1979

Optional Adjustments to Basis of Partnership Property on Transfer of Partnership Interests

Donald J. Weidner
Florida State University College of Law

OPTIONAL ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY ON TRANSFER OF PARTNERSHIP INTERESTS

by
DONALD J. WEIDNER

I. *Introduction*

Section 743(b) provides for optional adjustments to the basis of partnership property when a partnership interest is transferred by sale or exchange or on the death of a partner. The basic purpose of the optional adjustment is to set aside the entity theory of partnerships and recognize that when people trade in partnership interests they are, in effect, trading in the underlying partnership assets. The entity theory is reflected in the Uniform Partnership Act, which states that partnership property is held by the partners as "tenants in partnership."[1] The tenancy treats the partnership as an independent, almost tangible entity, that cuts the partners off from the partnership assets. The Uniform Act specifies that the interest of the partners is not in the partnership assets, but in the partnership entity. A partnership interest is seen as a separate asset, one that is personal property.[2] *M.H.S. Company* v. *Commissioner*[3] is a recent case that demonstrates the devastating tax consequences that can result from the unanticipated application of the entity theory. In *M.H.S. Company,* a corporation had some of its real property condemned. It reinvested the real property condemnation award by purchasing shopping center property, only it did so with another company, as equal tenants in common. The court held that the tenants in common were, as a matter of law, partners, and that therefore what the corporation had acquired was not real property, but an interest in a partnership, which is personal property. Accordingly, the proceeds of the real property condemnation award were not reinvested in property of "like kind," and the corporation was required to recognize gain on the condemnation award.

II. *Agreements About Contributed Property*

Special allocations with respect to contributed property must be taken into account when optional adjustments are made. The more important reason for discussing them at the beginning of this paper is

[1] Uniform Partnership Act § 25(1) (hereinafter cited as UPA).

[2] UPA § 26:

> A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property.

[3] 35 T.C.M. (CCH) 733 (1976), *aff'd per curiam,* 78-1 U.S.T.C. (CCH) ¶9442 (6th Cir. 1978).

that they are designed to prevent the same kinds of distortions of economic reality that optional adjustments seek to prevent. To understand what contributed property allocations are designed to do and prevent is to understand optional adjustments to basis.

A. *Distortions Absent Special Allocations.*

Unless the partnership agreement provides otherwise, the partner who contributes property will receive no special treatment with respect to that property; the partnership will allocate any gain or loss, *etc.*, just as if it had purchased the asset from a third party.[4] Stated differently, unless there is a special allocation, the partners' normal sharing ratios will determine the allocation of any depreciation, depletion, or gain or loss on the sale of contributed property. This simple approach can cause problems when the property is contributed with an adjusted basis different from its fair market value.

Consider how a partner who contributes cash rather than property might be unintentionally penalized if he does not draft away the general rule that partners divide gain on the sale of contributed property according to their normal sharing ratios. Cash and Property form an equal partnership. Cash contributes $1,000 cash and receives a $1,000 basis in his partnership interest. Property contributes inventory with an adjusted basis of $800 and a fair market value of $1,000. Property's basis in the inventory will be "rolled over" and become not only his basis in his partnership interest but also the partnership's basis in the inventory. Shortly thereafter, the inventory is sold for $1,000. Absent a provision in the partnership agreement to the contrary, the partnership's $200 gain on sale of the inventory is treated just as if it were a gain on property the partnership acquired by purchase from an outsider. That is, each partner must report $100 of the partnership gain on the sale of the inventory, and as a result each will have his basis in his partnership interest increased by $100.

This tax result does not accurately reflect the economic reality of either Cash or Property. Each has a partnership interest that is worth

---

[4] Code § 704(c)(1). Code § 704(c)(3) provides an exception to the general rule that, unless the agreement provides otherwise, depreciation *etc.* will be allocated as if the property had been purchased by the partnership from an outsider. The exception provides for the continuation of any preexisting arrangement among partners who contribute undivided interests to a partnership:

> *Undivided interests.*—If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the partnership correspond with such undivided interests.

$1,000, a 50 percent interest in a partnership that now has $2,000 in cash. Cash's gain is overstated because, in economic reality, Cash has made no gain. The partnership interest he now has is worth exactly the amount of cash he paid for it. Property's gain, on the other hand, is understated. He has "nailed down" the $200 value in excess of his basis in the property he contributed. Perhaps it is easier to see that as having occurred when he received the partnership interest that reflected the full value of the property he contributed. However, the general rule is that no gain or loss is recognized on contribution, the transaction is not closed at that point, his basis is simply rolled over into the partnership and into his interest. For tax purposes, the gain was nailed down by the partnership when it sold the asset.

The failure to accurately reflect economic reality penalizes the cash-contributing partner, at least in the short run. The size of the partnership interest Property received fully credited him with the precontribution appreciation in the property for which he received his interest. However, and perhaps this was not anticipated, Cash has been allocated half of the tax bill on that appreciation, which is part of the cost of the value for which Property received full credit. Stated differently, the "equal" partnership has become, inadvertently, not exactly equal. The partners got equal sharing ratios because they contributed equal value, but then the equal sharing ratio was used to pass on part of the cost of the appreciation in value, the tax bill, to the partner who contributed hard cash.

In general, the gap between economic reality and the amount of gain or loss reported will be "corrected" on liquidation of the partnership, or on a sale by the partners of their partnership interests. Property's basis in his partnership interest is still $100 below its value. He will ultimately have to report the additional $100 gain that, in economic reality, he achieved. Cash, on the other hand, has a basis in his partnership interest $100 in excess of its value. Assuming no other transactions, Property will realize $100 of gain on a liquidation or sale of his interest, i.e., the difference between the amount of cash he will receive, $1,000, and his $900 adjusted basis in his partnership interest ($800 initial basis increased by $100 gain he reported on sale of inventory). Thus, his economic gain of $200 ($1,000 cash received versus the $800 he paid for the inventory) is reported in two installments of $100 each. Cash, on the other hand, realizes a loss of $100 on liquidation of the partnership, or sale of his partnership interest, measured by the difference between his $1,100 adjusted basis in his partnership interest ($1,000 initial basis increased by $100 gain he reported on sale of the inventory) and the amount of cash he received, $1,000. He realizes no economic gain or loss, and this break-even result is reflected on his tax returns as the net result of a $100 gain followed by a $100 loss. In tabular form, these results are shown in Example 1.

EXAMPLE 1

Property Contributed With Value in Excess of Basis: No Special Allocation to Reflect the Built-In Potential for Gain

Equal Partnership Cash-Property has assets with $2,000 total value: $1,000 cash contributed by Cash plus inventory contributed by Property worth $1,000 with an adjusted basis of $800.

	Partnership's Basis in Inventory	*Basis of Partners in Partnership Interests*	
		Cash	*Property*
I. *At Formation*			
Property's basis in the inventory is rolled over into his basis in his partnership interest and into the partnership's basis; Cash's initial basis is the amount of money he contributed	$ 800	$1,000	$ 800
II. *After Sale of Inventory for $1,000*			
a) Partnership Gain			
Amount realized	$1,000		
less adjusted basis ..	−800		
Gain	$ 200		
b) Effect of sale of Inventory on partners (assuming sale proceeds not yet distributed)			
Initial Basis		$1,000	$ 800
Plus distributive share of gain ($100 each)		+100	+100
Adjusted basis in partnership interests		$1,100	$ 900
III. *Upon Liquidation of the Partnership*			
Gain (Loss) if partnership distributes all its cash in liquidation ($1,000 each)			
Adjusted basis		$1,100	$ 900
Amount distributed		1,000	1,000
		$ (100) Loss (unrecovered cost)	$ 100 Gain (distribution in excess of basis)

IV. *Cumulative Gain (Loss) Recognized*		
Gain on Sale of Inventory	$ 100	$ 100
Gain (loss) on Liquidation	+(100)	+100
Cumulative gain (loss) recognized . .	$ -0-	$ 200

There are two principal reasons why Cash may not be content with the offsetting loss, or reduced gain, he will ultimately receive because his basis in his partnership interest was increased by the amount of unreal gain he reported. First, he may not receive the "correction" for many years, perhaps not until the partnership is liquidated. He has, in effect, made an interest-free loan to the government (or to Property) for all those years. Second, in some situations, the long-run "correction" affects only the dollar amount of gain or loss recognized by the partners; characterization of the profit as ordinary income or capital gain remains permanently out of line with business reality. The $100 share of partnership gain Cash reported on the sale of the inventory was ordinary income; yet the ultimate "correction" for Cash is a $100 capital loss on the liquidation of his partnership interest. Cash has, in effect, the reverse of a good tax shelter: he has achieved tax acceleration rather than tax deferral and substituted ordinary income for capital gain.

B. *Special Allocations and Contributed Property.*

With respect to contributed property, section 704(c)(2) specifically authorizes special allocations of depreciation, depletion, and gain or loss on sale:

> *Effect of partnership agreement.*—If the partnership agreement so provides, depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, under regulations prescribed by the Secretary, be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.[5]

The Regulations make clear that partners have a great deal of flexibility to make allocations concerning contributed property. Depreciation, depletion, or gain or loss with respect to contributed property may be allocated to take into account *"all or any portion* of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution."[6] The allocation may apply to all contributed property or only to specific items.[7]

---

[5] Code § 704(c)(2).

[6] Treas. Reg. § 1.704-1(c)(2)(i) (1964) (emphasis added).

[7] *Id.*

Most basically, the partner who contributes property may be specially allocated all the built-in precontribution gain or loss:

> The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership.[8]

Thus, in Example 1, instead of waiting for the long-run "corrections" to make tax reality reflect economic reality, Cash and Property could have made a special allocation to make initial tax reality conform to economic reality. The variation between the basis and the fair market value of the contributed property would be taken into account by allocating the $200 built-in gain on the sale of the inventory entirely to Property. Property's initial basis in his partnership interest would be increased by the amount of gain allocated to him on the sale of the inventory, and Cash and Property would each have a $1,000 adjusted basis in his partnership interest, which is equal to its value.

