abolish § 752 and deny partners outside basis for partnership level debt. This solution prevents partners from using partnership debt to increase the basis in their partnership interest. An increase in outside basis minimizes tax on a distribution both under current law and under a deemed-sale approach.

The denial of outside basis for debt has far-reaching implications. Contributions of property subject to debt in excess of the property’s basis would result in tax even though the contributing partner’s personal liability for debt did not change. Partners no longer could take advantage of debt-financed losses. The ability to take such losses already is greatly circumscribed by the passive loss rules and the at-risk rules, but Professor Berger’s proposal would go farther. The passive loss rules do not apply to publicly held corporations, for example, and the at-risk rules do not apply to nonrecourse loans from qualified lenders. Denying outside basis for debt also would mean that partners would be taxed on the withdrawal of tax sheltered earnings from a partnership once their cash investment is recovered through distributions or loss allocations. The passive loss and at-risk rules generally limit only the pass-through of losses and do not prevent the tax-free withdrawal of sheltered earnings.

The two approaches also differ in how basis is recovered in a taxable distribution. The deemed-sale approach follows the rules for stock redemptions, treating a taxable distribution as part gain and part basis recovery. The accounts-based approach taxes gain first and treats a

120 Berger, note 99, at 108.

121 The rules I propose for accounting for debt produce the same result in Professor Berger’s Example 4.1, id. at 119-20, because the partner who contributes property subject to debt is relieved from a liability equal in amount to the excess of the liability over the property’s basis. The rules produce different results in the following cases (among others).

Example: A and B each contribute property worth $100, subject to a $60 debt with a $30 basis, to AB partnership for a half interest. Under Professor Berger’s proposal, A and B each would have $30 gain on the formation of the partnership because they contribute property with debt in excess of basis. Under my proposals, neither A nor B would have gain since their personal liability remains at $60.

Example: A contributes property worth $100, subject to an $80 debt with a $40 basis, to AB partnership for an 80% interest. B contributes $5 cash for a 20% interest. Under Professor Berger’s proposal, A would have $40 gain since that is the excess of the property’s debt over its basis. Under my proposal, A would have $16 gain, since B assumes that amount of the liability and A has a gain on his investment in the partnership in equal or greater amount.

122 Professor Berger would let general partners take advantage of losses financed by recourse debt by allowing them to reduce their basis below zero. Id. at 126.

123 IRC § 469.

124 IRC § 465.

125 IRC § 469(a)(2).

126 IRC § 465(b)(6).
distribution as a basis recovery only after gain is exhausted. A case can be made for either approach. The deemed-sale approach is consistent with the treatment of installment sales, and a transaction where a partner gradually liquidates an interest may be likened to an installment sale. But it is not clear that the rule on installment sales should be the norm. Treating distributions that are not out of earnings as fully taxable gain to the extent there is gain is analogous to the rules for taxing boot in a subchapter C nonrecognition transaction, in the nonrecognition rules for like-kind exchanges, sales and purchases of principal residences and involuntary conversions. Once gain is calculated and cash to pay tax on the gain is in hand, there is no good reason to defer recognition. Further, many sales are denied installment treatment. The deemed-sale approach increases the advantage of structuring dispositions of such assets as partnership contributions and distributions, which means there is greater need for something like the disguised sale rule. Finally, if parties want installment treatment (and the sale qualifies for such treatment), they can structure the disposition of an asset as an installment sale.

The one situation the deemed-sale approach clearly handles better than the accounts-based approach is where distributions alter interests in assets of different character (that is, capital or ordinary) that as classes have offsetting gains and losses (for example, capital assets as a class show a gain while ordinary assets as a class show a loss). Offsetting gains and losses across asset classes can mask each other in ways that have untoward consequences under the accounts-based approach. To take an unusual case, if capital and ordinary gains and losses perfectly offset, a distribution may result in shifting the character of gain and loss among partners.

Recall Example 10 where transfers land to a partnership for a series of cash distributions that gradually reduce his interest in the partnership to zero. The allocation of income to on his share of capital is like interest on an installment note. Professor Berger’s system apportions gain across the cash distributions much as in an installment sale. In Example 10, for instance, when A’s interest in partnership is reduced from 50% to 45% in year one, A would be required to recognize 10% (5/50ths) of the built-in gain on Blackacre in that year. This is the same result as under an installment sale where A receives 10% of the principal in year one. If an asset is not subject to installment sale treatment, the deferred-sale approach permits a taxpayer to avoid that prohibition by disposing of the asset through a partnership.

See IRC § 351(b)(1).

IRC § 1031(b).

IRC § 1034.

IRC § 1033(a)(2)(A).

If the seller’s risk is too great, a transaction structured as a sale might be recast as a partnership contribution and distribution. For example, if a sale is nonrecourse and much of the interest and/or principal is contingent on the future value of the asset sold, the venture may be treated as a partnership. Cf. Leahy v. Commissioner, 87 T.C. 56 (1986) (recharacterizing purported sale of movie as a joint venture).
Example 15: ABC partnership has cash of $100, inventory worth $100 with a basis of $70 and stock worth $70 with a basis of $100. Each partner's capital account is $90 and each has a $90 basis in his capital account. Ninety dollars is distributed to A in liquidation of his partnership interest. Under the accounts-based approach, A would have no gain on the liquidation and the basis of the partnership in its assets would not be adjusted. Under the deferred-sale approach, A would recognize an ordinary gain of $10 and a capital loss of $10 and the basis of the inventory in the hands of the partnership would be increased by $10 and the basis of the stock would be decreased by $10.133

If ordinary gains and capital losses of different character offset, but the net of the two is positive, distributions may result in taxable income far in excess of the amount distributed under the accounts-based approach.134 If ordinary gains and capital losses offset and the net of the two is negative, recognition of the ordinary gain is deferred until a partner's interest is completely liquidated.

This is not a critical flaw in the accounts-based approach. The accounts-based approach preserves the character of gain and loss in most situations. Character is preserved if the aggregate values of capital and ordinary assets are both positive or both negative.135 Character also is preserved if the assets bearing the gain and loss are distributed (even if gains and losses offset).136 In such cases, the timing of recognition of ordinary income is much the same as under § 751(b). The character of

133 The result under the deferred-sale approach is similar to the result under § 751(b), except A recognizes a capital loss on the disposition of his interest in the stock. Under § 751(b), there is only a deemed sale of the inventory.
134 See note 147.
135 If the asset is sold or distributed to another partner, it would be treated as a sale and gain or loss would have the appropriate character. If a partner liquidates his interest, a special rule defines the character of gain or loss on that sale by the character of the assets in which the partnership takes a corresponding step up in basis. See Example 20.
136 Assume inventory worth $90 is distributed to A in liquidation of his interest in Example 15. A would take $33.33 of the inventory with a $23.33 basis. See Section V.C.2, especially Example 31. This would leave A with a $66.66 basis in his partnership interest. The balance of the inventory would come to A with a $56.66 basis (which is the inside basis steeped up by the gain recognized by B and C on the distribution). See Example 25. A would have a $10 capital loss and would hold inventory worth $90 with a basis of $80. He would recognize $10 ordinary income when he sells the inventory.

Alternatively, assume stock worth $70 and inventory worth $20 is distributed to A in liquidation of his interest in Example 15. A would take one-third of the stock worth $23.33 with a basis of $33.33. This is his share of the stock. The remainder of the stock would come to A with a basis of $46.66, its fair market value. This would leave A with a $10 basis which is applied to the inventory. A would hold inventory worth $20 with a basis of $10 and stock worth $70 with a basis of $80.
gain or loss is preserved on distributions in all cases if gains and losses do not perfectly offset, though a net loss delays recognition while a net gain accelerates it. The one situation where character is not preserved is where gains and losses of different character perfectly offset (as in Example 14), but this is likely to be rare and may be dealt with through a special rule.

C. Complexity

Both the accounts-based system and the deemed-sale approach are complex.\textsuperscript{137} Both require frequent revaluation of partnership assets and often tiresome calculations and allocations of gain and loss. For example, under either approach a partnership with a frequent turnover in partners would need to revalue assets constantly as partners reduced their interests and every asset would have a long record to reflect how interests in it have changed over time. My proposal is more burdensome than Professor Berger’s, for I would require §704(c)-type allocations of gain and loss, not only when gain and loss assets are contributed to a partnership, but also when interests in gain and loss assets in a partnership change because of admissions or withdrawals of partners.

