Hyperlexis and the Loophole

Walter D. Schwidetzky
HYPERLEXIS AND THE LOOPHOLE

WALTER D. SCHWIDETZKY*

I. Introduction

In this article I would like to continue the discussion on the need to control "hyperlexis," the term coined two decades ago by Dean Manning1 to describe the "pathological condition caused by an overactive law-making gland."2 Unfortunately, Congress and its regulatory bodies have become hyperlexic to an extreme. As De Tocqueville noted, if we see a problem, we throw a law at it.3 Complexities are piled on top of complexities. Attempts to eliminate ambiguities rarely succeed; a law that resolves one ambiguity typically spawns many more. This whole process stems, I think, from the deluded belief that it is possible to have a perfect legal system. It is not. Humans are imperfect, and therefore so will be anything they

© 1996 Walter D. Schwidetzky

* Professor of Law, Director, Graduate Tax Program, University of Baltimore School of Law. B.A., 1974, J.D., 1978, M.B.A., 1978, LL.M., 1984, University of Denver. Professor Schwidetzky wishes to thank Professor Robert Keller of the University of Maryland School of Law and Professors Kenneth Lassen, Wendy Gerzog, and Fred Brown of the University of Baltimore School of Law for their editorial comments; Ms. Andrea Gillespie, a law student and former graduate tax student at the latter University, for her outstanding research efforts; and Ms. Peggie Albiker, for her labors at the word processor.


2. Manning, supra note 1, at 767.

3. Quoted in id. at 772.

403
create. Frederich Hayek hoped that "our generation may have learned that it has been perfectionism of one kind or another that has often destroyed whatever degree of decency societies have achieved." His hopes seem in vain.

Tax law is, of course, a case of hyperlexis run extraordinarily amok. Indeed, the Internal Revenue Code has gotten so out of hand that quite radical reform proposals are now on the table. Some commentators have suggested that we repeal the income tax law altogether and replace it with a value added tax or other substitute. It has been estimated that we spend $157 billion a year complying with the federal income tax laws. That amount of money is roughly equivalent to the value of the automobile output of Ford Motor Corporation and one-third of the output of Chrysler Corporation.

Much of the hyperlexis in the tax area masquerades as reform. The massive Tax Reform Act of 1986, pitched to the public via media as "tax simplification," served to increase the length of the tax code substantially. This article reviews one of the primary causes of hyperlexis in tax law, an obsessive desire to close tax "loopholes." It does not seem to matter how big the loophole is, how many people are using it, or how much revenue is being lost. Many innocent transactions are invariably caught in the undertow of loophole closure. While no solid figures appear to be available, I suspect that the revenues gleaned by closing many loopholes are often offset by revenue losses resulting from economic inefficiency and compliance costs generated by the new law. This is not to suggest all loopholes should be left wide open. Many do need to be closed. One would hope, though, that when loopholes are closed, Congress would keep hyperlexis principles in mind. In the past this has rarely been the case: Most often the law is complicated further, while opportunities for simplification are passed by.

The discussion will focus on my own area of interest, partnership taxation. Subchapter K (which contains most of the partnership tax provisions) has been the subject of numerous efforts to close supposed loopholes and thus provides fertile

4. FRIEDREICH A. HAYEK, THE CONSTITUTION OF LIBERTY 8 (1960) (referencing 2 DAVID HUME, ESSAYS 371, 373 (1742)).
5. See, e.g., U.S. Rep. Benjamin Cardin, Speech to the Maryland Bar Association Tax Section (Apr. 23, 1996) (Representative Cardin is a fairly liberal Democrat). In June 1995, Chairman Archer of the House Ways and Means Committee held hearings on replacing the income tax with another type of tax, including a value added tax (VAT). See Alan Shenh, JAPANESE CONSUMPTION TAX AFTER SIX YEARS: A UNIQUE VAT MATURE, 69 TAX NOTES 899, 900 (1995); see also REPORT OF THE NATIONAL COMMISSION ON ECONOMIC GROWTH AND TAX REFORM, 70 TAX NOTES 413 (1996) (also known as the Kemp Commission Report) (recommending a move toward a flat tax); Armey-Shelby Flat Tax, H.R. 2060, 104th Cong. (1996), S. 1050, 104th Cong. (1996) (would replace the current system with a 17% flat tax mostly on wages, pension distributions and cash flow of businesses, while increasing the standard deduction); S. 722, 104th Cong. (1996) (introduced by Senators Nunn & Domenici) (also known as the USA tax (unlimited savings account)) (would permit individuals to deduct savings from taxes and replace the corporate income tax with a VAT).
6. Cardin, supra note 5. Representative Cardin was quoting the Tax Foundation, a conservative Washington, D.C., think tank. According to Cardin, the Tax Foundation estimates compliance costs with all tax laws to be $250 billion. See id.
7. The increase forced many publishers to switch from one volume to two.
ground for this review. The areas I have chosen for analysis are the changes to the partnership contribution and distribution rules⁸ and rules governing payments to retiring partners.⁹