Furthermore, the partner who contributes cash may be given special allocations of depreciation or depletion:

> The appreciation or diminution in value represented by the difference between the adjusted basis and the fair market value of contributed property at the time of contribution * * * also may be used in allocating the allowable depreciation or depletion with respect to such property among the contributing partner and the noncontributing partners.[9]

These special allocations of depreciation and depletion may not exceed the amount of depreciation or depletion computed at the partnership level:

> In any case, however, the total depreciation, depletion, or gain or loss allocated to the partners is limited to a "ceiling" which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it.[10]

The examples in the Regulations cumulate into the following. C and D form an equal partnership. C contributes machinery worth $10,000 in which his adjusted basis is $4,000. This adjusted basis of $4,000 becomes the partnership's basis in the machinery and also becomes C's basis in his partnership interest. D contributes $10,000 in cash, which gives him a $10,000 basis in his partnership interest. If the contributed property depreciates at an annual rate of 10 percent, the part-

[8] *Id.*
[9] *Id.*
[10] *Id.*

nership could compute an annual depreciation deduction of $400. The contributed property does depreciate and is sold at the beginning of the second year for $9,000. Absent any special allocation, the depreciation deductions on the machine will be divided equally, as will any gain or loss when the partnership sells the machine.

In this situation, the partner who contributes cash may insist on a special allocation of the depreciation deductions on the machine:

> With his contribution of $10,000 cash, *D has, in effect, purchased an undivided one-half interest in the property* for $5,000. Since the property depreciates at an annual rate of 10 percent, D would have been entitled to a depreciation deduction of $500 per year. However, since under the "ceiling" approach the partnership is allowed only $400 per year (10 percent of $4,000), no more than $400 may be allocated between the partners, i.e., the partnership cannot allocate $500 of depreciation to D and thereby treat C as if C had received an additional $100 of income. Therefore, the partners allocate the $400 deduction for depreciation entirely to D and none to C, the contributor.[11]

In short, the partners are permitted to adopt an aggregate approach that treats the cash contributing partner as having directly purchased a 50% interest in the asset contributed by his fellow partner. Indeed, there is no suggestion that the allocation of all the depreciation deductions to the partner who contributed the cash might violate the substantial economic effect requirement.[12]

Continuing with the same fact pattern, couple the special allocation of depreciation deductions to D, the partner who contributed the cash, with a special allocation of gain on sale of machinery to C, the partner who contributed it with a value in excess of basis. The Regulations link the two types of special allocations without stating that they must be linked. They illustrate the allocation of the gain on sale of the machinery with a hypothetical agreement that

> the portion of the proceeds attributable to the excess of the fair market value of the property at date of contribution (less accumulated depreciation on such value) over its basis at date of contribution (less accumulated depreciation on such basis) shall result in gain to the contributing partner only.[13]

If the property is sold at the beginning of the second year of partnership operations for $9,000, the partnership gain of $5,400 ($9,000, the amount realized, less $3,600, the adjusted basis of the partnership

---

[11] Treas. Reg. § 1.704-1(c)(2)(i), Example (1) (1964) (emphasis added).
[12] *See* Code § 704(b)(2).
[13] Treas. Reg. § 1.704-1(c)(2)(i), Example (2) (1964).

[$4,000 initial basis less $400 depreciation deduction]) will be allocated pursuant to the agreement:

> The fair market value of the property as depreciated is $9,000 ($10,000, the value on contribution, less $1,000, the accumulated depreciation on such value). Under section 704(c)(2) and the terms of the partnership agreement, the $5,400 difference between $9,000, the fair market value as depreciated, and $3,600, the adjusted basis of the property, represents the portion of the gain to be allocated to C. None of this gain is allocated to D.[14]

Example 2 illustrates the results of the combined special allocations if the partnership liquidates after the sale of the machinery and distributes $9,500 each to C and D.

EXAMPLE 2

Property Contributed With Value in Excess of Basis: Special Allocations to Reflect the Built-In Potential for Gain

Equal Partnership CD Formed with $10,000 in cash contributed by D and Machinery contributed by C worth $10,000 with an adjusted basis of $4,000.

	Partnership's Basis in Machinery	*Basis of Partners in Partnership Interests* C	D
I. *At Formation* (C's basis in the machine is rolled over into his basis in his partnership interest and into the partnership's basis)	$4,000	$4,000	$10,000
II. *After $400 Depreciation Deduction* (allocated all to D)	$4,000 −400 $3,600	$4,000 $4,000	$10,000 −400 $ 9,600
	Partnership Gain		
III. *After Sale of $9,000* Partnership Gain Allocated Entirely to C (assuming sale proceeds are not yet distributed)	$9,000 −3,600 $5,400	$4,000 +5,400 $9,400	$ 9,600 $ 9,600

[14] *Id.*

IV. *Upon Liquidation of the Partnership*		
Gain (loss) if partnership distributes all its cash in liquidation ($9,500 each)	$9,400	$ 9,600
	−9,500	−9,500
	$ 100	$ (100)
	Gain (distribution in excess of basis)	Loss (unrecovered basis)
V. *Cumulative Gain (Loss [including depreciation]) Recognized*	$5,500	($ 500)

Note how this reflects economic reality. C reported cumulative gain of $5,500, which exactly equals the amount by which his $9,500 liquidating distribution exceeded his $4,000 basis in the machinery when he contributed it. Conversely, the $500 cumulative loss (including depreciation deductions) reported by D exactly equals his $500 cash loss. The special allocation of gain prevented D from reporting unreal gain on the sale of the machinery. In addition, the special allocation of depreciation deductions allowed him an early writeoff.[15]

III. *The Section 754 Election*

We have just seen that there is great flexibility in the area of special allocations concerning contributed property. There can be special allocations with respect to some contributed property even though there are no special allocations with respect to other property contributed to the same partnership. Furthermore, with respect to a particular item of contributed property, a special allocation may be made of only a portion of the built-in gain or loss.

Contrary to the ring sounded by the word "optional," such flexibility does not characterize the area of optional adjustments to basis. Optional adjustments to the basis of partnership property are made under sections 734(b) and 743(b). There is only one election to be made, under section 754, to bring both 734(b) and 743(b) optional adjustments into play.[16] The statute itself provides that both sections must be taken

[15] What if the depreciation deductions had overstated actual economic depreciation? In the context of the above example, the Regulations contain the following parenthetical:

> If the property were sold for more than $9,000, the portion of the gain in excess of $5,400 would be allocated equally between the partners in accordance with their agreement for sharing gains.

Id.

[16] Code § 754; Treas. Reg. § 1.754-1(a) (1972).

or declined as a package deal, and must be applied to all transactions of the type they embrace:[17]

> SEC. 754. MANNER OF ELECTING OPTIONAL ADJUSTMENT TO BASIS OF PARTNERSHIP PROPERTY.
>
> If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.[18]

The partnership may be refused permission to withdraw the election. The Regulations state that situations that "may be considered sufficient reason" for approving a request to revoke the election include a change in the nature of the partnership business, a substantial increase in its assets, a change in the character of its assets, and an increased frequency of retirements or shifts of partnership interests, which would result in greater administrative burden.[19] An application to revoke the election will not be approved if its primary purpose is to avoid stepping down the basis of partnership assets on transfer or distribution.[20]

In essence, the 754 election is a binding commitment to consistently treat transactions according to an aggregate theory of partnerships. In this respect, the 754 election adopts the same basic analytical approach as 704(c)(2) special allocations with respect to contributed property. The 754 election is a commitment, for example, to recognize that when a partner purchases an interest in a partnership, he is, in effect, purchasing a share of that partnership's assets. Consequently, he is given, under section 743(b), a special basis in those assets to reflect his purchase price. Similarly, the 754 election is a commitment to recognize that when a partnership makes a distribution to one of its members to liquidate his interest in the partnership, the remaining partners are, in effect, exchanging their interest in the property they distribute to him for the interest he relinquishes in the assets they retain. Consequently, the partnership's basis in those retained assets is adjusted under section 734(b) to reflect the exchange.[21]

---

[17] H.R. 9662, 86th Cong., 2d Sess. § 780 (1960), would have permitted separate elections as to transfers and distributions.

[18] Code § 754.

[19] Treas. Reg. § 1.754-1(c) (1972).

[20] *Id.*

[21] Unless a 754 election is in effect, there is no adjustment to the basis of

One cautionary note must be sounded before examining 743(b) in detail. The Regulations were amended in 1972 to confirm that an effective election cannot be made later than the year in which the transfer of a partnership interest or distribution of property occurred.[22] Thus, the purchaser of a partnership interest who wants the benefit of a 743(b) adjustment to the basis of partnership properties must see to it that the partnership makes an effective election for the year he purchases his partnership interest. This requirement is a trap for the unwary because the election may not have any effect until the assets are subsequently sold, which may not be until many years later.[23]

IV. *Section 743(b) Adjustments*

A. *Without Section 743(b).*

As explained above, when property is contributed to a partnership with a value different from its basis, special allocations are needed to avoid tax consequences that do not accurately reflect, or are directly contrary to, economic reality. Similarly, when a partnership interest is transferred, unless something special is done to the basis of partnership property, there can be tax consequences that distort economic reality.

---

property retained by the partnership when it distributes property to a partner. Code § 734(a). If a 754 election is in effect, 734(b) adjusts the basis of property retained after a distribution, whether the distribution is a current or a liquidating distribution. In part because there are different rules that apply to liquidating as opposed to current distributions, *see* Code §§ 731 and 732, the 734(b) rules are complicated. The basic idea behind 734(b) adjustments is perhaps seen most clearly in the context of a liquidating distribution. When a piece of partnership property is distributed to liquidate the distributee's interest in the partnership, the remaining partners give up their interests in the distributed property and receive in exchange the distributee's interest in the property they retain. As is generally true with like-kind exchanges, gain or loss is not usually recognized. Rather, the basis in property given up is reflected in the property acquired. Unlike 743(b) adjustments, which affect only the transferee, 734(b) adjustments to undistributed property affect all remaining partners. The basis of retained property is increased or decreased by any gain or loss recognized by the distributee, and increased or decreased by the amount by which the basis of the property in the hands of the distributee is less than or greater than the basis the partnership had in the property. Code § 734(b). A detailed discussion of 734(b) adjustments is outside the scope of this article. *See generally* W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ch. 25 (1977) (hereinafter cited as McKee) and A. Willis, Partnership Taxation ch. 36 (2d ed. 1976) (hereinafter cited as Willis).

[22] Treas. Reg. §§ 1.754-1(b)(1) and (2) (1972).