A partial answer to the charge that the administrative burden imposed by the accounts-based system is too great is that it is no greater than the administrative burdens imposed under current law. Section 704(c) already requires that assets be valued on contributions and that precontribution gain or loss be accounted for so that it can be properly allocated when an asset is sold or depreciated. The §704(b) regulations require similar measures when interests in assets shift because of admissions or withdrawals of partners if assets are revalued on the shift in interest.\textsuperscript{138} Abolishing the ceiling limitation changes the allocation of gain or loss when assets are sold or depreciated, but does not make the calculation more complex. Taxing gain on asset distributions and reductions of interests by partners imposes some new administrative duties, but the additional administrative burden should be small since most of the relevant

\textsuperscript{137} Complexity is one reason the ALI rejected a deferred-sale approach. ALI Study, note 13, at 131. Another reason was the importance such an approach places on asset valuations, which the ALI thought opened the door to abuse. The report gives as an example one case where partners may not value assets to the best of their ability: where two partners contribute assets of equal, but uncertain value. Such cases are rare since people cannot be confident of the relative values of their assets unless they try to ascertain their actual value. The real problem is that the actual value of assets will be known and used to determine partners’ relative interests, but that asset value will be understated across the board on the books. This, of course, is fraud. We might hope people will be honest, especially since dishonesty requires conspiracy among all partners, present and future. Furthermore, undervaluations are risky since the Service need only establish the value of one asset beyond dispute to determine the value of all since any intentional discrepancy presumably will be replicated across all assets.

\textsuperscript{138} See note 40 and accompanying text.
information (for example, the value of a partner's capital account, the value of the distributed asset and the value of other assets) already must be produced. The accounts-based system also requires that partnerships maintain new accounts for accumulated profits and debt, but again the burden is slight because the information is already produced.

In any event, the administrative burden imposed by either system may be lessened greatly by the use of computers. The calculations are purely mechanical and can be done with programs that ask partners (or their accountants) to enter existing information. For example, one of the more difficult cases technically is where a new partner is admitted into a partnership holding depreciable assets with varying lives and built-in gain and loss, there are earnings in the following year, and at the end of the year the new partner takes one of the assets in reduction of his interest. It would not be too difficult to write a program ensuring the proper outcome if the partners enter the following: their capital accounts prior to the admission of the new partner, the capital account of the new partner, the basis and value of the partnership's assets on the admission of the new partner and the year-end distribution, the basis of their partnership interests, the earnings in the year in question and the depreciation schedule of the assets. This information ought to be currently available with the exception perhaps of the value of the individual assets when the new partner is admitted and later when his interest is reduced. Partners can be expected to revalue assets to protect their own interest if they think there has been a significant change in the assets' real value and book value on an aggregate basis, which will cover the most troubling cases. Partners may be relieved from having to revalue small individual assets by rules that allow them to account for built-in gain or loss on a mass basis.

The possibility of mechanizing the system creates a decided advantage over the current system. Mechanization is possible because judgment need never be exercised except in the valuation of assets and capital accounts, and valuation judgments are often ones that partners may make for themselves without the advice of lawyers or accountants. Under the current system, the disguised sale rule involves close questions of judgment, particularly when there is a distribution within the two-year presumption period that is not a straightforward distribution of profits. This requires partners to employ lawyers or accountants for advice.

Further, the disguised sale rule requires the collection of information that is unnecessary under the accounts-based system. For instance, under the disguised sale regulations, when property subject to debt is contributed to a partnership, the history of the debt must be traced. An accountant or lawyer must determine if the debt is more than two years
old, and, if it is not, for what purpose it was incurred. \textsuperscript{139} Under an accounts-based system, it is irrelevant when or why the debt was incurred. It is sufficient to know the value of the asset and the amount of the debt.

This answer to the complaint that the accounts-based system is too complex and burdensome on taxpayers might be conclusive but for the suggestion that there is widespread noncompliance with the current rules, particularly among small or closely held partnerships. Indeed, anecdotal evidence suggests that the hot asset rules (which are comparable to the deferred-sale approach or an accounts-based system in the administrative burdens they impose) are widely ignored, even by large law firms with sophisticated tax practices in filing their own returns.

The answer to widespread noncompliance with the existing rules may lie in greater enforcement. This move would cut in favor of the proposals made here. If partners are forced to take their administrative duties under § 704(c) and § 751 and the § 704(b) and § 707(a)(2)(B) regulations seriously, the accounts-based system is preferable to the current rules because it provides the maximum administrative return for their efforts. Once assets are valued, the taxpayer's and the Service's work is essentially done. Everything else follows mechanically or involves information (such as the amount of earnings and debt or depreciation schedules) that the partnership already produces.

If the burden imposed under current law and the proposals made here still seems too great for some taxpayers, the solution may be to bifurcate subchapter K. One part would be for partnerships with the sophistication and resources to value assets and to monitor accounts and shifts of interests. These partnerships could be put under the deferred-sale approach or the accounts-based system. \textsuperscript{140} The administrative burdens imposed on them could be lessened somewhat. For example, a law firm that admits a new partner ought not be required to account individually for all of its furniture and equipment. Valuation and allocation of deferred gain (or loss) might be required only for assets above a certain value (for example, the firm's building if it owns its offices) or with a

\textsuperscript{139} See note 184. The administrative burdens imposed by the disguised sale regulations are clearest in instances where the regulations demand the filing of an information return. An information return must be filed if there is a distribution to a partner within two years after the partner contributed property to the partnership unless the distribution qualifies as a guaranteed payment, a reasonable preferred return or an operating cash flow distribution. Reg. § 1.707-3(c)(2). Debt incurred within two years of the contribution of property subject to that debt must be disclosed unless the debt comes within the special rules for debt incurred to make capital improvements or trade debt. Reg. § 1.707-5(a)(7)(ii).

\textsuperscript{140} The proposed Tax Simplification Bill of 1991 would take a step in this direction by requiring large partnerships (those with 250 or more partners) to use the deferred-sale approach to deal with precontribution gain or loss. See note 112.
sufficient difference between basis and value. Remaining assets can be dealt with on an aggregate basis.\textsuperscript{141}

Another pass-through system would be created for small or closely held partnerships which are not capable of shouldering the administrative burdens imposed by the accounts-based system or a deferred sale approach (or the burdens imposed by current law). This system could be similar to subchapter S. This system is not perfect (in particular, subchapter S has no rule similar to § 704(c) to prevent gain or loss shifting on contributions of assets with built-in gain or loss and no rule similar to § 734(b) permitting inside basis adjustment when gain or loss is recognized on distributions), but the rules requiring corporations to recognize gain on asset distributions\textsuperscript{142} and requiring shareholders to recognize gain and loss on non pro rata stock redemptions\textsuperscript{143} go a long way towards solving the problems dealt with here, particularly when coupled with the rule denying outside basis for enterprise level debt.

V. THE ACCOUNTS-BASED SYSTEM DEVELOPED

This section describes the accounts-based system in more detail. The first subsection describes the novel part of the system: the rules taxing distributions not out of accumulated earnings. The second subsection describes the rules taxing distributions of assets. The third subsection describes limited exceptions that permit some pass through of gain and loss. The final section suggests rules for debt-financed distributions. Those who think this system an academic exercise may still find comparisons of the system with some aspects of the disguised sale regulations to be of interest, particularly the material regarding the determination of whether a distribution is out of profits\textsuperscript{144} and the treatment of debt-financed distributions.\textsuperscript{145}

A. Distributions Not Out of Earnings

The heart of the accounts-based system is the rule that partners recognize gain on their investment in the partnership if they receive a distribution in excess of their share of accumulated earnings (or debt). Gain on

\textsuperscript{141} Section 751 treats inventory as a hot asset only if it is substantially appreciated (that is, its value is greater than 120% of its basis). IRC § 751(a)(2), (d)(1). The legislative history of the § 704(c) changes in 1984 authorize Treasury to issue regulations that permit the aggregation of property contributed by a single partner and relaxation of the rule requiring allocation of precontribution gain or loss if the spread between basis and fair market value was less than 15% and \$10,000. 1984 Bluebook, note 43, at 213-14.

\textsuperscript{142} IRC § 311(b).

\textsuperscript{143} IRC § 302(b).

\textsuperscript{144} See notes 154-59 and accompanying text.

\textsuperscript{145} See notes 180-89 and accompanying text.
an investment in a partnership is measured by the difference between a partner's basis in her interest and her capital account. This rule ensures that earnings are not taxed twice (the strongest argument for nonrecognition) while taxing gain when distributions of other assets alter interests in gain assets held by a partnership.

Thus, under the accounts-based system, if a partner contributes a gain asset to a partnership and immediately receives a cash distribution, she would recognize gain on the distribution.

Example 16: A contributes Blackacre (basis $50, worth $100) to AB Partnership. B contributes $100 cash. Ten dollars cash is immediately distributed to A and to B. A would have $10 taxable income on the distribution because she has no accumulated earnings and because she has $50 gain on her investment in the partnership. B would have no income because his basis in his partnership interest equals his capital account.

If, however, the partnership has accumulated earnings, the partner could withdraw her share of the earnings tax free.