Each of these areas plays an important role within subchapter K. The changes that have been made are of very recent origin and thus provide a good snapshot of the viability of hyperlexis principles today. Sections 704(c)(1)(B) and 737 reveal a particularly vivid demonstration of hyperlexis. The "reformers" have used a sledgehammer to kill a fly of a loophole. I recommend they be repealed. The amendments to I.R.C. § 736 illustrate how even when changes are needed, they are made in a way that needlessly complicates the law. I recommend a simpler approach.

II. Partnership Contribution and Distribution Rules

A. Background

Ordinarily, contributions of property to and distributions of property from a partnership are made on a tax-free basis;¹⁰ no gain or loss is recognized.¹¹ Congress was concerned that these rules could be used to disguise what in substance is a sale or a taxable exchange.¹² For example, assume that A wants to sell

---

9. See id. § 736.
10. See id. §§ 721, 731.
11. See id. §§ 721, 731(a). An exception is made for distributions of cash in excess of basis, when gain is recognized. See id. § 731(a)(1). A partner can recognize a loss on a distribution in liquidation of his interest if he receives only money, unrealized receivables and inventory, and the amount of cash and carryover basis in the property is less than his basis in his partnership interest. See id. § 731(a)(2).
12. In a famous transaction, May Department Stores (May Co.) took advantage of these provisions while avoiding the repeal of General Utilities. The General Utilities doctrine stands for the proposition that a corporation need not recognize a gain or loss on the distribution of property to its shareholders. See BORIS I. BITTNER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 8.20 (6th ed. 1996). The 1986 Act largely repealed what was left of the doctrine. See I.R.C. §§ 311(b), 336(a) (1994).

It could have sold or distributed to its shareholders a real estate subsidiary's appreciated stock worth $550 million, and recognized substantial gain under I.R.C. §§ 1001 or 311(b), respectively. Instead May Co. formed a partnership with PruSimon. May Co. and the PruSimon were equal partners. PruSimon contributed $550 million to the Partnership. May Co. contributed the stock of the subsidiary. If the form of the transaction is honored, both contributions are tax-free transactions under I.R.C. § 721. The partnership then used the cash to purchase $550 million of May Co. stock in the open market. (Technically, the stock was actually purchased from May Co., which had purchased it in a self tender.) For accounting purposes the transaction is treated as a redemption by May Co. of half of its stock held by the Partnership in exchange for half of the stock of its subsidiary. The reason for this result is that, by entering into the partnership, May Co. effectively gave up ownership of one-half of the stock of the subsidiary and obtained an interest in one-half of its own stock that the partnership purchased. Had it been treated as a redemption for tax purposes, May Co. would have recognized gain on the half of the subsidiary stock exchanged for its stock. I.R.C. § 311(b). To complete the tax avoidance scheme, at a later date the partnership could have distributed the May Co. stock to May Co. and the subsidiary stock to PruSimon. These distributions would have arguably been tax free under I.R.C. § 731(a)(1). Since this would liquidate the partnership, each partner would take a basis in the distributed property equal to its
substantially appreciated property to B. A straight sale is taxable under I.R.C. § 1001. Instead A and B form a partnership. A contributes the property; B contributes cash that he would otherwise have used to buy the property. A's contribution of the property to the partnership is ordinarily tax free under I.R.C. § 721. Thereafter, the partnership liquidates, distributing the property to B and the cash to A. Distributions (in liquidation or otherwise) from a partnership to a partner are ordinarily tax free under I.R.C. § 733. Thus, it appears that A and B, by using the partnership tax rules, can turn what in substance is a taxable sale into a tax-free transaction. B, on distribution of the property, takes a basis in the property equal to the basis in his partnership interest. Thus, B receives a full cost basis in the property.