[23] *Compare* Allison v. United States, 379 F. Supp. 490 (M.D. Pa. 1974) and Neel v. United States, 266 F. Supp. 7 (N.D. Ga. 1966) (declaring the predecessor of the 1972 "time for 754 filing" Regulation invalid) *with* Jones v. United States, 553 F.2d 667 (Ct. Cl. 1977) and *Dupree, infra* note 43 (upholding the requirement, *Jones* addressing itself to the Regulation as amended in 1972). An additional year to make the election would have been permitted by H.R. 9662, 86th Cong., 2d Sess. § 780 (1960).

Unless the 754 election is in effect, there is no adjustment to the basis of partnership property on transfer of a partnership interest, whether the transfer be by way of sale or exchange or because of the death of a partner.[24] Consider how the absence of an adjustment can compel the purchaser of a partnership interest to report gain when, in economic reality, he has no gain at all. Assume equal partnership ABC with the following balance sheet:

	Adjusted Basis	*Market Value*
Assets:		
Cash	$ 300	$ 300
Inventory	900	1,800
Fixed Assets	600	1,200
Total	$1,800	$3,300
Capital:		
A	$ 600	$1,100
B	600	1,100
C	600	1,100
Total	$1,800	$3,300

Assume, further, that P purchases C's partnership interest for $1,100, and that the inventory is subsequently sold for $1,800, its value when P purchased his interest.

If no 754 election is filed, there is no adjustment to the basis of partnership property when P purchases C's interest. Thus, when the inventory is sold for $1,800 by the equal partnership ABP, each partner must report a $300 share of the $900 partnership gain. This distorts economic reality. The full value of P's share in the inventory was reflected in the price P paid for his partnership interest, and he has no economic gain if the inventory is sold an instant later. Nevertheless,

[24] Code § 743(a). *But see* Code § 732:

> (d) *Special Partnership Basis to Transferee.*—For purposes of subsections (a), (b) and (c) [concerning basis a partner will have in property distributed to him by his partnership], a partner who acquired all or part of his interest by a transfer with respect to which the . [754 election] is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect . . . to treat as the adjusted partnership basis of such property the adjusted basis such property would have if . . . [743(b)] were in effect with respect to the partnership property. The Secretary may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

See also Treas. Reg. § 1.732-1(d) (1956).

he must recognize $300 of ordinary income because no adjustment to basis was made to give him credit for the price he paid for his partnership interest. Stated differently, there was no election to ignore the partnership as an entity and acknowledge that when P purchased his partnership interest he was purchasing a share in the partnership's assets. P's consolation prize is that his basis in his partnership interest is increased by his share of the gain, giving him an adjusted basis in his partnership interest of $1,400 ($1,100 initial basis increased by $300 share of gain on sale of inventory). P may not be satisfied with the long-run "correction" that will take place because his basis has been increased. As with the cash contributing partner who is penalized by a failure to make a special allocation on the contribution of appreciated property, P may have to wait for a long time for the "correction" and may find that the long-run "correction" for the $300 of ordinary income he reported on sale of the inventory is simply a $300 capital loss on liquidation of the partnership. Because 743(b) prevents the distortion from occurring in the first place, eliminating the need for the eventual "correction," it can change both the timing and the character of the income that would otherwise be reported.

B. *Operation of Section 743(b).*

If the 754 election is in effect, 743(b) adjusts the basis of partnership property on certain transfers of partnership interests.[25] If the election is in effect, and the transfer is by sale or exchange or on death of a partner, the partnership must

> (i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or
>
> (ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest.[26]

The increase or decrease in the basis of partnership property is an adjustment that is made with respect to the transferee partner only.[27] In short, the new partner, the transferee, is given his own special basis in partnership assets. Stated differently, the 754 election suspends the

[25] Treas. Reg. § 1.743-1(b)(3) (1956):

> (3) *Returns.* A transferee partner who has a special basis adjustment under section 743(b) shall attach a statement to his income tax return, for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

[26] Treas. Reg. § 1.743-1(b)(1) (1956).

[27] *Id. But see* text accompanying notes 91-92 *supra.*

normal operation of the entity theory and requires 743(b) to treat the new partner as someone who directly purchased a share in the partnership assets:

> Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743(b). . . . This special basis is his share of the common partnership basis (i.e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments.[28]

Section 743(b) introduces us to a concept that is peculiar to the optional adjustment to basis provisions: that of a partner's share of the "common partnership basis." To emphasize, there are now three basis concepts that must be dealt with: (1) common partnership basis, sometimes referred to as "inside basis," which is the partnership's basis in its assets, which includes partnership liabilities; (2) the partner's share of the common partnership basis, sometimes referred to as "the partner's inside basis," or "his inside basis;" and (3) the partner's basis in his partnership interest, sometimes referred to as his "outside basis." The total 743(b) adjustment is the amount necessary to make a new partner's initial inside basis equal his initial outside basis.

Section 743 itself indicates only very generally how to compute a partner's "inside basis:"

> A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of an agreement described in section 704(c)(2) (relating to effect of partnership agreement on contributed property), such share shall be determined by taking such agreement into account.[29]

The Regulations offer some additional guidance:

> Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third of such basis.[30]

One simple ratio can not be used to determine a partner's share of

---

[28] *Id.*

[29] Code § 743(b) also has a special provision with respect to property subject to depletion:

> In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

[30] Treas. Reg. § 1.743-1(b)(1) (1956).

common partnership basis if, for example, the partners share in partnership capital in different ratios than they share in partnership liabilities: [31]

> A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities.[32]

The reference to capital and surplus may be initially misleading to some, because the new partner's interest in "capital and surplus" is determined from his adjusted basis capital account, which is his share of the excess of the adjusted basis of partnership assets over partnership liabilities.[33] His share of partnership liabilities is determined in accordance with the section 752 Regulations.[34]

Although the following example illustrates a 743(b) adjustment on the sale of a partnership interest, the adjustment is the same whether the partnership interest is sold or exchanged or transferred on the death of a partner. The partners in ABC have equal interests in capital, profits and liabilities. Assume P purchases A's partnership interest for $22,000 when the balance sheet of the partnership is as follows:

ASSETS

	Adjusted Basis	*Market Value*
Cash	$ 5,000	$ 5,000
Accounts Receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable Assets	20,000	40,000
Total	$55,000	$76,000

LIABILITIES AND CAPITAL

	Adjusted Basis	*Market Value*
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	$55,000	$76,000

[31] Treas. Reg. § 1.743-1(b)(1), Example (2) (1956), involves a situation in which the partners have equal interests in partnership profits, but not in partnership capital.

[32] Treas. Reg. § 1.743-1(b)(1) (1956).

[33] *See* McKee, *supra* note 21, at ¶ 24.02[1].

[34] Treas. Reg. § 1.752-1(e) (1956).

The amount of the 743(b) adjustment is the difference between transferee P's basis in his partnership interest and his share of the adjusted basis of partnership property. Stated differently, the amount of the 743(b) adjustment is the difference between transferee P's outside basis and his inside basis:

> [P's basis in his partnership] interest [his outside basis] is $25,333 (the cash [P] paid for A's interest, $22,000, plus $3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property [his inside basis] is $18,333, i.e., $15,000 plus $3,333. The amount to be added to the basis of partnership property is, therefore, $7,000, the difference between $25,333 and $18,333.[35]

The Regulations emphasize that the amount of the adjustment to basis in this situation does not depend on the selling partner's adjusted basis for his interest in partnership capital.[36] Most basically, P is being treated as if he directly purchased an interest in the assets of the partnership. In this example, he gets to "up his basis" in those assets so that, when they are sold, he will only pay gain to the extent he has actually experienced economic gain.[37] As discussed below, however, the rules on how to allocate basis adjustments can cause a transferee to be treated somewhat differently than a purchaser of an interest in the assets themselves.[38]

C. *Depreciation and Depletion.*

The 743(b) adjustment permits the transferee's basis in his partnership interest to be reflected, for his benefit alone, in the basis of partnership assets. This avoids requiring the transferee partner to recognize gain attributable to appreciation in value that he paid for when he purchased his interest. Conversely, it prevents the transferee from recognizing a loss on depreciation in value that was reflected in the price he paid for his interest. If a 754 election is in effect and the partnership has depreciable property, the transferee will be allowed

[35] Treas. Reg. § 1.743-1(b)(1), Example (1) (1956).

[36] Treas. Reg. § 1.743-1(b)(1) (1956).

[37] Rev. Rul. 79-92, 1979-11 I.R.B. 10 (March 12, 1979), involved a three-person partnership that sold a parcel of real property and sought to report the gain on the installment method of Code § 453. The complication arose because two of the partners were to recognize gain but the third, because he received a 743(b) upward adjustment to basis in the property when he purchased his partnership interest, was to recognize a loss. Losses may not be reported on the installment basis, and the third partner would recognize his entire loss in the year the partnership sold the property. Nevertheless, even though the election to use the installment method is made by the partnership and not by the individual partners, the Service ruled that the other two partners could be allocated their shares of gain according to the installment method.

[38] *See* text accompanying notes 123 to 129 *infra.*

depreciation on a basis that reflects his basis in his partnership interest. He will be treated as if he had purchased, or inherited, undivided interests in the partnership assets, and then contributed them to the partnership.[39]. In this respect, the 743(b) adjustment does much more than an allocation with respect to contributed property, because it actually increases the total amount of depreciation deductions that can be taken.

Assume equal partnership ABC has a single asset, a depreciable asset with a basis of $300 and a value of $600, on which it is computing accelerated depreciation. C sells his partnership interest to P for its value of $200. Without a 743(b) adjustment, the partnership would simply continue to depreciate the asset on a basis of $300, and allocate P his one-third of the deduction. Section 743(b), however, gives P a $100 upward adjustment to basis. The partnership can continue to compute accelerated depreciation on its adjusted basis of $300, and P remains entitled to his one-third share of that amount. In addition, P is permitted to depreciate his $100 743(b) increase in basis.[40] However, P may generally only use straight line depreciation with respect to his $100 upward adjustment.[41]

When a 743(b) adjustment is made to the basis of partnership property subject to depletion, any depletion allowable is determined separately for each partner, including the transferee partner, based on his interest in such property. When the basis of partnership property

---

[39] J. Pennell & J. O'Byrne, Federal Income Taxation of Partners and Partnerships 147 (1970) (hereinafter cited as Pennell).