Example 17: A contributes Blackacre (basis $50, worth $100) to AB Partnership. B contributes $100 cash. In the first year, AB Partnership earns $20 net profits which is allocated evenly between A and B. On the last day of the year, $10 is distributed to A in reduction of her interest. A would recognize no gain on this distribution because it is out of accumulated earnings. If $20 were distributed to A, she would recognize $10 gain.

This rule ensures that earnings are never taxed twice.

A partner would also recognize gain on a distribution attributable to an interest in a gain asset that appreciates while held by the partnership. This may occur, for example, if a new partner contributes cash or an asset for an interest in the partnership and the cash or that asset is distributed to one of the original partners.

Example 18: AB Partnership owns Whiteacre (basis $100, worth $200). A's basis in her partnership interest is $50. The partnership has no accumulated earnings. C contributes $100 for a one-third interest in the partnership. A's and B's capital accounts are increased to $100 on the contribution. Fifty dollars is distributed to A before the partnership has any further earnings. A has $50 gain on the distribution.
The same result would follow, even without the admission of a new partner, if cash from earnings allocated to $B$ is distributed to $A$ in reduction of her interest.

*Example 19:* $AB$ Partnership owns Whiteacre (basis $100,$ worth $200) and $50$ cash. $A$’s basis in her interest is $50. $A$ has no accumulated earnings. (The partnership earned $100$ at some earlier point and $50$ was distributed to $A$. The remaining $50$ are $B$’s accumulated earnings.) Fifty dollars is distributed to $A$. $A$ would have $50$ gain on the distribution.

If a partner recognizes gain on a distribution, the partnership would increase its basis in the appreciated assets by the amount of gain recognized. If a partnership has more than one asset, the increase would be apportioned among assets by the following formula: gain or loss that would be allocated to the partner on the sale of asset $x$ (gain recognized on the distribution/the partner’s total potential gain on her interest$^{146}$). This formula allocates the basis increase to the assets giving rise to the gain in the proportion triggering the gain.

*Example 20:* $A$ contributes Blackacre (basis $50,$ worth $60$) and Whiteacre (basis $20,$ worth $40$) to $AB$ Partnership. $B$ contributes $10$ cash and stock (basis $70,$ worth $90$). Before the partnership has any earnings, $10$ cash is distributed to $A$ in reduction of her interest. $A$ would have $10$ taxable income on the distribution. The basis of Blackacre would be increased by $3.33$ ($10$ gain allocated to $A$ on the sale of Blackacre times the $10$ gain realized divided by the $30$ total gain on her interest). The basis of Whiteacre would be increased by $6.66$ ($10 \times 20/30$).$^{147}$

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$^{146}$ This is her capital account minus her basis in her partnership interest.

$^{147}$ The formula also produces the correct result when a partnership has assets with offsetting gain or loss, and gain or loss is recognized on a distribution.

*Example:* $ABC$ Partnership has $100$ cash, inventory worth $100$ with a basis of $70,$ $X$ stock worth $60$ with a basis of $30$ and $Y$ stock worth $40$ with a basis of $50.$ $A$ has a capital account of $100$ and a basis in his interest of $85.$ Fifteen dollars is distributed to $A.$ Under the rules proposed here, $A$ would be taxed on $15$ gain, the difference between his basis in his interest and his capital account. Ten dollars of this gain would be ordinary and $5$ would be capital gain. The basis of the $X$ stock would be increased by $8.33$ and the basis of the $Y$ stock would be decreased by $3.33.$ This is the gain and loss that would be allocated to $A$ if the stock were sold.

This rule may have troubling consequences if there are large amounts of gain and loss of a different character that do not perfectly offset. In that situation, a small distribution can have significant tax consequences.

*Example:* $AB$ Partnership has $50,000$ cash, inventory worth $100,000$ with a basis of $50,000$ and stock worth $52,000$ with a basis of $100,000.$ $A$’s capital account is $101,000$ and his basis in his partnership interest is $100,000.$ One thousand dollars is
This formula also provides a mechanism for determining the character of the gain to the distributee if that is necessary. To the extent that gain would result in a basis increase in ordinary income assets, it would be ordinary income to the distributee.

The system requires that an accumulated earnings account be maintained by a partnership for each partner. This is similar to the accumulated adjustments account of a subchapter S corporation.\(^1\) The account would be increased by taxable income and decreased (below zero if necessary) by tax losses allocated to a partner. The account also would be decreased by distributions considered to be out of the account and not out of capital or the proceeds of the debt.

Some adjustments should be made in the account. It should be increased by tax exempt income allocated to a partner to preserve the exemption. Without such an adjustment, distributions of exempt income might be taxable.\(^1\) One might adjust the account on the basis of book

\[\text{distributed to } A.\]

Under this rule, \( A \) would have $25,000 ordinary income and a $24,000 capital loss. Unless he has other capital gains, \( A \) would be able to deduct only $3,000 of the capital loss. Thus, a $1,000 distribution could result in $22,000 income to \( A \).

This is an aspect of the problem discussed earlier involving gains and losses of offsetting character under an accounts-based approach. See notes 96-98 and accompanying text.

These adjustments are no more complicated (and are considerably more accurate) than the adjustments required by § 755 when a partnership adjusts the basis of its assets under § 734(b) on a distribution. First, the § 755 regulations require adjustments by class of assets (capital or ordinary) on the basis of net gain or loss within the class. Reg. § 1.755-1(a)(1)(i), (c) Ex. 3. Thus, Treasury does not permit adjustments within a class where gains and losses offset. See McKee et al., note 31, ¶ 24.04[1] Ex. 2.

Second, the regulations only permit adjustments that reduce the difference between an asset's basis and its fair market value. Reg. § 1.755-1(a)(1)(ii) and (iii). This is not always appropriate where basis adjustments are made because of distributions under § 734(b), because sometimes the adjustment must increase the difference between basis and fair market value to preserve a gain or loss. See McKee et al., note 31, ¶ 25.02[2].

Example: \( ABC \) Partnership has three assets: \( \text{Blackacre} \) (value $100, basis $70), \( \text{Whiteacre} \) (value $100, basis $55) and \( \text{Greenacre} \) (value $100, basis $40). All are capital assets. \( A \) has a capital account of $100 and a basis of $55 in her interest. \( \text{Greenacre} \) is distributed to \( A \) in liquidation of her interest. Under § 732(b), \( A \)'s basis in \( \text{Greenacre} \) is $55. If a § 755 election has been made, under § 734(b)(2)(B) the partnership is supposed to decrease the basis of \( \text{Blackacre} \) and \( \text{Whiteacre} \) by $15 (the increase in the basis of \( \text{Greenacre} \)). This cannot be done under § 755 because it increases the difference between basis and market value.

The accounts-based system avoids this problem. The distribution of \( \text{Greenacre} \) would be treated as a sale by the partnership of a two-thirds interest in \( \text{Greenacre} \) for $66.66. The partnership would recognize $40 gain and the basis of \( \text{Greenacre} \) in \( A \)'s hands would be $80. \( A \) would be treated as receiving a distribution in the amount of $100. Her gain in the partnership would be $45. She would recognize $25 of this gain because $20 is allocable to \( \text{Greenacre} \). See Section V.C.2. The partnership would increase the basis of its remaining assets by $25. Ten dollars is allocated to \( \text{Blackacre} \) and $15 to \( \text{Whiteacre} \).

\(1\) IRC § 1368(e)(1)(A). Note, however, that the subchapter S account is a corporate level rather than a shareholder account.

\(1\) Cf. Reg. § 1.705-1(a)(2)(ii) (increasing partner's basis in partnership interest for tax exempt income earned by partnership). Exempt income is not added to the accumulated adjustments account of a subchapter S corporation. IRC § 1368(e)(1)(A).
depreciation, and not tax depreciation, to preserve the benefits of accelerated depreciation.\textsuperscript{150} But this would require the maintenance of separate books and depreciation schedules and probably is not feasible. Moreover, the current system of depreciation was not meant to be a preference or subsidy,\textsuperscript{151} and so the advantage, if any, in the present system may not warrant preservation. The accumulated earnings account also should be reduced by expenditures that are not deductible or capitalized, such as bribes and penalties that cannot be deducted under § 162(c).\textsuperscript{152} This is necessary to preserve the "sting" in the rule denying the deduction.

The adjustment of the accumulated earnings account based upon tax income and not book income has important implications when a partner has tax income in excess of book income due to allocations of built-in gain to him under § 704(b) or (c).

\textit{Example 21:} A contributes zero basis receivables worth $10 to a partnership. The partnership collects $5 on half of the receivables. Under § 704(c), this $5 income must be allocated to A though she has no book income (the value of the receivables is already included in her capital account). A’s accumulated earnings account also would be increased by $5; otherwise A would pay tax twice on whatever part of the $5 is distributed to her.