In this highly simplified example of what is commonly referred to as a "mixing bowl transaction" there are, however, a few problems. Even without statutory disapproval, if A and B are the only partners, a court most likely would apply the step transaction doctrine to classify the transaction as a sale. If in order to avoid the step transaction doctrine A and B remain partners for a meaningful period of time, they both share the risks of change in the value of the property, unless they agree to allocate all appreciation and loss to B and manage it exclusively for B's benefit. Again, if they take these steps, substance over form principles might treat the original transaction as a sale. Assuming those problems can be overcome, there is yet another difficulty. If A receives a distribution of cash in excess of his basis in the partnership interest, he recognizes gain to the extent of the excess. Since A's basis in his partnership interest is equal to the basis of the contributed property, when A receives the money contributed by B, A still recognizes all of the gain inherent in the property on contribution. Also, I.R.C. § 751(b) and/or I.R.C. § 736(a) insure that any ordinary income inherent in the contributed property is not converted into capital gains. Thus, without more facts, the stated transaction

basis in its partnership interest, I.R.C. § 732(b). Thus eventually May Co. could have (and may in fact have) effectively exchanged its subsidiary stock for its own stock on a tax-free basis. A direct exchange would have been fully taxable under I.R.C. §§ 1001 or 311(b).

In response to the May Co. transaction, the Service promptly issued Notice 89-37, 1989-1 C.B. 679. This notice indicated that from the date of the notice similar corporate transactions will be effectively treated for tax purposes in the same manner as it is for accounting purposes. Applying this rule to the May Co. transaction would have meant that May Co., upon the partnership's purchase of its stock, would have been deemed to have redeemed its own stock for the PnSimon stock, making any gain inherent in the PnSimon stock taxable to May Co. under I.R.C. § 311(b). Since the Notice was prospective only, however, it did not apply to the May Co. transaction. See Lee A. Sheppard, May Department Stores and the Use of Partnerships to Avoid Asset Gain Recognition, 45 TAX NOTES 23 (1989); see also Mark P. Gergen, Reforming Subchapter K: Contributions and Distributions, 47 TAX L. REV. 173, 177 (1991).


14. The step transaction doctrine requires interrelated steps of an integrated transaction to be taken as a whole rather than be treated separately. See BORRIS L. BITTKER & MARTIN J. MCAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 1.3(5) (2d ed. 1995); see also infra note 20.


16. See id. § 731(a)(1).

17. See id. § 722.

18. Under I.R.C. § 751(b), if as a result of a non-pro rata distribution the partnership and the partner
offers A no great benefit. But, those additional facts might exist. A may be a partner in an existing partnership and have a substantial basis in his partnership interest. The other partners could agree (or A could have sufficient bargaining power to force the other partners) to permit B to temporarily be a partner to effect the transaction. As this discussion demonstrates, it was not all that easy to "beat the system," but under the original rules of subchapter K it was possible, and on occasion did happen.19

Congress responded in 1984 with I.R.C. § 707(a)(2)(B). It provides that when there is a transfer of money or property to a partnership and there is a related transfer of money or property by the partnership to the contributing partner, the transfers will be treated as a sale or exchange if that is their substance.20 Somewhat belatedly, in 1992 the Service promulgated final regulations under I.R.C. § 707(a)(2)(B).21 The regulations provide that if a distribution to a partner occurs within two years of the contribution by that same partner, the transactions are presumed to be related.22 Sales or exchange treatment results unless the presumption is rebutted with "facts and circumstances clearly establishing that the transfers do not constitute a sale."23 Thus, the example discussed above most likely would not survive muster under I.R.C. § 707(a)(2)(B), provided the parties "complete" the transaction and distribute the property and cash within two years. If no distribution occurs within two years, the transactions are presumed to be unrelated unless the facts and circumstances clearly establish that the transfers

exchange interests in ordinary income and nonordinary income property, a phantom, taxable exchange is deemed to occur which is designed to insure that all the partners recognize their fair shares of ordinary income inherent in "unrealized receivables (defined in I.R.C. § 751(c) to include I.R.C. § 1245 ordinary recapture gain inherent in partnership property) and substantially appreciated inventory. I.R.C. § 736(a) has a comparable, and somewhat redundant rule, that applies when payments are made to a retiring partner and the partnership holds "unrealized receivables," defined by reference to I.R.C. § 751(c). See infra notes 109-14 and accompanying text.

19. See, e.g., Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980).

20. See I.R.C. § 707(a)(2)(B). Actually, even prior to the enactment of I.R.C. § 707(a)(2)(B), there was authority in the regulations to attack abusive transactions, though it was rarely used. Section 1.721-1(a) of the Treasury Regulations provides:

In all cases, the substance of the transaction will govern, rather than its form. . . . Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721.