[40] Section 743(b) is a two-edged sword. Just as a transferee may benefit by a 743(b) increase in basis, he may be burdened by a 743(b) decrease in basis. Just as 743(b) can increase the depreciation deductions allowable, so, too, it can decrease the depreciation allowable. Treas. Reg. § 1.167(c)-1 (a)(6) (1972) provides in part:

> Moreover, where a partnership is entitled to use [certain accelerated] depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable . . . (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

[41] Treas. Reg. § 1.167(c)-1(a)(6) (1972):

> (6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§ 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 are not applicable to property in the hands of a . . . transferee . . . unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. . . . [W]here a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase. . . .

subject to depletion is increased by 743(b), the transferee partner may take depletion computed on cost, including his special basis adjustment, if that is greater than his share of percentage depletion. This is true even if the other partners use percentage depletion.[42]

D. *Consequences of Failure to Timely Elect.*

As indicated above, the long term "correction" for a failure to file an election may be unsatisfactory both because it may be long in coming and because ordinary income might only be "corrected" with a capital loss. *Estate of Dupree* v. *United States,*[43] in which the Fifth Circuit was moved to note that "there is no equity in tax law," illustrates an additional reason why a transferee of a partnership interest may find the possibility of a long-term "correction" much less satisfactory than a 743(b) adjustment. *Dupree* involved a limited partnership formed in 1947 to own and operate a particular motel. Mr. Dupree and his wife owned as their community property a 15% limited partnership interest. In 1957, Mrs. Dupree died and left her one-half of the 15% partnership interest to their son. Thereafter, Mr. Dupree and his son each owned a 7½% interest in the partnership.

Upon the death of his wife, Mr. Dupree's basis in his 7½% interest was "stepped up" to its then fair market value.[44] His basis in his partnership interest became $71,250, almost five times larger than his $14,973 share of the common partnership basis. The court assumed that the death of Mrs. Dupree in 1957 resulted in a "transfer giving rise to a right of an election under Section 754. . . ." [45] If a 754 election

[42] Code § 743(b) (last sentence); Treas. Reg. § 1.743-1 (b)(1)(ii) (1956).

[43] 391 F.2d 753 (5th Cir. 1968).

[44] In general, the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death. Code § 1014 (a). Code § 1014(b)(6) provides that property "considered to have been acquired from" a decedent includes

> property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State . . . if at least one-half of the whole of the community interest in such property was includable in determining the value of the decedent's gross estate. . . .

[45] 391 F.2d at 758. The Court's assumption was ruled correct in Rev. Rul. 79-124, 1979-16 I.R.B. 10 (April 16, 1979), which involved H, whose interest in a partnership was community property, and his wife W. The partnership had a 754 election in effect for the year of H's death and the Service ruled that both halves of the partnership interest were to be treated as transferred on death, with the result that there were 743(b) adjustments with respect to both halves of the partnership interest. The transfer was easiest to see in the case of H's interest, which was transferred from H to his estate. The transfer of W's interest was deemed to take place under the rule of section 1014(b) (6), *supra* note 44, because at least one-half of the total partnership interest was included in H's gross estate. Hence, W took her one-half interest with a basis stepped-up to fair market value on death, just as H's estate took H's one-half interest, and received optional adjustments even though she did not become a partner under state law.

had been in effect, Mr. Dupree would have been entitled, indeed required, under 743(b), to increase his basis in the motel by $56,277, the amount by which his outside basis exceeded his inside basis. Stated differently, as to Mr. Dupree, the partnership's basis in the motel would have been increased by $56,277.

On August 1, 1960, the partnership sold the motel, computed a capital gain, and allocated Mr. Dupree a 7½% share of that gain, $52,441. Had the partnership had a 754 election in effect, Mr. Dupree's special basis adjustment with respect to the motel would have resulted in his reporting a $3,834 *loss* on the sale of the motel, rather than a $52,441 gain. However, the partnership did not claim a 754 election until it filed an amended return two-and-a-half years after the sale. The court held that the amended return was ineffective to make the 754 election, and that the Service had properly required Mr. Dupree to report a $52,441 share of the partnership's gain on the sale of the motel.

Mr. Dupree's basis in his partnership interest was increased by the gain he reported on the motel sale, and the question is why was he not content with this built-in "correction." Part of the answer lies in the fact that Mr. Dupree was not permitted to claim a loss on liquidation of the partnership. When the partnership distributed the proceeds of the motel sale in liquidation of the partnership, Mr. Dupree received cash and a 7½% interest in two notes that had been given for the balance of the purchase price. Because the distribution was a liquidating distribution, Mr. Dupree took the notes with a "substituted basis:" the basis he had in his partnership interest immediately prior to the liquidating distribution, reduced by the amount of cash he received as part of that distribution.[46] The result was that he took a basis in the notes, $85,556, that was far in excess of their face amount, $52,500. He claimed that he had obviously realized a loss on this liquidating distribution, *at least* to the extent that he could never possibly recover the amount by which his basis in the notes exceeded their face amount. Indeed, not only had he suffered a loss to the extent basis exceeded face amount, but also the Service stipulated that the fair market value of the notes was little more than half their face amount. Nevertheless, said the court, the "unquestioned" loss could not be recognized:

> Section 731 . . . clearly defers for tax purposes recognition (as distinguished from realization) to a partner of a loss on notes received in a distribution from a partnership.[47]

The Ruling specified that the same result would have followed if W had died first.

[46] Code § 732(b).

[47] 391 F.2d at 757. The court said the specific provisions of Code § 731 prevail over the more general provisions of Code § 165(a), upon which Mr. Dupree relied:

The second reason that Mr. Dupree, through his estate, was dissatisfied with the long-term "correction" as a substitute for a 743(b) adjustment, was that his death prevented recognition of the loss. At his death, the basis in the notes was reduced, under section 1014(a), from $85,556, down to their fair market value. Therefore, Mr. Dupree never did recognize the loss that would have "corrected" the artificial gain he reported on the sale of the motel. The court was unmoved by the tax consequences of the obliteration of the Dupree family:

> In passing, we note that taxpayer's death deprived him of ever receiving income tax recognition of the loss sustained. Even if this were inequitable, there is no equity in tax law, but it was not inequitable because the taxpayer was in no different position than any other citizen who held a capital asset which had dropped in vlaue but who died before selling the asset and obtaining a recognizable tax loss on it.[48]

It might be noted that it would have helped Mr. Dupree if the partnership had simply distributed undivided interests in the motel. Mr. Dupree could then have sold his undivided interest and claimed a section 1231 loss. This is the approach that was successfully taken in *Harris* v. *Commissioner*,[49] and the Dupree estate attempted to argue that this was what in fact had happened with the motel—that it had been sold by the partners individually and not by the partnership. Although the court cited evidence[50] that Mr. Dupree had wanted the transaction so characterized, it concluded that the documentation actually used simply did not support such a characterization.

E. *Only Certain Transfers Affected.*

Section 743(b) is not activated by all transfers of partnership interests. The only transfers that trigger 743(b) adjustments are those by way of sale or exchange and those caused by the death of a partner.[51]

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

[48] 391 F.2d at 758 (citation omitted).

[49] 61 T.C. 770 (1974).

[50] The

> relevant evidence favorable to the position of the taxpayer was the testimony of [his son] who testified that he "understood the partners were to dissolve the partnership and to sell the property and to receive the proceeds therefrom"; that it was his "preference that each partner should receive his separate note" from the sale; that he objected to the filing of the final partnership return prior to its filing; and that he and his father (the deceased taxpayer here) "were informed that the partnership was to terminate."

391 F.2d at 759.

[51] The application of 743(b) to the transfer of an interest in a tiered partnership is described in Rev. Rul. 78-2, 1978-1 C.B. 202. Investment partnership IPP was formed for the purpose of holding interests in operating real estate partner-

The purpose behind the limitation to these two types of transfers is unclear, but the major effect seems to be the exclusion of transfers by gift. Most other transfers will be included in the broad category "sale or exchange." [52]

It should be emphasized that there is no "sale or exchange" when a partnership admits a new partner in return for a contribution of cash or property.[53] Consider the rule that a partnership automatically terminates for tax purposes if there is a "sale or exchange" of 50 percent or more of the total interest in partnership capital and profits within a twelve month period.[54] If the partnership simply admits new members who receive a 60 percent interest in the partnership capital and profits in return for their cash contributions, the partnership will not terminate, because there is no sale or exchange.[55] This is true even though the same result could have been achieved had the newcomers purchased portions of the interests of the original partners. So, too, an incoming partner who wants a 743(b) adjustment must attend to the *form* by which he becomes a member.[56]

Consider, for example, the newcomer who enters a partnership that owns an apartment house that has been depreciated at an accelerated rate and has a value far in excess of its adjusted basis. If the newcomer is simply admitted to the partnership in return for his cash contribution, there is no "sale or exchange," and hence no 743(b) adjustment, even if a 754 election has been filed.[57] Accordingly, if the building is sold after his admission, the newcomer must report his share of partnership gain, including his share of any ordinary income "recap-

---

ships, one of which was OPP. IPP and OPP each had a 754 election in effect for the year in which an interest in IPP was sold. The Service ruled, that for the purpose of 743 and 754, the transfer of an interest in IPP, whether by sale or exchange or on death, is considered to result in an adjustment to the basis of the property of OPP as though the transferee of the interest in IPP were a partner of OPP. Accordingly, the sale of an interest in IPP resulted in (a) an adjustment to the basis of IPP's partnership interest in OPP, and (b) an equivalent basis adjustment to OPP's property with respect to IPP and the transferee of IPP only.

[52] McKee, *supra* note 21, at ¶ 24.03[1], n.18:

> [If the type of exchange] under § 351 or similar carryover-basis sections ... triggers a § 743(b) adjustment, it may serve as a vehicle for a partner who acquired his interest in a transaction with respect to which a valid § 754 election was not in effect to rectify discrepancies between his basis for his interest and his share of the basis of partnership assets. This might be accomplished, for example, by a conveyance of the interest from an individual partner to his wholly owned corporation in exchange for stock in a § 351 transaction.

[53] Treas. Reg. § 1.743-1(a) (1956).