There is a similar effect if a partner has taxable income in excess of book income because of special allocations of depreciation under § 704(b) or (c).\textsuperscript{153} These adjustments are consistent with the purpose for maintain-

\textsuperscript{150} Under the § 704(b) regulations, book depreciation is assumed to equal tax depreciation (or to occur over the same period and at the same rate if the value and basis of an asset differ). Reg. § 1.704-1(b)(2)(iv)(g)(3). The earnings and profits of a subchapter C corporation are calculated using straight line and not accelerated depreciation. IRC § 312(b). This rule is disadvantageous to shareholders of C corporations because it increases earnings and profits, which results in treating corporate distributions as dividends.

\textsuperscript{151} S. Rep. No. 313, 99th Cong., 2d Sess. 95-96 (1986), reprinted in 1986-3 C.B. (Vol. 4) 95-96 (stating that objective of the changes in depreciation was neutrality).

\textsuperscript{152} A similar adjustment is made in the accumulated adjustments account of an S corporation. IRC §§ 1368(e)(1)(A), 1367(a)(2)(D).

\textsuperscript{153} Consider the following example:

\textit{Example:} A contributes a machine worth $100 with a basis of $50 to AB Partnership. The machine has a five-year useful life and earns $26.40 net of expenses except depreciation each year. The double declining balance method is used to compute tax depreciation on the machine and the straight line method is used to compute book depreciation. For book purposes, income and depreciation are split evenly between A and B. In year one (ignoring the half-year convention), A and B each have $3.20 book income ($13.20 - $10.00 book depreciation). But depreciation deductions are allocated entirely to B under § 704(c). Thus, A’s taxable income is $13.20 (B recognizes a loss of $6.80). A’s accumulated earnings account should be increased by the $3.20 book income plus the $10.00 adjustment for the § 704(c) allocation. Over five years, the cumulative effect of
ing the accumulated earnings account because the special allocation results in the partner paying tax on the built-in gain.

The disguised sale regulations look to book income rather than tax income to determine whether a distribution is out of a partner's share of profits. This issue arises under the presumption that operating cash flow distributions (in essence, distributions of profits) are not part of a sale.\footnote{Reg. § 1.707-4(b)(1).} Under the proposed regulations, net cash flow equals taxable income or loss increased by deductions (such as depreciation) not matched by a cash charge and decreased by expenditures (such as debt repayments and capital expenditures) not matched by a deduction.\footnote{Reg. § 1.707-4(b)(2).}

The use of book and not tax income to determine whether a distribution is within the presumption weakens the rule slightly. So long as distributions are out of a partner's share of taxable income, they cannot be received tax free (because they are taxed at the partnership level) and there can be no reduction in the partner's capital account (which is adjusted by tax and not book income). By defining presumptively nontaxable cash flow by book and not tax income, the regulations makes it possible to partially liquidate a partner's interest without gain recognition.

\textit{Example 22:} \(A\) contributes research on an enzyme for dissolving oil to \textit{RD Partnership}. \(A\) has a $1,000 basis in this property and it is valued at $2,000. \(B\) and \(C\) each contribute $2,000. This $4,000 is spent in year one developing the enzyme. \(A\) performs no services for the partnership. The partnership elects to deduct this expense in year one under § 174. Under a licensing agreement entered into with \textit{XYZ Corporation}, the partnership is paid $4,000 in year one for the right to use the enzyme for three years. Under the partnership agreement, income is allocated to the partners in accordance with their relative tax capital accounts. However, no distributions will be made to \(B\) and \(C\) until \(A\)'s tax capital account is zero. In year one, \(A\)'s tax income is zero and his book income is $1,666. This is distributed to \(A\), reducing his tax capital account to $334. \(B\) and \(C\)'s tax capital accounts remain at $2,000.\footnote{This assumes that the value of the enzyme remains $2,000; otherwise, capital accounts would have to be revalued on the distribution. This is not too tenuous an assumption because the increase in value of the enzyme from development would have to be offset by the decrease in value from relinquishing the right to the enzyme for three years.}

\footnote{These adjustments would be the same as allocating $50.00 taxable gain to \(A\) on the sale of the machine and increasing her accumulated earnings account by the same amount.}
If the licensing agreement is executed when the partnership is formed, this is a fairly transparent scheme for $A$ to transfer most of his interest in the enzyme to $B$ and $C$ for cash. Under the regulations, the distribution of cash is considered an operating cash flow distribution and is presumed not to be part of a sale.

This is not a major flaw in the regulations for several reasons. First, usually the divergence of tax and book income, which makes such a transaction possible, is not very dramatic. Second, the rule that operating cash flow distributions are not part of a sale is only a presumption. Facts and circumstances "clearly" to the contrary may overcome the presumption. Third, to come within the presumption, a partner's operating cash flow distribution must equal net cash flow times the lesser of his share in profits that year and his overall share in profits over the life of the partnership. Thus, in Example 22, the Service might argue that $33\%$ is not $A$'s share in profits over the life of the partnership because he has a smaller share of profits in later years once his interest is reduced. However, the regulations never indicate how a partner's share of profits over the life of the partnership is to be measured. It is not obvious how shares that vary over time should be weighted to account for time and changing profits. Of course, points two and three are reminders that one flaw in the proposed regulations is their uncertainty. Aggressive transactions are neither clearly safe, nor clearly defined as sales.

Capital accounts generally should be maintained as under the current § 704(b) regulations, although a few changes should be made in those rules to ensure that capital accounts reflect the real value of a partnership interest. If a partner enters a partnership that owns appreciated assets, the regulations permit, but do not require, an increase in the capital accounts of the original partners to account for that appreciation. Similarly, the regulations permit, but do not require, an adjustment of capital accounts to reflect changes in the value of partnership assets when a partner reduces his interest in a partnership. These adjustments should be mandatory.

It is probably unwise and unnecessary to require revaluations of partnership assets in the absence of a contribution or a distribution that alters partners' relative interests in capital. Where there is a shift in relative

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157 Reg. § 1.707-4(b)(1).
158 Reg. § 1.707-4(b)(2)(i).
159 Reg. § 1.707-4(b)(2)(ii) provides a safe harbor—the partner's smallest percentage interest in any material item over the three-year period beginning with the year of the distribution—but it also states that other percentages may be used.
162 Under the current regulations, periodic revaluations are permitted, but are not required, for investment partnerships with readily valued assets, such as securities, if that is a generally accepted accounting practice. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii).
interests, values set by the partners generally can be trusted because their interests are adverse. Without a shift in interests, there is no such constraint, and it is not necessary to require periodic revaluations. Assuming a distribution is not a gift, non pro rata distributions that do not affect interests in a partnership must be advances and should be treated as loans to the distributee. Pro rata distributions do not change relative interests and may be dispersed out of capital, but gain escapes taxation in such cases only in unusual circumstances.

B. Distributions of Gain or Loss Assets

A distribution of an asset should be treated as a sale of the asset by the partnership. Thus, if a partnership distributes a gain asset, the partners will recognize gain.

Example 23: A contributes Blackacre (basis $50, worth $100) to ABC Partnership. B contributes Whiteacre (basis $70, worth $100). C contributes $100 cash. Blackacre is immediately distributed to C with its value and basis unchanged. A would have $50 taxable gain. If instead, Whiteacre were distributed to C, B would have $30 gain. If instead, Blackacre were distributed to B, A would have $50 gain and B would have $30 gain.

The partnership would recognize a loss on the distribution of a loss asset. If a partnership dissolved and distributed all of its assets, this rule would take precedence over the rule discussed in Section V.A. Thus, in Example 23, if the ABC Partnership dissolved and A took Whiteacre, B took Blackacre, and C took $100 cash, A would recognize $50 gain on the distribution of Blackacre to B and she would recognize no gain on the distribution of Whiteacre.

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163 Advances creating a deficit in a capital account will not be treated as part of a disguised sale under § 707(a)(2)(B) if capital accounts are respected and the make-up obligation is not too far in the future. 1984 Bluebook, note 43, at 232. Currently, distributions are treated as loans if the partner has an obligation to repay the distribution. Reg. § 1.731-1(c)(2).

164 Two conditions must be met. First, there must be insufficient accumulated earnings to account for the distribution; otherwise, it would not be taxable in any event. See Examples 16 and 17. Second, the partner's gain on her investment in the partnership must be attributable entirely to appreciation in the value of partnership assets that postdates the last shift in interest; otherwise, there will be a discrepancy between her basis and capital account giving rise to gain on a distribution. See Example 18.

165 A's accumulated earnings account would be increased by $100, the $50 gain recognized plus the $50 original basis of Blackacre.

166 The $50 gain would be allocated to A on the deemed sale of Blackacre so A's basis in her interest would be $100 and equal to the fair market value of A's partnership interest.
The other partners would recognize gain on a distribution of a gain asset even if the distributee partner is not taxed because she has sufficient accumulated earnings.