Treas. Reg. § 1.721-1(a) (1960); see also Treas. Reg. § 1.733-1(c)(3) (1960) (having similar effect).


23. Id. § 1.707-3(d). If the distribution occurs more than two years after the contribution, the contribution and distribution are presumed to be unrelated unless facts and circumstances clearly establish that the transfers constitute a sale. See id.
constitute a sale.\textsuperscript{24} Nonsale treatment is typically quite appropriate. If the parties are willing to stay in partnership over two years, there is unlikely to be any real abuse. As equal partners, both \(A\) and \(B\) are at risk for changes in the value of the property. Further, the I.R.C. § 707(a)(2)(B) regulations now specifically address partnership allocations of gains and losses that might effectively neutralize the risk to \(A\) during the two-year waiting period. If such allocations exist, the regulations, applying the equivalent of substance over form principles, treat the property and cash as exchanged on contribution to the partnership.\textsuperscript{25}

\section*{B. The Attack}

Section 707(a)(2)(B) was not seen by Congress as a sufficient weapon to address mixing bowl transactions. In 1989, Congress enacted I.R.C. § 704(c)(1)(B)\textsuperscript{26} and in 1992, I.R.C. § 737.\textsuperscript{27} These provisions should be subordinate to I.R.C. § 707(a)(2) and only apply to the extent it does not.\textsuperscript{28} Although I.R.C. §§ 704(c)(1)(B) and 737 strengthen the government's ability to address certain abuses, they are far too broad in scope and, consistent with hyperlexis principles, create numerous other problems.

Under I.R.C. § 704(c)(1)(B), if property contributed by a partner is distributed to another partner within five years of the contribution, the contributing partner is required to recognize the gain or loss she would have recognized under I.R.C. § 704(c)(1)(A)\textsuperscript{29} as though the property had been sold. I.R.C. § 737 addresses partners who contribute property to the partnership and within five years receive a distribution of other property from the partnership. I.R.C. § 737 requires the contributing partner to recognize a gain (but not a loss) to the extent of the lesser of the "net precontribution gain" or the amount by which the fair market value of the distributed property exceeds the partner's basis in her partnership interest.\textsuperscript{30} The net precontribution gain is the gain that would have been recognized by the partner under I.R.C. § 704(c)(1)(B) if \textit{all} of the property contributed by the partner within five years of the actual distribution had been distributed to another partner.\textsuperscript{31}

\begin{itemize}
\item \textsuperscript{24} See \textit{id.} § 1.707-3(d).
\item \textsuperscript{25} See \textit{id.} § 1.707-3(f) ex. 8.
\item \textsuperscript{28} See Terence F. Cuff, The Section 737 Regulations — Part I, at 6 (July 12, 1996) (unpublished manuscript, forthcoming in the \textit{Journal of Partnership Taxation} (on file with the \textit{Oklahoma Law Review}) [hereinafter Cuff 1].
\item \textsuperscript{29} Under I.R.C. § 704(c)(1)(A), income, gain, loss, and deduction with respect to property contributed by a partner is shared among the partners so as to take account of the variation between the basis and the fair market value of the contributed property. Thus, if a partner contributed property with a loss inherent in it, when the partnership sold the property the loss would be allocated to the contributing partner after adjusting for any depreciation deductions allocated to the partner which reduced the variation between the original basis and fair market value of the property. \textit{See} Treas. Reg. § 1.704-3(b)(1), (2) ex. 1(ii) (as amended in 1995).
\item \textsuperscript{30} See I.R.C. § 737(a) (1994).
\item \textsuperscript{31} See \textit{id.} § 737(b).
\end{itemize}
both I.R.C. §§ 704(c)(1)(B) and 737, the partner's basis in the partnership interest and the partnership's basis in the property is adjusted for the gain or loss recognized.\textsuperscript{32}

I.R.C. §§ 704(c)(1)(B) and 737 are entirely mechanical. If a taxpayer falls within their provisions, the relevant gain or loss is recognized. There is no need for a factual demonstration on the part of the taxpayer or the Service as to whether the contributions and distributions actually are related. They can in fact be completely unrelated. There is an argument that I.R.C. §§ 704(c)(1)(B) and 737 represent tax simplification, providing a bright line test rather than the fuzzy one of I.R.C. § 707(a)(2)(B). The simplification comes at the expense of equity, since unrelated contributions and distributions are brought within the coverage of the code. However, given the Kafkaesque nature of the code, a bit of inequity might be a cheap price to pay for genuine simplification. If the substitution of a bright line is all that was achieved by I.R.C. §§ 704(c)(1)(B) and 737, it would be hard to argue against their existence. Alas, there is more.