[54] Code § 708(b)(1)(B).

[55] Rev. Rul. 75-423, 1975-2 C.B. 260.

[56] It is not a precondition to a 743(b) adjustment that the transferee of a partnership interest become a member of the partnership under state law. Rev. Rul. 79-124, *supra* note 45.

[57] Nor does a distribution from the partnership to a retiring partner trigger a 743(b) adjustment. Pennell, *supra* note 39, at 147.

tured." To prevent such a distortion, the newcomer will want to acquire membership not by contribution, but by purchasing interests from the existing partners. They, on the other hand, may find the purchase route distasteful because it requires them to report gain on the sale of their partnership interests.[58]

F. *The Effect of 704(c)(2) Allocations.*

As indicated above, a partner's "inside basis" is computed by taking into account any 704(c)(2) special allocations with respect to contributed property.[59] Assume that A, B, and C form partnership ABC. A contributes land worth $1,000, Blackacre, in which he has an adjusted basis of $400, and B and C each contribute $1,000 in cash. Although they generally agree to share profits equally, they make a 704(c)(2) special allocation. A, who contributed Blackacre, is specially allocated any gain on the sale of Blackacre attributable to the $600 by which its value exceeded its basis at the time of contribution. Assume, finally, that Blackacre appreciates in value to $1,300 and that one of the three partners will sell his partnership interest to P for $1,100.

In this situation, if a 754 election is in effect, the amount of P's 743(b) adjustment will depend on whose interest he purchases. If P purchases A's interest for $1,100, P will acquire A's inside basis of $400. Without the 704(b)(2) special allocation, A, B, and C would have simply divided the total $2,400 partnership basis equally among themselves. The effect of the 704(c)(2) special allocation, however, is to confine A to the $400 basis he had in the building and to give B and C each the full $1,000 basis in the cash they contributed.[60] The amount of P's 743(b) special basis adjustment is $700, the difference between his $1,100 outside basis and the $400 inside basis he takes from A. This $700 adjustment to the basis of partnership property applies to P only. If the partnership subsequently sells Blackacre for $1,600, the gain is $1,200 ($1,600 amount realized less the partnership's $400 basis in Blackacre). Under the partnership agreement, the $600 of this gain that is attributable to the precontribution appreciation in value, is allocable to A's successor, P. The remaining $600 gain is not subject to the special allocation and is allocable among the partners equally—$200 each. P's distributive share of the partnership gain is thus $800, the sum of the $600 specially allocated to him plus the $200 allocated according to his normal sharing ratio. P's $700 special basis

[58] Willis, *supra* note 21, at § 28.14, suggests the existing partners might enter into an installment sale in this situation.

[59] Treas. Reg. § 1.743-1(b)(2) (1956) states that a partner's inside basis shall be determined by taking into account "the effect of the contribution of undivided interests under 704(c)(3)." *But see* McKee, *supra* note 21, at ¶ 24.02[2].

[60] To emphasize, for 743(b) purposes, 704(c)(2) allocations are viewed as allocations of basis rather than as allocations of gain or loss.

adjustment, however, reduces the amount of gain he must report from $800 to $100. B and C, on the other hand, each have a $200 gain that is unaffected by the 743(b) adjustment.

If P purchased his interest from B or C instead of from A, the amount of his basis adjustment would be different. If P purchased B's interest for $1,100, he would succeed to the $1,000 inside basis B was allocated under 704(c)(2). In this situation, P's special basis adjustment is only $100, the difference between his $1,100 outside basis and the $1,000 inside basis he took over from B. The first $600 of the $1,200 partnership gain on the sale of Blackacre is allocated to A, and the remaining $600 divided equally among A, P, and C. Because P has a $100 special basis adjustment, his $200 gain is reduced to $100.

G. *Death of a Partner.*

Section 743(b) adjusts the basis of partnership property on the death of a partner[61] in essentially the same way as it does when a partnership interest is sold or exchanged: the transferee is given his own special basis in partnership assets to reflect his initial basis in his partnership interest. Currently and traditionally, the transferee's initial basis in his partnership interest is determined under section 1014 (a).[62]

The basic rule of section 1014(a) is that the owner of property acquired from a decedent takes that property with a stepped-up basis equal to the fair market value of the property at the date of the decedent's death, or at the alternate valuation date.[63] The person who receives a partnership interest from a decedent will have an initial basis in that partnership interest equal to the fair market value of the interest at the date of death, or at the alternate valuation date, after two adjustments:

> The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities,

[61] Rev. Rul. 79-84, 1979-10 I.R.B. 18 (March 5, 1979), dealt with a partnership interest held in a grantor trust. The grantor trust ceased to be revocable when the grantor died, and the partnership interest was deemed to pass to the trust. Accordingly, because the interest was in a partnership that had a 754 election in effect, the transfer of the interest to the trust on the death of the grantor triggered a 743(b) adjustment to basis.

[62] Code § 1023, passed as part of the Tax Reform Act of 1976, would replace section 1014's step-up in basis approach with a carryover basis approach. The effective date of section 1023, originally December 31, 1976, was postponed until December 31, 1979 by section 515 of the Revenue Act of 1978. The Senate Finance Committee has added the permanent repeal of 1023 to the "windfall profits tax" presently before Congress. S. Rep. No. 96-394, 96th Cong., 1st Sess. 176, 125 Cong. Rec.S15699 (daily ed. Nov. 1, 1979) (to accompany H.R. 3919).

[63] The alternate valuation date is determined under Code § 2032.

> if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent. . .under section 691.[64]

The first adjustment is necessary to carry out the basic policy of section 1014 to treat the successor as if he or she had purchased the interest from the decedent at its fair market value at the date of death, or alternate valuation date. Just as the purchaser of a partnership interest has an initial basis in his partnership interest that is the sum of the price he paid for the partnership interest plus the share of any partnership liabilities he undertakes, so, too, the initial basis of the transferee on death is the value of the partnership interest increased by the amount of partnership liabilities he undertakes.

The second adjustment is necessary because section 1014(c) states that section 1014 does not apply "to property which constitutes a right to receive an item of income in respect of a decedent under section 691." [65] In short, the purpose of section 691 is to make sure that the decedent's successor pays tax on amounts to which the decedent was entitled but on which the decedent never paid tax.[66] The income items would escape taxation if the decedent's successor were to receive a stepped-up basis in them. For example, a cash-method decedent would not have reported his right to receive a $100 future payment for services he performed, and would have had a zero basis in that right.[67] The right to receive the $100 payment passes to his successor as income in respect of the decedent which, by definition, has not yet been reported.[68] If the right to receive the $100 has a value of $100 at death or alternate valuation date, and if the successor were to receive a stepped-up basis to the $100 value, the policy of section 691 would be defeated because the actual receipt of the $100 would simply reduce basis and never be recognized. To avoid this result, if property constitutes "income in respect of a decedent," the decedent's basis carries over to his successor

---

[64] Treas. Reg. § 1.742-1 (1956).

[65] Code § 1014(c).

[66] Treas. Reg. § 1.691(a)-1(b) (1965) states that the term "income in respect of a decedent" includes:

> (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
>
> (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and
>
> (3) Income to which the decedent had a contingent claim at the time of his death.

[67] If the decedent purchased the right to receive the $100 payment, rather than earned it, his basis in the right would be his cost.

[68] The character of income of a successor in interest of a decedent on collection of income in respect of a decedent is the same as it would have been in the hands of the decedent. Code § 691(a)(3).

and is not "stepped-up" by section 1014.[69] If a partnership interest is acquired from a decedent, and a portion of that interest is treated as income in respect of a decedent, treatment of the transfer will be fragmented: the income in respect of a decedent portion will pass with a carryover basis whereas the rest of the interest will receive a stepped-up basis.

The question then is when will a portion of a partnership interest be deemed to represent income in respect of a decedent. The only statutory provision that specifically treats a portion of a partnership interest as income in respect of a decedent is section 753, and it only refers to section 736(a) payments, which are certain payments made by a partnership to a partner to liquidate his interest:

> SEC. 753. PARTNER RECEIVING INCOME IN RESPECT OF DECEDENT.
>
> The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.[70]

Thus, any 736(a) payments not reported by the deceased partner will be reported by his successor in interest.[71]

The Regulations under section 753 specify a second situation in which a transferee of a partnership interest will be deemed to receive income in respect of a decedent. When a partner dies,

> the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691.[72]

A partner who dies must report a share of partnership income on his final return only if a partnership year ends within or with his last taxable year, which ends with his death. Because the tax year of the

---

[69] Nor is it adjusted under § 1023.

[70] Treas. Reg. § 1.753-1(a) (1956) provides, in part:

> The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

[71] For further discussion of section 736(a) payments as income in respect of a decedent, including the extent to which section 736(a) embraces items not considered income in respect of a decedent outside of Subchapter K, *see* McKee, *supra* note 21, at ¶ 23.03 [2][a].

[72] Treas. Reg. § 1.753-1(b) (1956). See the Example in Treas. Reg. § 1.753-1(c) (1956).

partnership does not automatically close when a partner dies,[73] either with respect to the remaining partners or with respect to the deceased partner, the deceased partner is not required to report a share of partnership income attributable to the fraction of the partnership year that had run by his death:

> The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest.[74]

If the successor were to receive a step-up in basis to the value of the right to receive that income, it would forever escape tax. Therefore, it is income in respect of a decedent that must be reported by his successor in interest.[75]

Quick's Trust v. *Commissioner*[76] established that income in respect of a decedent will be found in partnership interests in many more situations than the only two mentioned in section 753 and its Regulations. One Mr. George Edward Quick was one of two equal partners in a cash method, calendar year partnership that provided architectural and engineering services. From 1957 on, the partnership's only activity was collecting accounts receivable for professional services previously rendered. On January 23, 1960, Mr. Quick died, when the partnership had no outstanding liabilities and when its only assets were cash and accounts receivable that were payable through 1967. Because partnership income had been reported on a cash method, the accounts receivable for services had a zero basis. They had a face amount of $518,000 and a fair market value of $454,991. The fair market value of Mr. Quick's partnership interest at the date of his death was $264,914, $227,495 of which was attributable to 50% of the fair market value of the accounts receivable. His partnership interest passed to a trust, which became the taxpayer in *Quick*.[77]

The partnership attached a 754 election to its return for 1960, the year of Mr. Quick's death. The trust claimed that it received an initial basis in Mr. Quick's partnership interest equal to the full value

[73] The partnership taxable year will close for all partners if and when the death results in termination of the partnership for tax purposes. Treas. Reg. § 1.706-1(c)(3) (1976).