Example 24: A contributes 10 shares of stock, each worth $10 and with a basis of $5, to AB Partnership. B contributes Whiteacre (basis $70, worth $100) to the partnership. In the first year, the partnership has $20 of income in rents and dividends allocated evenly to A and B. At the end of the year, B receives one share of stock worth $10 with a basis of $5 in a distribution. B would have no income because her accumulated earnings equal the value of the stock distributed. A would have $5 gain.

This is proper because, by distributing stock to B in lieu of her share of the earnings, A exchanges that stock for accumulated cash or other assets purchased with the cash.

Where a partner recognizes gain on the distribution of an appreciated asset, he would increase the individual basis in his partnership interest and his accumulated earnings account by the amount of gain recognized. The partnership would increase the basis of the distributed asset by the amount of the gain recognized. The augmented basis would carry over to the distributee.

Example 25: A contributes 10 shares of stock each worth $10 and with a basis of $5 to AB Partnership. B contributes Whiteacre (basis $70, worth $100). In the first year, the partnership earns $20 in rents and dividends, which are allocated evenly to A and B. At the end of the year, B receives one share of stock worth $10 with a basis of $5 in a distribution. B would have no income because her accumulated earnings equal the value of the stock distributed. A would have $5 gain. The basis of the share distributed to B would be increased by the $5 gain to $10 and that would become B’s basis in the share. A’s basis in her partnership interest would be increased by $5 to $65.

Conversely, if the other partners recognize a loss on a distribution of an asset, the basis of the asset would be decreased by the amount of the loss and the lower basis would carry over to the distributee. The other tax consequences to the distributee follow from the rule in the preceding subsection. In Example 25, the distribution is out of earnings so B would not have gain on the distribution. B’s basis in the partnership would be reduced by the basis she takes in the stock. If the distribution were not out of earnings, B would recognize gain on the distribution (assuming she
has gain on the investment in the partnership). This gain would equal B’s basis in the stock and there would be no reduction in her basis in the partnership.\footnote{A special rule is needed for distributions in complete liquidation of an interest where there is a loss. To preserve character, the distributee’s basis in the asset should equal the fair market value of the other partner’s share in the asset plus the basis of his share. The basis of his share would be subtracted from his outside basis and any remaining outside basis would be treated as a loss. The operation of this rule is illustrated in note 136.}

It may seem counterintuitive that the augmented basis of the asset benefits the distributee and not the other partners, because the other partners pay tax on that gain. However, if the distribution is not taxable to the distributee, it is because the distribution is made out of earnings or because her basis in her partnership interest equals the value of her capital account. If that is the case, the distribution of an appreciated asset leaves the other partners with a greater interest in full basis assets inside the partnership. These adjustments preserve the equivalence of inside and outside basis. For example, the partnership’s balance sheet before and after the distribution is as follows in \textit{Example 25}:

\begin{center}
\begin{tabular}{lcc|cc}
\multicolumn{3}{c|}{\textit{Predistribution Balance Sheet}} & \multicolumn{2}{c}{\textit{Postdistribution Balance Sheet}} \\
\hline
\textit{Assets} & \textit{Value} & \textit{Basis} & \textit{Value} & \textit{Basis} \\
\hline
Stock & $100 & $50 & $90 & $45 \\
Land & 100 & 70 & 100 & 70 \\
Cash & 20 & 20 & 20 & 20 \\
\hline
\end{tabular}
\end{center}

The basis of the remaining assets of the partnership would increase if the distributee recognizes gain on the distribution under the rule described in the last subsection.\footnote{Consider the following example: \textit{Example:} A contributes 10 shares of stock each worth $10 and with a basis of $5 to \textit{AB Partnership}. B contributes Whiteacre (basis $70, worth $100). Before the partnership has any earnings, B receives in a distribution one share of stock worth $10 with a basis of $5. A would recognize $5 gain on the distribution of the stock to B. B would recognize $10 gain—the value of the stock—because she has no earnings and she has $30 potential gain on her investment in the partnership. A would increase her basis in her partnership interest by $5.}
Finally, the ceiling rule\textsuperscript{169} should be abolished. This is relevant when an increase in the value of an asset is allocated to a partner (or partners) and the asset later decreases in value and is sold or distributed. Such cases may be handled by keeping records of booked gains and losses on an asset and accounting for all such items on sale or distribution of the asset.

\textit{Example 26}: A contributes Blackacre (basis $50, worth $100) to ABC Partnership. B and C each contribute $100 cash. The $50 gain on Blackacre provisionally is allocated to A. Blackacre decreases in value and is sold for $70. A $10 loss on the sale would be allocated to A, B and C, and a $50 gain would be allocated to A. B and C would have a tax loss of $10 and A would have a tax gain of $40.\textsuperscript{170}

If there are a series of contributions and distributions that alter partners' relative interests in capital during a period in which a partnership's assets fluctuate in value, there will be a number of book items of gain or loss provisionally allocated to each partner that must be netted out when the asset is sold or distributed.

\textbf{C. Limited Pass Through}

In some cases the proposed rules may seem too harsh. For example, if a partner contributes cash and a gain asset and immediately withdraws the cash, he would recognize gain on the distribution under the rule proposed in Section V.A. This subsection proposes rules for this and related cases.

\textbf{1. Cash Distributions}

Plausible arguments can be made for not recognizing gain on distributions attributable to cash contributed by a partner or cash proceeds of the sale of an asset contributed by a partner.

\textit{Example 27}: A contributes Blackacre (basis $0, value $100) and $100 cash to AB Partnership for a two-thirds interest. B contributes $100. Shortly thereafter, $100 is distributed to A.

\textsuperscript{169} See notes 34-37 and accompanying text.

\textsuperscript{170} A distribution of Blackacre to a partner raises special problems dealt with in the next subsection.
Under the proposed rules, A would have a $100 gain on the distribution. This may seem unfair because had A originally contributed only Blackacre and retained the cash, the gain would not be taxed. To tax A might discourage contributions of cash to a partnership because a partner would know that she could not retrieve her cash without recognition of any gain in the investment. Furthermore, A could argue that she already has paid tax on the withdrawn cash, that she contributed out of after-tax earnings. For both reasons, it may seem inappropriate to tax distributions out of cash contributions. This can be avoided by adding cash contributions to the accumulated earnings account.

If distributions out of cash contributions are not taxed, it also is logical not to tax distributions of cash proceeds from the sale of an asset contributed by a partner in the amount of the asset's basis (cash proceeds that represent gain allocated to the partner would not be taxed as they are accumulated earnings). Mechanically this would be done by adding to a partner's accumulated earnings account the basis of an asset he contributes when the asset is sold.

Example 28: A contributes Blackacre (basis $0, value $100) and Whiteacre (basis $100, value $100) to AB Partnership for a two thirds interest. B contributes $100 cash. Whiteacre is sold for $100. One hundred dollars would be added to A's accumulated earnings account and $100 could be distributed to A without gain recognition.

The contribution of Whiteacre is indistinguishable from a contribution of cash where Whiteacre is later sold: A already has paid tax on that $100.

These rules would segregate a partnership's cash and noncash assets into separate pools. Once the pool of noncash assets is dipped into, any gain on assets in that pool would be recognized. Adding the basis of a contributed asset to the accumulated earnings account only upon sale of the asset may seem arbitrary. The consequence in Example 27, for example, is that A would recognize gain if cash were distributed to her before Whiteacre was sold, but not if cash were distributed after it was sold. This is, however, a defensible attribution rule, for, if Whiteacre has not been sold, the cash distributed to A must come from cash contributed by B, and its distribution to A takes on the character of a classic disguised sale.

Not taxing distributions out of cash contributions or the proceeds from the sale of an asset contributed by a partner is not fatal to the proposed system. It merely defers the recognition of gain somewhat longer in a few cases. It is, however, essential to the system that noncash assets be treated as a single pool and that gain be recognized when that pool is dipped into. The alternative would be to treat a distribution as attributa-
ble to a particular asset if it reduces the value of a partner's interest in the partnership below the value of that asset. This would permit a partner who contributes several assets to a partnership, some appreciated and some not, to defer the recognition of gain on a series of liquidating distributions until the value of the gain assets is reached. It also would require stacking assets to determine when each is reached. A partner, for example, might elect to place an asset at the top of the stack although it is a gain asset because it will be sold soon in any event. Such a rule would cause significant consequences to turn upon the taxpayer's ability to define assets in the smallest units possible. A partner who contributes a going concern, for example, would want to divide that concern into as many assets as possible to delay the recognition of gain on distributions attributable to the most appreciated assets.