C. Utopia Lost

One difficulty is that both I.R.C. §§ 704(c)(1)(B) and 737 can apply at the same time. If two partners each contribute property to the partnership, and within five years the property contributed by one partner is distributed to the other, both code sections apply. The calculations can become complex.\textsuperscript{33}

Another difficulty with both code sections is the time frame. Congress did not explain why a five-year time frame was chosen. It is improbable that anyone

\textsuperscript{32} See id. §§ 704(c)(1)(B)(iii), 737(c). As an example, individuals A, B and C form ABC land development partnership. A contributes plots A1 and A2, each of which has a fair market value of $100,000, and an adjusted tax basis of $75,000. B contributes his recently acquired plot B which has a fair market value of $200,000 as well as a tax basis of $200,000. C makes a cash contribution of $200,000. Under I.R.C. § 722 the partner's bases in their partnership interests are as follows: A, $150,000; B, $200,000; and C, $200,000.

Difficulties arise and within five years, A accepts plot B in complete liquidation of his partnership interest and B accepts plot A1 as a partial liquidation of his partnership interest. The distribution to B of property A1 within five years gives rise to a gain which A must recognize under I.R.C. § 704(c)(1)(B). The gain is the difference between the original fair market value of $100,000 less depreciation (not applicable in this example) and its adjusted tax basis of $75,000. As a result, A recognizes a $25,000 gain and the adjusted tax basis in her partnership interest is increased accordingly from $150,000 to $175,000. See id. § 704(c)(1)(B)(ii).

Section 737 requires that A also recognize a gain on her receipt of plot B. Section 737 states that "in the case of any distribution by a partnership to a partner" the partner must recognize gain equal to the lesser of either the amount by which the fair market value of the distributed property exceeds the partner's basis in her partnership interest or the net precontribution gain. See id. § 737(a). In this case, the fair market value of plot B is $200,000 and it exceeds A's partnership basis of $175,000 by $25,000. This $25,000 excess is also equal to A's remaining precontribution gain. Therefore, A must recognize a $25,000 gain on this distribution also.

I.R.C. § 737 does not apply to the distribution of property A1 to B since B does not have any net precontribution gain, and in any event the fair market value does not exceed his basis in his partnership interest of $200,000.

\textsuperscript{33} See supra note 32.
intending to manipulate the contribution and distribution rules would do so over five years. It is far too long. Values of the relevant properties can change dramatically over this period of time. Further, many (likely mostly) innocent transactions will be caught in the net of I.R.C. §§ 704(c)(1)(B) and 737. An argument in favor of such prophylactic treatment is that the tax-free contribution and distribution rules are misguided. The argument would be that anytime a taxpayer exchanges an interest in one property for another via the partnership vehicle, the transaction should be taxable. If that is the point, an argument exists not to provide a period of limitation at all. I.R.C. §§ 704(c)(1)(B) and 737 should apply regardless of the length of time between the contribution and distribution. Perhaps the five-year time frame was chosen nonetheless for practical reasons (there does not appear to be any guidance in the legislative history). Congress may have concluded that it would be too difficult to maintain the data necessary to calculate gain and loss after five years. If that is the case, similar limitations should appear elsewhere. Often they do not. For example, there is no time limit on the application of I.R.C. § 704(c)(1)(A).\footnote{Section 704(c)(1)(A) provides that “income, gain, loss and deduction with respect to property contributed to the partnership by a partner shall 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 . . . .” I.R.C. § 704(c)(1)(A) (1994).}

There are problems with the internal operations of both code sections. Unscrupulous taxpayers may be inclined to manipulate the fair market values of the relevant properties to avoid I.R.C. §§ 704(c)(1)(B) and 737.\footnote{See Cuff 1, supra note 28, at 18-22.} Even for honest taxpayers it is difficult to determine the fair market values of the many properties that have no ready market.\footnote{See Cuff 1, supra note 28, at 16.} How does one value a product under development, for example? Sections 704(c)(1)(B) and 737 should generate significant litigation on fair market value questions, further taxing an already overburdened court system. Unfortunately, this issue is not unique to I.R.C. §§ 704(c)(1)(B) and 737. Fair market value determinations are increasingly common in tax law (including the operation of I.R.C. § 707(a)(2)(B)).