[74] Treas. Reg. § 1.706-1(c)(3)(ii) (1973).

[75] Treas. Reg. § 1.753-1(b) (1956):

> This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes.

[76] 54 T.C. 1336 (1970), *aff'd*, 444 F.2d 90 (8th Cir. 1971).

[77] The facts have been simplified somewhat to ease discussion. Mr. Quick's estate initially succeeded to his interest in the partnership. His estate held the interest for five years, and then transferred it to the trust, which was created a little over a year prior to Mr. Quick's death. The trust conceded its liability as transferee of the estate.

of Mr. Quick's interest at the date of his death, and refused to reduce this initial basis because it claimed that it had not received any income in respect of a decedent. Accordingly, the trust claimed a huge 743(b) upward adjustment to basis with respect to the partnership accounts receivable, computed as the difference between its initial "outside basis" of fair market value of the interest at date of death, and its initial share of common partnership basis. The common partnership basis, and hence the trust's share thereof, was extremely low because the partnership had a zero basis in all its accounts receivable. Said the Tax Court:

> [T]he net result of this adjustment was to increase the basis of the accounts receivable. . . from zero to an amount slightly less than one-half of their face value. If such treatment was correct, it substantially reduced the amount of the taxable income to the partnership from the collection of the accounts receivable under section 743(b) and the [trust was] entitled to the benefit of that reduction.[78]

The trust reasoned that a partnership is an entity that has its own assets in which its members have no direct interest; that the member's asset is a partnership interest that is independent of the partnership's assets; and that section 753 and its Regulations provide the only two situations in which the transferee of a partnership interest will be deemed to receive income in respect of a decedent.

The Tax Court said that the entity theory should not be "inexorably" applied and rejected the notion that a partnership interest is "a unitary res, incapable of further analysis."[79] It cited legislative history to the effect that "income rights relating to unrealized receivables or fees are regarded 'as severable from the partnership interest and as subject to the same tax consequences which would be accorded an individual entrepreneur.' "[80] It held that the right to share in the proceeds of the accounts receivable constituted income in respect of a decedent with respect to the trust. Thus, the trust's initial basis in its partnership interest was the fair market value of the interest at the date of death minus the extent to which that value reflected income in respect of a decedent, that is, minus the fair market value of the accounts receivable for past services.

Although there has been some disagreement about the court's conclusion,[81] *Quick* is generally interpreted to have two basic messages. First, a partnership interest that is transferred on the death of a partner will be fragmented such that the successor in interest will be deemed to receive income in respect of a decedent to the same extent as if the

[78] 54 T.C. at 1341.
[79] *Id.* at 1345.
[80] *Id.* at 1343.
[81] *See* Willis, *supra* note 21, at §§ 42.04-05.

interest he received was that of a sole proprietor rather than a partner. Accordingly, the fair market value of income in respect of a decedent is not included in the successor's initial basis in his partnership interest. Second, the fragmentation approach also means that, even if there is an overall upward adjustment to basis of partnership properties under 743(b), none of it may be allocated to items that constitute income in respect of a decedent. This preserves the integrity of section 691 in the partnership context.

H. *Property Distributions After 743(b) Adjustments.*

The effect of 743(b) adjustments on subsequent distributions of property depends upon the identity of the distributee and the property distributed, and on whether it is distributed in a current or in a liquidating distribution.

(1) *Distributee gets property subject to his own special basis adjustment.* If a partner receives a distribution of property with respect to which he has a special basis adjustment, his basis adjustment will be taken into account when relevant under section 732, which provides different rules for current and liquidating distributions.[82] If he receives property in a current distribution, he will take that property with the basis it had in the hands of the partnership, including his own special basis adjustment with respect to it.[83] If he receives property in a liquidating distribution, he will receive a "substituted basis" in the property equal to his adjusted basis in his partnership interest, reduced by any money received in the same distribution.[84] If this substituted basis is different from his share of the partnership's basis in the distributed assets, including his special basis adjustments, the difference must be allocated by the partnership among the assets it retains.[85]

(2). *Distributee gets property subject to an adjustment for another partner.* If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee does not take into account the other partner's special basis adjustment.[86]

---

[82] Code §§ 732(a) and (b).

[83] Treas. Reg. § 1.732-2(b) (1956). This is subject to the 732(a)(2) limit of his adjusted basis in his partnership interest, reduced by any money received in the same distribution.

[84] Code § 732(b).

[85] Treas. Reg. § 1.743-1(b)(2)(ii), Example (2)(c) (1956). Although the distributee's special basis adjustments with respect to property he receives in a liquidating distribution will not affect the total amount of his "substituted basis" in the distributed assets, they can affect the allocation of the substituted basis among the distributed assets. *Id.* at Example 2(b).

[86] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).

> However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property.[87]

In this context, "like kind" refers to "property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc." [88] Presumably, if there is no remaining like property, the partner entitled to the adjustment will have his adjustment held in abeyance until the partnership acquires additional like kind property.[89]

(3). *Distributee relinquishes interest in property subject to his own special basis adjustment.* The flip side of the coin of the distributee who receives property subject to another's adjustment, is the distributee who relinquishes his interest in property in which he has a special basis adjustment.

> If, at the time a partner receives property. . . he relinquishes his interest in other property of a like kind with respect to which property he has a special basis adjustment, the adjusted basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest.[90]

A partner who receives a current distribution is considered to relinquish only his interest in property distributed to other partners. Accordingly, he will take the property he receives with the basis it had in the hands of the partnership, plus or minus the special basis adjustment he had with respect to the like property distributed to someone else.

A partner who receives a liquidating distribution relinquishes his interest in all property retained by the partnership. If a partner receives a liquidating distribution of property, including money, with respect to which he has no special basis adjustment, and relinquishes his interest in property with respect to which he has a special basis adjustment,

> and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which distributee did not use his special basis adjustment.[91]

---

[87] *Id.*
[88] *Id.*
[89] *See* McKee, *supra* note 21, at ¶ 24.05.
[90] Treas. Reg. § 1.743-1(b)(2)(ii) (1956).
[91] Treas. Reg. § 1.734-2(b)(1) (1956).

The Regulations set out the simple situation in which a partner receives a liquidating distribution that consists entirely of cash, in an amount equal to his basis in his partnership interest, and relinquishes all interest in partnership property with respect to which he has a special basis adjustment. In this situation, the liquidated partner's special basis adjustment simply passes to the partnership.[92]

Note that there must now be a qualification to the general statement that a section 743(b) adjustment only affects the transferee partner. If there is a subsequent distribution that prevents the transferee from carrying on his own special basis adjustment, his adjustment might pass to and be used by the partnership, and hence affect all the remaining partners.

I. *Transfers Subsequent to 743(b) Adjustments.*

The Regulations contain a "successive transfer" rule which provides that, when there is more than one "transfer" of a partnership interest,

> the last transferee's special basis adjustment, if any, under section 743(b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment.[93]

If I receive a special upward basis adjustment because of the relationship between the price I paid for my interest and common partnership basis, I am not offended that the person to whom I sell my interest must compute his own special basis adjustment based on the relationship between the price he pays me and his share of common partnership basis. If, on the other hand, I wish to give my partnership interest to my favorite nephew, I am deeply offended that my special basis adjustment might simply disappear. Because transfer by gift does not trigger a 743(b) adjustment, my nephew will not have an opportunity to obtain his own special basis adjustment. It does not seem fair that there should be a loss of basis that puts my donee in a worse position than I was in. The argument can be made that the only "transfers" embraced by the "successive transfer" rule are those that trigger a new 743(b) computation, because the new 743(b) computation simply replaces the earlier 743(b) computation.[94]

V. *Allocating the 743(b) Adjustment*

Section 743(b) only determines the total dollar amount of the adjustment to the basis of partnership property. It does not determine

[92] *Id.* For further discussion of distributions subsequent to 743(b) adjustments, *compare* McKee, *supra* note 21, at ¶ 24.05 *with* Pennell, *supra* note 39, at 171-75.

[93] Treas. Reg. § 1.743-1(b)(2)(iv) (1956).

[94] McKee, *supra* note 21, at ¶ 24.06, considers this interpretation of the Regulations "strained."

how the total amount is allocated among specific partnership properties. Rather, the total adjustment is allocated among partnership properties by section 755. As can readily be imagined, a transferee who receives his own special upward basis adjustment, might rather "up his basis" in ordinary income assets than in capital gain assets. Conversely, a transferee who must record his own special decrease in the basis of partnership assets, might rather decrease his basis in capital gain assets than in ordinary income assets. Section 755 allocates basis adjustments between ordinary income and capital gain assets in order to prevent the conversion of ordinary income into capital gain.

Section 755 contains a "general rule" and a "special rule" for allocating the total amount of the optional adjustment among specific partnership properties. The "general rule" of 755(a) provides that the total adjustment shall be allocated in a manner "which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties," or in any other manner permitted by the Regulations.[95] The Regulations do not detail any alternative manner; they simply authorize an application to the District Director for permission to use an alternative method.[96] The "special rule" of 755(b) states, that in the application of section 755(a)'s "general rule," the adjustment to basis shall be allocated to

> (1) capital assets and property described in section 1231(b) [hereinafter "capital gain" property], or
> (2) any other property of the partnership [hereinafter "ordinary income" property],[97]

depending on the extent to which each of the two classes is responsible for the adjustment. The terms "general rule" and "special rule" are somewhat misleading in this context, because the "special rule" must be applied, i.e., the total adjustment must first be allocated between the two basic classes of property, before the "general rule" can be applied:

> The amount of the increase or decrease...in the adjusted basis of the partnership property shall first be divided.. between the two classes of property described in section 755(b). Then the portion of the increase or decrease allocated to each class shall be further allocated to the bases of the properties within the class in a manner which will

---

[95] Code § 755 (a).

[96] Treas. Reg. § 1.755-1(a)(2) (1956).