2. Distributions of Assets

Under current law, if a partner contributes appreciated property to a partnership and later receives that same property back in a distribution, she is not taxed.\textsuperscript{171} There is a similar exception for nonrecognition on distributions to partners of hot assets that they contributed to a partnership.\textsuperscript{172} These rules reflect a plausible judgment that the arguments for taxing distributions are weaker when a partner withdraws an asset that she contributed to the partnership. This may be justified by reasoning that the partner's position has not changed. Such a rule also may reduce the disincentive for transferring assets to partnerships in the cases where the disincentive is likely to be most strongly felt, that is, where there is uncertainty about the prospects for a venture. A partner knows that, if a venture fails, she always may withdraw her assets without adverse tax consequences.

A case also may be made for not taxing partners on distributions of property to the extent of their interest in the property through the partnership. The argument is that the distribution is not an exchange to the extent of the partners' original interest in the property. Consider a partnership that owns fungible assets, such as stock or grain in a silo. If such a partnership dissolves and distributes the stock or grain pro rata, there is arguably no exchange and each partner merely takes what was always hers. Similarly, if a partnership that owns an appreciated parcel of land liquidates and distributes the parcel to the partners as cotenants, the partners have not really altered their interests in the parcel. If a partnership that owns two appreciated parcels of land dissolves and distributes

\textsuperscript{171} IRC § 704(e)(1)(B).
\textsuperscript{172} IRC § 751(b)(2)(A).
one parcel to each partner, they might argue that their position has not changed with respect to half of each parcel.

Four rules avoid gain recognition in those cases: First, a partner is not taxed on a distribution of an asset to the extent gain on the sale of the asset would be allocated to her under §704(c). This would be done mechanically by subtracting the gain from the amount that would otherwise be recognized on the distribution under the proposed general rule. Second, this gain also is subtracted from the amount the other partners would otherwise recognize on a sale of the asset for its fair market value. Third, where a partner receives a distribution of property she contributed to a partnership, it would be treated as a recovery of her basis in her partnership interest up to her original basis in the property. Fourth, where a partner receives a distribution out of a pool of fungible assets, it would not be treated as an exchange of assets within the pool.

Under these rules, no gain or loss would be recognized where a partner contributes an asset to a partnership and later receives that asset in a distribution if the asset's value is unchanged.

Example 29: A contributes Blackacre (basis $70, worth $100) to a partnership. Later, A receives Blackacre in a distribution when it is still worth $100. A would have no gain on the distribution. Thirty dollars of the value of Blackacre would be gain allocated to A under §704(c) if Blackacre were sold, and the remaining $70 would be treated as basis recovery because that was A's original basis in Blackacre. The other partners would have no gain because the $30 on the sale of Blackacre would be allocated to A under §704(c).

This would be the result even if a partner had gain on her investment in the partnership with respect to other assets.

Example 30: A contributes Blackacre (basis $70, worth $100) and $100 to AB Partnership. B contributes $200 cash. The $300 cash is invested in Whiteacre, which increases in value to $400. Blackacre is distributed to A when it is still worth $100. A would have no taxable gain. Although A's potential gain is $80 (her capital account would be increased to $250 to reflect the appreciation in the value of Whiteacre at the time of the distribution), she would have no gain because the $100 distribution would be reduced by the $30 gain that would be allocated to A on the sale of Blackacre and her $70 original basis in Blackacre. The other partners would have no gain on the distribution of Blackacre.
These rules also would limit recognition of gain on a distribution of an asset that appreciates while in a partnership. Gain would not be recognized to the extent it would be allocated to the distributee on the sale of the asset under § 704(b). However, if special allocations are prohibited, most distributions would involve some gain recognition.

Example 31: A and B each invest $50 in a partnership that buys two parcels of land, Blackacre and Whiteacre. Profits, gain and loss on the two parcels are divided equally between A and B. Each parcel increases in value to $100. The partnership dissolves and A receives Blackacre and B receives Whiteacre. Because the partnership dissolves, the rule taxing distributions would be applied first. A would recognize $25 gain on the distribution of Whiteacre to B. (The other $25 gain is not recognized because it would be allocated to B on the sale of Whiteacre.) The basis of Whiteacre would be increased to $75. Simultaneously, B would recognize $25 gain on the distribution of Blackacre to A and the basis of Blackacre would be increased to $75. A would take Blackacre and B would take Whiteacre, each with a $75 basis.

These rules should be applied before it is determined whether a distribution is out of the distributee’s accumulated earnings.

Example 32: A contributes Blackacre (basis $70, worth $100) and B contributes Whiteacre (basis $80, worth $100) to AB Partnership. In the first two years of operation, the partnership earns $40, which it retains. This $40 income is allocated evenly between A and B, increasing their capital accounts to $120 and increasing A’s basis in his interest to $90 and B’s basis to $100. During the same period, Blackacre increases in value to $120 and Whiteacre increases in value to $140. At the start of year three, C contributes $150 cash to the partnership for a one third interest. Upon C’s admission to the partnership, the value of Blackacre and Whiteacre would be increased on the partnership books and A and B’s capital accounts would be restated as $150. Without any further changes, Blackacre is distributed to A in reduction of his interest. Of the total distribution of $120, $70 (the original basis of Blackacre) would be a recovery by A of his basis in his partnership interest. A would have a capital account of $60 and a basis of $20 in his interest. Of the remaining $50 value of Blackacre, $40 would not be taxed because that is the gain that would be allocated to A on the sale of Blackacre. The other $10, out of earnings,
would reduce A's basis in his interest to $10. His capital account would be $30. B would recognize $10 gain on the distribution of Blackacre ($50 gain less the $40 gain that would be allocated to A on sale of Blackacre). The basis of Blackacre in A's hands would be $80. The basis of Blackacre would be increased by the gain recognized by B. B's basis in his interest would be $110. There would be no change in the basis of Whiteacre.

It is appropriate to apply the pass through rules before the rules on distributions out of earnings because the pass through rules assume a distribution is out of capital and not out of earnings.

The abolition of the ceiling rule makes it possible for some partners to have gain and others losses on distributions of assets. Such cases require an exception to the rule that a distributee is not taxed on a distribution of an asset to the extent that gain on the sale of the asset would be allocated to him or to the extent of his original basis in the asset. If the other partners would have a net loss on a deemed sale of a distributed asset and the distributee would have gain, gain should be taxed to the distributee up to the lesser of those two amounts.

Example 33: A contributes Blackacre (basis $70, worth $100) to AB Partnership. A is credited with a capital account of $100 and $30 gain is provisionally allocated to A on Blackacre. B contributes $100 cash. Blackacre increases in value to $180 and C contributes $140 to the partnership for a one third interest. A's and B's capital accounts are increased to $140 and each is provisionally allocated $40 gain on Blackacre. Blackacre decreases in value to $30 and is distributed to A in reduction of his interest. Each partner would be allocated a $50 capital loss attributable to the drop in Blackacre's value. B would have a $10 tax loss on the distribution of Blackacre (the $40 gain booked on C's admission less the later $50 loss) and C would have a $50 tax loss. Their aggregate loss would be $60. A would have a $20 gain on the sale of Blackacre (the $30 gain booked on the contribution plus the $40 gain booked on C's admission less the later $50 loss). A would recognize $20 gain on the distribution because this is the lesser of the other partner's loss and his gain on a deemed sale of Blackacre. A would have a $30 basis in Blackacre (the original basis ($70) less the loss recognized by B and C ($60) plus the gain recognized by A ($20)). A's remaining basis in his partnership interest would be $60 (his original basis ($70) plus the gain recognized by A ($20) less the basis of Blackacre ($30)). B and C each would have a
basis of $90 in his interest (for each, his original basis less his loss).

This rule reflects the economic effect of a distribution. In Example 33, for instance, A is left with a partnership interest worth $60 (his share of the partnership's $280 cash) and an asset worth $30. These rules would ensure that A is taxed on the value of his partnership interest to the extent that the gain results from Blackacre. For similar reasons, if a distributee would recognize a loss on a deemed sale of a distributed asset, he should be permitted to recognize that loss on the distribution to the extent of the gain the other partners would recognize on the sale of the asset.

D. Debt

Generally, borrowing proceeds are not considered income and debt-financed expenditures are treated like expenditures of after-tax dollars. Debt repayments, however, are not deductible, and, if a debt is cancelled, there is taxable income.

In subchapter K, § 752 preserves these principles. An increase in partnership liabilities is treated as a cash contribution by partners equal to their share of the liability. This provides a partner with additional basis in his partnership interest so that he may take advantage of debt-financed deductions under § 704(d) or withdraw debt proceeds without recognition of gain under § 731. A decrease in partnership liabilities is treated as a cash distribution, which reduces basis in a partnership interest, or is taxed as gain.

Consistent with these principles, a distribution of cash or property that is attributable to a partner's share of partnership borrowings should not be taxable, even if the distribution exceeds the distributee's accumulated earnings and she has gain on her investment in the partnership. A rule is necessary, however, to determine whether a distribution is attributable to debt. Moreover, a rule is required to recast what was a debt-financed distribution as a capital distribution where the debt is later repaid out of partnership capital.

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173 Woodsam Assocs., Inc. v. Commissioner, 198 F.2d 357 (2d Cir. 1952).
175 IRC § 61(a)(12). There are a limited number of exceptions in § 108 which generally either require that the payment of the liability would have given rise to a deduction, IRC § 108(e)(2), or require that the taxpayer forfeit tax benefits in the form of net operating losses or basis, IRC § 108(b).
176 IRC § 752(a).
177 IRC § 752(b).
178 IRC § 733.
179 IRC § 731.
The rules proposed here would ensure that a distribution out of a distributee's share of the partnership debt would not be taxed. Generally, this would be done by treating a distribution (or an allocation of losses) as an advancement on debt and not as a distribution to the extent of a partner's share of the partnership debt. This would mean, for example, that if a partner contributes appreciated property to a partnership, the partnership then borrows, and the partner's share of the proceeds of the loan are distributed to him, the distribution of loan proceeds would not give rise to gain.

1. The Disguised Sale Regulations Compared

The disguised sale regulations state that distributions on debt cannot give rise to gain to the extent of a partner's liability on the debt. Under the regulations, a distribution of debt proceeds may be treated as consideration on a sale only if the amount distributed exceeds the partner's share of the debt. Furthermore, a contribution of debt encumbered property (which results in a deemed distribution) may result in a sale only to the extent that the liability is shifted to the other partners.

A major difference between current law and the accounts-based system is that where a distribution is not made out of debt, the proposal automatically would result in gain recognition (assuming there is gain and the distribution is not out of earnings). Under the proposed regulations, the determination that a distribution is not out of debt merely opens the question of whether, under the general rules, it is part of a disguised sale. If debt-encumbered property is contributed to a partnership, the rule under the proposed regulations is somewhat different: The portion of the debt assumed by other partners is recast as sale proceeds if the debt was incurred within two years of the contribution in anticipation of the contribution and it does not fall under several exceptions.

180 Reg. § 1.707-5(b)(1), (2).
181 Id.
182 Reg. § 1.707-5(a)(1).
183 Reg. § 1.707-3(a)(1), (b)(1).
184 The regulations distinguish between qualified (good) and unqualified (bad) debts. To the extent other partners assume an unqualified debt, it is treated as a distribution of sale proceeds. Reg. § 1.707-5(a)(1). The rules define qualified debts and so define unqualified debts by inference. Reg. § 1.707-5(a)(6). A debt is qualified if it is more than two years old, or if it is less than two years old, but is not incurred in anticipation of a contribution (there is a presumption that such a debt is incurred in anticipation of a contribution), or it is allocable to capital expenditures or it is a trade debt. In addition, a qualified debt cannot exceed the fair market value of the property contributed.

If there is an assumption of qualified debt in connection with a sale, part of the qualified debt assumed by the partnership may be treated as consideration paid on the sale. Reg. § 1.707-5(a)(5). The amount of the qualified debt treated as consideration is the lesser of the amount that would be so treated if it were unqualified debt (that is, the amount of the debt assumed by other partners) or the amount obtained by multiplying the qualified debt by the partners' net
There are some other differences. Under the accounts-based system, debt is treated as a pool. Thus, if proceeds of a debt in excess of a partner's share of that debt are distributed to him, the partner may not be taxed if the partnership has other debts. Under the proposed regulations, each debt is analyzed separately in determining whether a distribution is out of debt. Moreover, the proceeds of a debt actually must be traced to the partner under the §163 tracing rules if they are to be shielded as a debt financed distribution.\(^{185}\)

If a partner contributes property subject to a debt, he may have taxable gain under the proposed regulations notwithstanding the fact that the assumption of his debt by the other partners is offset by his assumption of their debt. The proposed regulations try to make allowances for this situation with a rule that offsets multiple liabilities assumed “pursuant to a plan.”\(^{186}\) “Plan,” however, is undefined. Furthermore, an exception to this rule is made for debts assumed with the “principal purpose” of avoiding gain because of an assumption of another debt.\(^{187}\) The proposed regulations do not indicate what constitutes a prohibited purpose.\(^{188}\) One important unanswered question is whether a partner may borrow against property he contributes to equalize contributions when another partner contributes debt encumbered property.

The accounts-based system also differs from the regulations in its approach to debt-financed distributions when the distributee's share of the debt is later reduced. In this situation, the accounts-based system treats the reduction of debt as a distribution of cash. If there is gain and there are no earnings, that gain is taxed. The proposed regulations deal with this situation by providing that the origin of a distribution in debt will be disregarded if, at the time of the distribution, there was a plan to reduce equity percentage with respect to the property.” Id. This is derived by dividing the other consideration paid on the exchange by the excess of the fair market value of the property over the amount of the debt. In essence, a transfer of property subject to otherwise good debt is tainted by a related sale (apparently disguised or not). The greater the other consideration in relation to the transferor's equity in the property, the greater the taint.

Example: A contributes Blackacre, which is worth $100x and is subject to $40x of qualified debt, to Partnership. After the contribution, A is liable for one half the debt. He immediately receives $10x cash; $6.66x of the qualified debt is considered sale proceeds. This is derived by multiplying the $40x liability by 16.7%, or the $10x other consideration paid divided by $60x equity in the property. If the other consideration was $20x, the amount would be $13.33x or 33% of $40x. No matter how much other consideration is paid, the amount of the debt recast as sale proceeds cannot exceed $20x, or the amount of the debt for which the other partners assume liability.

\(^{185}\) Reg. § 1.707-5(b)(1).

\(^{186}\) Reg. § 1.707-5(a)(4), 5(f) Ex. 7.

\(^{187}\) Id.

\(^{188}\) Example 8, which illustrates the rule, simply stipulates that the debt was incurred to avoid gain because of the assumption of another debt. Reg. § 1.707-5(e) Ex. 8.
the debt and one of the principal purposes of that plan was to minimize gain on the distribution.\footnote{Reg. § 1.707-5(b)(2)(iii). There is a similar rule for reductions of debt when property is contributed subject to debt. Reg. § 1.707-5(a)(3).}

The differences between the two approaches result from the fundamental difference between the disguised sale rule, which looks to the historic connection between a contribution and a distribution to determine if the gain is to be taxed, and an accounts-based system, which looks to the effect of a distribution on a partner's current accounts. Thus, under the disguised sale rule, a contribution of property subject to debt may result in a deemed sale only if there is sufficient connection between the debt and the contribution. Also, under the disguised sale rule, a partner can avoid sale treatment on an otherwise suspect distribution on the ground that it is out of debt for which he is liable only if he actually can trace the distribution to the debt. None of the above concerns matter under the accounts-based system.

2. \textit{The System Explained}

The accounts-based system requires two new partnership accounts: a debt account and a debt advancement account. The sum of the two accounts is the partner's share of partnership liabilities. A partner's share of partnership liabilities is first accounted for in the debt account. Distributions or deductions attributable to debt allocated to a partner are shifted from the debt account to the debt advancement account. This reflects the benefit a partner has received. Distributions are not taxed to the extent that they can be charged to the debt account.

\textit{Example 34:} \(A\) contributes \textit{Blackacre} (basis $50, worth $100) to \textit{AB Partnership}. \(B\) contributes $100 cash. \(A\) and \(B\) share equally in gain and losses. \textit{AB Partnership} borrows $100. \(A\)'s debt account increases to $50 and her basis in her interest increases to $100. The partnership distributes $50 to \(A\) before it has earnings. \(A\) has no income on the distribution because it is not in excess of her debt account ($50). Her debt account is reduced to zero on the distribution and her debt advancement account is increased to $50. \(A\)'s capital account is reduced to $50. \(A\)'s basis in her partnership interest is reduced to $50.

The capital account is reduced by a distribution charged to the debt account, but not below zero.\footnote{With the creation of debt advancement accounts, negative capital accounts can and should be an impossibility. Under current law, a negative capital account may arise in two ways. One is where a partner is allocated debt financed losses or receives debt financed distributions. In such a case, a debt advancement account serves the same purpose as a negative}
partnership interest. This is necessary because a partner’s share of debt is included in the basis of her partnership interest. Depreciation and other losses should be charged first against the capital account and then against the debt account.

Distributions in excess of a partner’s debt account are dealt with under the general rules for distributions: They are income if they are not out of accumulated earnings to the extent of a partner’s gain in her investment in the partnership.

Example 35: The facts are the same as those in Example 34. A second distribution of $50 is made to $A$. She has $50 taxable income because her debt account and her accumulated earnings account are zero and her capital account ($100) exceeds her basis in her interest ($50). $A$’s capital account is reduced to zero.

Such a distribution is taxed under the general rules for taxing distributions because the debt account is zero.