[97] Code § 755(b)(1) & (2). The term "capital gain" property will be used to refer to the first class because gains on sales or exchanges of 1231(b) property are also generally capital gains. However, the recapture provisions may require that part of the gain from "capital gain" property be taxed as ordinary income.

reduce the difference between the fair market value and the adjusted basis of partnership properties.[98]

A. *Allocation Between the Two Classes.*

The first step, therefore, is to determine how the lump sum basis adjustment will be allocated between capital gain property and ordinary income property. Simply add up, within each class, the difference between the fair market value and the adjusted basis of the assets. This will result in a figure, for each of the two classes, that will be either a net value above basis or a net value below basis. If the total 743(b) adjustment is an increase, and one class of assets has a net value above basis and the other class has a net value below basis, the entire increase in basis will be allocated to the class with the net value above basis. None of the increase in basis will go to the class with the net value below basis, even though some of the assets in the net value below basis class may have value above basis.[99] If each class has a net value above basis, the total upward basis adjustment is allocated between the two classes in proportion to their relative amounts of value above basis.[100]

B. *Allocation Within a Class.*

After the adjustment has thus been allocated between the two classes of property, or all to one of the classes, as the case may be, the amount allocated to a particular class must further be allocated among the properties in that class. The allocation within a class must be done "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties."[101] When there is an increase in basis to be allocated to partnership assets, "such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference

---

[98] Treas. Reg. § 1.755-1(a)(1)(i) (1956).

[99] *See* Treas. Reg. § 1.755-1(c), Example (3) (1956); McKee, *supra* note 21, at ¶ 24.04[1]; Pennell, *supra* note 39, at 156.

[100] In *Bartolme, infra* note 115, an upward adjustment was allocated between prepaid interest, which was treated as a 1231(b) asset, and land that was considered "any other property":

> These being the only eligible assets [the only assets whose fair market value was in excess of basis], the allocation need be made only as between the two classes, with no further breakdown within the classes.

62 T.C. at 832. The amount to be allocated for the new partner in question was $27,746. The prepaid interest had a fair market value $406,000 greater than its zero basis. The land had a fair market value $738,196 greater than its basis. *Id.* at 833:

> Applying the formula mentioned above, 406,000/1,144,196 or 35.5 percent of the $27,746 is to be allocated to prepaid interest, and 738,196/1,144,196, or 64.5 percent is to be allocated to the land.

[101] Code § 755(a)(1).

between the value and basis of each." [102] If there is a decrease in basis to be allocated to partnership assets, "such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each." [103]

C. *Problems of Valuation.*

The allocation rules just described depend on a determination of the fair market value of all partnership assets. In many situations, it is quite difficult to identify and value all the assets of a partnership. Certain significant assets may not even appear on the partnership books.[104] Such difficulties were involved in *Cornish v. United States,*[105] the leading case on the allocation of 743(b) adjustments. *Cornish* involved a very profitable eleven-person partnership engaged in the manufacture and sale of lumber and other wood products produced at two very productive sawmills it owned and operated. The two sawmills were designed and built at minimum cost by the partnership's very talented general manager, who was both an architect and an engineer. The partnership owned timber and cutting contracts on timber tributory to these two mills. On June 1, 1955, it purchased a third sawmill and also the contract rights to cut a substantial amount of timber tributory to the new mill.

On the same day the partnership purchased the new mill, the original eleven partners sold part of their interests to new partners, under contracts that required each new partner to pay $200,000 for a 5% interest. The taxpayers in *Cornish* were two of the new partners, each of whom made only a $100 downpayment on the $200,000 purchase price. Each was to pay the balance in annual installments out of his share of partnership income, payment in full to be made in not more than fifteen years. The promise to pay the balance was nonrecourse; each could withdraw from the partnership at any time without any obligation to pay the balance of the purchase price.

A 754 election was in effect for the year the partnership interests were sold. Based on the $200,000 purchase price, each new partner

---

[102] Treas. Reg. § 1.755-1(a)(1)(ii) (1956).

[103] Treas. Reg. § 1.755-1(a)(1)(iii) (1956).

[104] Goodwill is an asset that frequently does not appear on the partnership books. Treas. Reg. § 1.755-1(a)(1)(iv) (1956), requires that a portion of any optional basis adjustment

> be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014, in accordance with the difference between such value of the good will and its adjusted basis at the time of the transaction.

See also James T. McKay, 1968-276 T.C.M. (PH) ¶ 68,276.

[105] 348 F.2d 175 (9th Cir. 1965), *rev'g and remanding* 221 F. Supp. 658 (D. Or. 1963).

computed a 743(b) upward adjustment to basis of $105,371, the excess of his outside basis over his inside basis. The new partners attempted to allocate as much as possible of their upward adjustment to depreciable assets. Because the touchstone for allocating basis adjustments is the value of the partnership assets, the new partners relied on a document that all buying and selling partners had agreed to, which purported to state the fair market value of partnership assets used to compute the sale price of the partnership interests.

The district court said the purported valuations "would challenge the thinking process of the most imaginative person. . . ." [106] It noted, for example, that the depreciable assets of the third mill were assigned a value more than double what the partnership paid for them that very day. Despite protestations of the taxpayers to the contrary, it concluded that

> the tax consequences of the plan must have been obvious and must have been a major factor in plaintiffs agreeing to pay, out of profits, a price many times greater than that for which the assets were purchased on the very day in question.[107]

And so it came to pass that the district court and the Ninth Circuit undertook to determine exactly what it was the new partners had purchased, and how their 743(b) adjustment would be allocated.

The Ninth Circuit said that the purchase price of the partnership interests

> breaks down into three classes: the fair market value of the tangible assets (including timber cutting contracts); the part of the negotiated price which should be attributed to going concern value as a nondepreciable intangible asset, and the balance, representing partnership overvaluation, which should be prorated between tangibles and the nondepreciable intangibles.[108]

The Ninth Circuit treated the partnership's depreciable intangible assets, the timber cutting contracts, the same as it treated the partnership's tangible partnership assets. The basic question was whether the value of these assets was enhanced by the "know how" of the highly skillful and successful original partners. Was it appropriate, in allocating the 743(b) adjustment, to recognize that the third mill and the accompanying timber contracts were worth much more than the partnership paid for them because they had passed into the hands of an unusually efficient group of entrepreneurs? The Ninth Circuit distinguished between value added by past and prospective exercise of "know how." It said that to the extent

---

[106] 221 F Supp. at 662.

[107] *Id.*

[108] 348 F.2d at 185-86.

> the special skills and abilities of the selling partners, exercised prior to the taxpayers' appearance on the scene, made these particular sawmills more valuable than ordinary sawmills, * * * the value thereby added belonged to the sawmills as tangible assets, and not to some intangible asset which might be called "past exercise of skills and abilities." [109]

The court attributed this increase in value for past services to the sawmills rather than to the timber cutting contracts.

On the other hand, because the eleven selling partners were not obligated to continue to devote their skills and abilities to partnership business, "the prospective exercise of these skills and abilities [was] not purchased by the buying partners." [110] Therefore, the new partners were denied "an enhancement in the market value of the tangible assets to reflect future services of the selling partners." [111] Furthermore,

> neither may this element be regarded as an intangible asset, since it was not purchased by the incoming partners. Thus to the extent that the negotiated price of the sawmills [between buying and selling partners] reflects a factor of this kind it represents an over-valuation of partnership assets which should be distributed, pro rata, between the tangible assets and the nondepreciable intangible assets. . . .[112]

In short, the new partners paid too much for their partnership interests because they gambled on the fact that the original partners would continue to devote themselves to the partnership, and the overpayment should have been allocated among all partnership assets.

The new partners argued that the value of the partnership assets was greater because of the very favorable terms under which they purchased their partnership interests; they had to pay a "time-price differential" attributable to the partnership assets in order to finance the acquisition of their partnership interests on a nonrecourse basis over fifteen years. Because neither the Service nor the new partners argued that any portion of the $200,000 payments constituted interest, and because the case arose prior to the passage of rules that imputed interest in certain installment sales,[113] the Ninth Circuit held that the time-price differential was part of the purchase price and not interest. It further said that the district court

> acted correctly in declining to consider this factor in placing a market value on the tangible properties. On the other hand, any value associated with this differential does not

[109] *Id.* at 182.
[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *See* Code §§ 163(b) & 483.

> constitute an intangible asset as such. To the extent that the negotiated price reflects such a factor, it represents an overvaluation of the partnership assets, tangible and intangible.[114]

The intangible asset the Ninth Circuit said the district court failed to recognize as such was going concern value.[115] The district court found no value in good will but did take going concern value into account to determine the value of the tangible partnership assets. The Ninth Circuit agreed that going concern value is different than good will, but said that going concern value

> cannot be classified as an enhancement in market value of depreciable assets for purposes of depreciation. While the in-

---

[114] 348 F.2d at 184.

[115] In *Bartolme* v. *Commissioner*, 62 T.C. 821 (1974), the intangible asset that did not appear on the partnership books was "unamortized prepaid interest." In 1964, a cash-method limited partnership was formed and purchased a tract of land by giving three notes totaling $1,859,000. The partnership prepaid 53½ months' of interest on these notes, $580,000, and deducted the entire amount on its 1964 partnership return. The prepaid interest did not appear as an asset on the partnership books because the partnership deducted the full amount rather than capitalize it.

The following year, an investment group purchased a one-third interest in the partnership, and the partnership immediately filed a 754 election. When the partnership filed its election it claimed to have two partnership assets to which an adjustment in the basis of partnership property could be allocated: land and an item designated "unamortized prepaid interest." The new partners allocated a little more than half of their upward basis adjustments to the land, and the rest to the "unamortized prepaid interest," which they amortized over the remaining 37½ months covered by the prepayment.

The Tax Court said it was clear that the prepayment had value when the taxpayer bought his partnership interest, and was an intangible asset eligible for a 743(b) upward adjustment because its value was greater than its zero basis. The Tax Court said the fact the asset did not appear on the partnership books was irrelevant, and said that granting the new partners an amortizable basis in the prepaid interest would not result in a double deduction:

> If the buyer subsequently depreciates or amortizes the excess amount he paid for a fully depreciated or expensed asset, he is not taking a second deduction of the cost paid by the partnership but is merely depreciating or amortizing his own additional cost in that asset.
>
> . . . .
>
> . . . Here, petitioner has paid for an interest in the prepaid interest and is seeking to amortize *his* cost thereof.