Decreases in a partner’s share of partnership liabilities are charged first against the debt account and then against the debt advancement account. Reductions in the debt advancement account are not income to a partner if they can be charged to accumulated earnings.

Example 36: The facts are the same as those in Example 34. The partnership has $20 net taxable earnings in year two and repays $20 of the debt. This reduces $A$’s share of liabilities by $10. $A$ has no income although her debt account is zero because the entire reduction is charged against her $10 accumulated earnings account. It reduces her debt advancement account to $40.

Tax should not be imposed in such a case because the reduction of debt comes out of earnings. The debt is repaid with what is, for $A$, after-tax dollars at the partnership level. Reductions in the debt advancement account that are not taxed as gain reduce the basis in a partnership interest.

If accumulated earnings are zero, reductions in the debt advancement account result in gain to the extent that a partner’s capital account plus his debt advancement account exceed his basis in his partnership interest.
Example 37: The facts are the same as those in Example 34. The debt is repaid in year two and the partnership has no earnings. This reduces A's share of liabilities by $50. A has $50 taxable income because her debt account and accumulated earnings accounts are zero and her debt advancement account plus her capital account ($50 plus $50) exceeds the basis in her partnership interest ($50). A's debt advancement account is reduced to zero and her capital account remains at $50.

This case illustrates how a liability reduction can be treated as a distribution of capital.

For purposes of determining gain on debt reduction a partner's basis in his interest is reduced by the amount of the reduction in his debt account on the transaction.

Example 38: A and B each contribute $5 to AB Partnership. The partnership borrows $90 and purchases an asset for $100 that is depreciable over five years on a straight line basis. In year one, the income from the asset equals the interest on the debt. There are no earnings and each partner has a $10 tax loss from depreciation. After year one, A's basis in his partnership interest is $40, his capital account is zero (the first $5 depreciation allocated to A is charged to his capital account), his debt advancement account is $5 and his debt account is $40. C contributes $90 in year two and the debt is repaid with this cash. There is a $45 reduction in A's share of partnership liabilities: $40 is charged against A's debt account and $5 is charged against his debt advancement account. A has $5 income because he has no accumulated earnings and his debt advancement account plus his capital account ($5 + zero) is $5 greater than his basis in his partnership interest (which is zero because he loses $40 basis from the reduction in his debt account).

Example 38 illustrates one reason why decreases in the debt advancement account may be income although a partner has no gain on his investment in the partnership: The positive account represents the tax benefit of losses that have passed through to the partner.

Basis is reduced only by the reduction in the debt account, and not by the total liability reduction to avoid double counting some reductions as income.

Example 39: A contributes Blackacre (basis $100, worth $100) to AB Partnership. B contributes $100 cash. The partnership borrows $100 and distributes $50 to A. A's debt account is re-
duced to zero, his debt advancement account is increased to $50, his basis in the partnership is $100 and his capital account is reduced to $50. Without any other changes, the debt is repaid. A’s debt advancement account is reduced by $50, but he has no income because his basis in his partnership interest ($100) equals his capital account plus his debt advancement account ($50 plus $50). A’s basis in his partnership interest is reduced to $50.

On a contribution of debt-encumbered property, the contributing partner should be credited with a debt account equal to his share of partnership liabilities, and the entire amount of the liability should be treated as an immediate cash distribution. The contributor’s basis in his interest initially should equal his basis in the contributed property plus his share of partnership liabilities (including his share of the liability encumbering the property he contributes). His initial capital account should equal the full value of the contributed property, disregarding the encumbrance. This does not overstate the contributor’s basis in his interest or his capital account because of the other adjustments. The other partners also increase their bases in the partnership interests by their shares of the liability.

Example 40: A contributes Blackacre (basis $50, worth $300, subject to a $100 debt) to AB Partnership. B contributes $200 cash. The debt is shared equally. A initially is credited with a $300 capital account and a $100 basis in his partnership interest (his $50 basis in Blackacre plus his share of partnership liabilities). There is a $100 deemed cash distribution. The first $50 deemed distribution reduces A’s basis in his interest to $50, reduces his debt account to zero, reduces his capital account to $250 and increases his debt advancement account to $50. The second $50 is taxed as gain to A because he has no accumulated earnings and his capital account plus his debt advancement account ($300) exceeds his basis in his interest ($50). A’s capital account is reduced by $50 to $200. The partnership’s basis in Blackacre is increased by $50 to $100, the gain recognized by A. B’s basis in his partnership interest is $250 (his cash contribution plus his share of liabilities).

These adjustments may seem strange, but they are the adjustments that would be made if A contributed Blackacre free of debt and the partner-

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191 This is a change from the current regulations. See Reg. § 1.704-1(b)(2)(iv)(b).
ship subsequently borrowed $100 and distributed the proceeds to \( A \).\(^{192}\)

That these adjustments are appropriate also can be seen by considering the effect of repaying the debt.

*Example 41:* The facts are the same as those in *Example 40.*

The debt is repaid with $100 cash. \( A \) has $50 gain. His debt advancement account is reduced by $50. This is taxable to \( A \) because he has no accumulated earnings and his debt advancement account plus his capital account ($50 + $200) exceeds his basis in his interest ($50). The partnership's basis in *Blackacre* is increased by $50, the gain recognized by \( A \). *AB Partnership* holds *Blackacre*, which is worth $300, free of debt, and $100 cash. \( A \)'s capital account is $200 and \( B \)'s capital account is $200. \( A \)'s basis in his interest is $50. \( B \)'s basis in his partnership interest is $200. The partnership's basis in *Blackacre* is $150.

If the partnership sells *Blackacre*, the entire $150 is allocated to \( A \) under § 704(c).

Distributions of encumbered property should be bifurcated into a sale of the property (with the debt included in the sales price) and a reduction of the debt.

*Example 42:* The facts are the same as those in *Example 40.* \( C \) joins the partnership and contributes $200. Later \( C \) receives *Blackacre* subject to the debt in liquidation of his interest. There is a $200 gain on the sale allocated to \( A \). This increases \( A \)'s accumulated earnings to $250 (the $200 gain plus the $50 original basis of *Blackacre*), and it increases \( A \)'s basis in his interest to $250. After the sale there is a $50 reduction in \( A \)'s debt advancement account attributable to the reduction in liability. This does not result in gain to \( A \) because it is out of accumulated earnings. Because the reduction is attributed to accumulated earnings, it reduces \( A \)'s basis in his partnership interest to $200 and his accumulated earnings account to $200. The reduction in liabilities also decreases \( B \)'s debt account by $50 and his basis in his partnership interest to $200.

\(^{192}\) \( A \)'s initial basis in her partnership interest is $50 and \( B \)'s initial basis is $200. \( A \)'s capital account is $300. When the partnership borrows $100, \( A \)'s basis is increased to $100 and \( B \)'s basis is increased to $250, and each partner has a debt account of $50. The analysis of the distribution of $100 to \( A \) is the same as in *Example 40.*
The consequences would be the same if the partnership sold \textit{Blackacre} to a third party and part of the proceeds of the sale were used to repay the debt.

\textbf{VI. Conclusion}

My goal is to refashion subchapter K as a complete system of highly formal rules. The system would dictate the tax consequences for any transaction based on the form of the transaction. To succeed, such a system must minimize differences in the tax treatment of formally different, but economically similar transactions, for otherwise taxpayers will manipulate form to reduce tax. The proposals in this article move in this direction by reducing the tax differences between deferred payment sales and partnership contributions and distributions. Another way to improve the system is to alter rules governing partnerships to make important economic consequences follow form. An example is my proposal that partners be required to allocate income and loss in accordance with relative capital accounts, a rule that would compel partners to value capital accounts with care. This change also compels partners who want to share risk or the timing of income differently to use loans, options or other devices, using forms for which, hopefully, there are appropriate tax rules.

Admittedly, some of the rules proposed in this article are quite complex, particularly the rules on debt. Such complexity is inevitable if formal rules are to regulate complex phenomena successfully. But the proposed rules are no more complex than § 704(c), § 751 or the § 704(b) regulations, and, in some important respects, they impose less administrative burden than the § 707(a)(2)(B) regulations because they require the collection of less information and are entirely mechanical in their application once assets are valued.

Rules such as I propose take advantage of the distribution of intellectual and other resources in our tax system. The least well-equipped part of the tax system is the enforcement arm of the Service. Most of the talent and time to ponder difficult problems is in the Bar, the Treasury's Tax Legislative Counsel's Office, the committees on the Hill and the academy. Rules like the disguised sale regulations, which are composed of vague anti-abuse rules, leave the difficult choices to be made in the field, by practitioners and the Service, and there is no doubt who is likely to prevail in that arena. A complete system of highly formal rules requires the Bar, the committee staffs and the academy to resolve the difficult problems at the rule-drafting stage. Once those problems are resolved and the law is clear, one may hope that the Bar will devote its talent to following the rules, rather than trying to exploit them.