62 T.C. at 830-31. The Tax Court said that the Service should not pursue the purchaser of the partnership interest simply because it had been unsuccessful in its pursuit of the seller:

> The tax advantage gained in this transaction was that the seller of the partnership interest was able to deduct against ordinary income the amount it paid as prepaid interest and report as capital gain the amount it received in the transfer for its interest therein. . . . [The Service] must have realized this when . . . [it] determined a deficiency against the seller, but apparently concluded that there was nothing in the law to prevent the seller from realizing this advantage, because . . . [it] settled with the seller for no deficiency.

Id. at 831.

> dividual tangible assets may wear out and be replaced, going concern value does not wear out with the individual assets. And when a worn out tangible asset must be replaced the cost to the business of doing so is not augmented by the fact that the acquisition is to become part of a going concern.[116]

The cost the new partners paid for going concern value was incurred for "a true nondepreciable intangible asset of the partnership." [117]

To summarize, the Ninth Circuit held that the portion of the new partners' purchase price attributable to "overvaluation" was to be used to increase the basis of partnership assets, both tangible and intangible. It rejected the argument that its approach was contrary to section 755's mandate to allocate 743(b) adjustments "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties. . . ." [118] It explained that this mandate means

> that where there are several classes of depreciable partnership properties, the percentage of difference between the fair market value and the adjusted basis of each shall be maintained in allocating the total amount of the increase in the adjusted basis attributable to depreciable assets.[119]

As section 743 was first introduced in the House of Representatives, it provided that the total basis adjustment would be spread among the underlying partnership properties "in proportion to their respective adjusted bases." [120] During hearings, it was pointed out that such a rule would result in a disproportionately low allocation to assets with a low basis but high market value. The Senate accepted the suggestion that the criterion for allocation should be the fair market value of the partnership assets, but added that the total adjustment must be allocated "in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis" of partnership properties. The Ninth Circuit felt that because

> the concept of fair market value was injected for allocation purposes, not limitation purposes, the term "reducing the difference" must have been intended to establish a formula for allocating all of the increase in adjusted basis on a proportional basis, not to withhold from allocation such part of the increase which might exceed the fair market value of the class of property to which it attaches.[121]

---

[116] 348 F.2d at 185.

[117] *Id.*

[118] Code § 755(a)(1).

[119] 348 F.2d at 186.

[120] Hearings on H.R. 8300 Before the Senate Finance Comm., 83d Cong., 2d Sess. 1323.

[121] 348 F.2d at 186, n.17.

It reasoned that to permit optional adjustments to increase basis above market value avoids discrimination against the partnership form:

> If a man pays ten thousand dollars for a commercial building having a fair market value of eight thousand dollars, the entire ten thousand dollar cost normally becomes his basis for depreciation. It does not, however, if it can be shown that he intentionally paid part of the price for a nondepreciable intangible asset such as good will or going concern value.[122]

D. *Flaws in the Allocation of Basis Adjustments.*

Even if the identity and value of partnership assets are clear, there are fundamental flaws in the rules that determine and allocate optional adjustments. The first example in the Regulations to illustrate the allocation rules deals with the purchase of a one-third interest in partnership ABC, which has the following balance sheet:

ASSETS

	Adjusted Basis	*Market Value*
Capital asset X	$1,000	$1,500
1231(b) asset Y	1,000	900
Inventory Z	700	600
	$2,700	$3,000

LIABILITIES AND CAPITAL

	Adjusted Basis	*Market Value*
Liabilities	$ 0	$ 0
Capital		
A	$ 900	$1,000
B	900	1,000
C	900	1,000
	$2,700	$3,000

If Purchaser P purchases A's one-third interest for its fair market value of $1,000, P is entitled to a special basis adjustment of $100, the

[122] *Id.* at 186, n.18. *But see* S. Rep. No. 1616, 86th Cong., 2d Sess. 123. In discussing proposed Code § 783, which was part of H.R. 9662 (1960), the Senate Finance Committee indicated an intention to clarify

> present law by specifically providing that the adjusted basis of any partnership property shall not be increased above its fair market value as a result of any special basis adjustment.

Id.

excess of his $1,000 outside basis over his $900 share of common partnership basis. The Regulations allocate this entire upward adjustment to asset X because it is the only asset with a value above basis.[123] Accordingly, the bases of partnership assets with respect to P become:

Capital asset X	$433.33	(⅓ of common partnership basis plus $100 adjustment)
1231(b) asset Y ...	333.33	(⅓ of common partnership basis, unadjusted)
Inventory Z	233.33	(⅓ of common partnership basis, unadjusted)
	$999.99	(inside basis as adjusted upward to equal outside basis)

The allocation does not put new partner P in the position he would have been in had he directly purchased an undivided interest in the partnership assets. The result does not completely satisfy the statutory purpose to reduce the difference between the fair market value and the adjusted basis of partnership properties, although it tends to do so with those assets whose value has the same positive or negative relation to basis as the total positive or negative 743(b) adjustment. Contrast the result if the partnership distributes an undivided one-third interest in each asset to A, who then sells the undivided interests in the assets to P at their fair market value:

	P's Inside Basis Per section 755	*Market Value P's Share*	*P's Basis Per Direct Purchase*
Capital asset X	$433.33	$ 500	$ 500
1231(b) asset Y ...	333.33	300	300
Inventory Z	233.33	200	200
	$999.99	$1,000	$1,000

Consider the evil 743(b) seeks to avoid: tax consequences that distort economic reality and must await long-term "correction." If Capital asset X were sold immediately after P purchased his partnership interest, P would be required to report $66.67 gain, even though, as an economic matter, he has no gain, because the price he paid for his partnership interest reflected the full value of his share of Capital asset X. Conversely, if 1231(b) asset Y and Inventory Z were sold immediately after P purchased his partnership interest, P would report a loss even though, as an economic matter, he has no loss, because the purchase price he paid reflected the depreciated value of those assets.

[123] Treas. Reg. § 1.755-1(c), Example (1) (1956).

Note that the $500 value of P's ⅓ share in Capital asset X exceeded P's $333 share of common partnership basis in X by $177, more than the $100 total 743(b) adjustment. An allocation would treat P as if he directly purchased an interest in partnership assets only if it increased the basis of Capital asset X by more than $100 and offset the additional increase with a corresponding decrease in the basis of the assets with value below basis. Stated simply, the method that will prevent distortions is one that allocates to each asset whatever basis increase or decrease is necessary to make the transferee's share of the adjusted basis of the asset, equal to his share of its value.

Perhaps the most extreme example of 743(b)'s failure to prevent distortions is the situation in which the value in excess of basis of certain partnership properties equals the amount of value below basis in other partnership properties. If the total value equals the total basis, and the transferee purchases his partnership interest for the value of his share of the assets, there apparently is no 743(b) adjustment because there is no difference between his basis in his partnership interest and his share of common partnership basis. Assume, for example, a partnership with the following balance sheet:

ASSETS

	Adjusted Basis	*Market Value*
Inventory	$ 0	$150
Capital asset	300	150
	$300	$300

LIABILITIES AND CAPITAL

	Adjusted Basis	*Market Value*
Liabilities	$ 0	$ 0
Capital		
A	100	100
B	100	100
C	100	100
	$300	$300

If P purchases C's partnership interest for $100, there apparently is no adjustment with respect to P under the rule of 743(b). This is true even though P would have a $50 basis in his share of each asset had he directly purchased undivided interests in them. The 743(b) adjustment is the difference between the purchasing partner's basis in his partnership interest, here, $100, and his proportionate share in the

common partnership basis, here, $100. The difference between the two is zero and, hence, the 743(b) basis adjustment is zero.[124] If the partnership sells the inventory for $150, it will recognize income of $150, and P's distributive share of that income will be $50.

Not only is P required to report $50 of ordinary income when, in economic reality, he has no gain of any kind, but the income has been taxed twice. Assume that C's adjusted basis in his partnership interest was $100 when he sold it to P for $100. On the overall basis, it might not seem that C has recognized a taxable gain on the sale. But section 751(a) requires an allocation of the sale price to the substantially appreciated inventory.[125] C realized ordinary income of $50 on the sale of his interest in inventory and a capital loss of $50 on the sale of the balance of his partnership interest. P will again report $50 of ordinary income when the partnership sells the inventory.

The Regulations suggest a method of solving P's problem by permitting the partnership to increase by $50 the basis of its inventory and decrease by $50 the basis of its capital asset. These adjustments would be with respect to P only, and would treat P exactly as if he had directly purchased a share in the partnership's assets. The statute itself permits allocation of the adjustment "in any other manner permitted by regulations prescribed by the Secretary."[126] The Regulations authorize partnerships to apply for permission to use other methods by filing an application with the District Director within thirty days after the close of the taxable year in which the adjustment is to be made.[127] They specifically anticipate that permission may be given to increase the basis of some assets and decrease the basis of others:

> [T]he district director may permit the partnership to increase the bases of some partnership properties and decrease the bases of other partnership properties under section 734(b) or section 743(b). Each increase or decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 734(b) or 743(b). Adjustments that both increase and decrease the basis of partnership assets will be permitted by the district director only upon a satisfactory showing of the values for partnership assets used by the parties

[124] It could be argued that if the "excess" of outside basis over inside basis, or vice-versa, is zero, the *total* zero 743(b) adjustment may be achieved by equal positive and negative adjustments. This is not the prevailing interpretation of present law. Willis, *supra* note 21, at § 29.06.

[125] *See* Willis, *supra* note 21, ch. 27.

[126] Code § 755(a)(2).

[127] The thirty day limit has been criticized widely as unduly restrictive.

> to determine the price at which a partnership interest was sold, the value of the decedent's partnership interest at date of death (or alternate valuation date, if used), or the amount of a distribution.[128]

It would appear that, under these Regulations, after P purchases C's partnership interest in the example just discussed, the partnership could, with respect to P only, increase by $50 the adjusted basis of inventory and reduce by $50 the adjusted basis of the capital asset, providing it filed a 754 election and obtained, in the appropriate amount of time, the permission of the district director to use the alternative method.[129]

[128] Treas. Reg. § 1.755-1(a)(2) (1956).

[129] *But see* McKee, *supra* note 21, at ¶ 24.04[2], where it is pointed out that these Regulations may only apply to allocations within a particular class.