1. I.R.C. § 737

Closing supposed loopholes tends to create others, a hyperlexis fundamental. In the case of I.R.C. § 737, it is fairly easy to avoid its application. I.R.C. § 737 does not present a problem as long as the fair market value of the distributed property does not exceed the partner's basis in the partnership interest. A partner's basis in his partnership interest is increased by his share of partnership debt under I.R.C.
§ 752(a). Thus, a partner's basis in his partnership interest could be increased to an amount in excess of the fair market value of the distributed property by having the partnership allocate a suitable amount of debt to the distributee partner. There are a variety of ways of achieving this objective including leveraging the asset to be distributed or, if the distributee will continue as a partner in the partnership, by leveraging the assets remaining in the partnership. Alternatively, a partner could contribute additional high basis property to obtain the increase in his partnership interest basis. The property contribution might even be of loss property, which could reduce the net precontribution gain.

Alternatively, if the property distribution is of a type that can be broken up, the distribution could be made in relatively small installments so that no single distribution exceeds the partner's basis in his partnership interest. Or the partnership may characterize the distribution as a draw or an advance. In the case of a draw or an advance, the distributee partner's basis in the partnership interest is determined as of the last day of the partnership's taxable year. At that time the basis is increased under I.R.C. § 705 for the partner's share of partnership income for the year, possibly increasing basis above the fair market value of the distributed property. Additional partnership borrowing or reallocation of partnership debt could also provide the necessary basis increase under I.R.C. § 752(a).

38. See Cuff I, supra note 28, at 24-25. A partner shares in recourse debt based on the partner's economic risk of loss with regard to the debt. See Treas. Reg. § 1.752-2(a) (as amended in 1992). A partner shares in nonrecourse debt based on a stacking rule. Nonrecourse debt is allocated to a partner first based on that partner's share of "minimum gain," then based on her share of I.R.C. § 704(c) gain if the partnership disposed of all partnership property subject to nonrecourse debt for no consideration other than satisfaction of the debt, and finally based (essentially) on a partner's share of partnership profits. See Treas. Reg. § 1.752-3(a) (1991).

If a property being distributed is subject to debt, then all of the partners' share of partnership debt goes down by the secured debt, and the distributee partner's share of debt is increased by the debt to which the distributed property is subject. See Treas. Reg. § 1.752-1(b) (1991). The net increase in the distributee partner's share of the debt increases his partnership interest for the purpose of determining whether the fair market value of the distributed property exceeds his basis in the partnership interest. See Treas. Reg. § 1.737-1(a)(3) (1995).

For example, assume a partner's predistribution tax basis in her partnership interest is $100,000, including $10,000 of partnership debt. The partnership distributes property to the partner with a fair market value of $190,000 in liquidation of the partner's partnership interest. The property is subject to a $100,000 liability. There is a net increase in the partner's liability of $90,000 ($100,000 less $10,000 preexisting liability share). This increases the partner's basis to $190,000 under I.R.C. § 752(a) and Treas. Reg. § 1.737-1(a)(3). There thus is no I.R.C. § 737 gain on the distribution.

40. See Sheppard, supra note 37, at 16.
As this discussion demonstrates, I.R.C. § 737 should rarely be a problem for the experienced practitioner. It represents more of a trap for the unwary. Thus a code section designed to combat transactions of highly sophisticated taxpayers will, for the most part, not have that effect. Instead, it will catch the "little guy" who does not have access to able tax counsel. Hyperlexis strikes again.

I.R.C. § 737 generates additional complexity through the need to preserve the character of the gain inherent in contributed property. A partner might contribute multiple properties, the sale of some of which would generate ordinary income, whereas the sale of others would generate long or short term capital gain. Under the regulations, on the distribution the partner recognizes gain proportionate to the gain inherent in the contributed property. 43 The character is determined as if the property were sold to a third party by the partnership, thankfully without the special characterization rules such as I.R.C. § 707(b)(2). 44 If 30% is ordinary income and 70% is capital gain, on the distribution of property to the partner any gain recognized will be characterized the same way. In fact, gains and losses should be placed in at least three baskets: ordinary, capital, and I.R.C. § 1231. 45 The gains and losses in each basket are netted under the regulations. A basket with a net loss is ignored. 46 Rules like these make tax professionals want to open up a t-shirt shop in Hawaii. 47

I.R.C. § 737 does not apply if property contributed by a partner is distributed to that same partner. 48 Seems straightforward? What if the property is fungible? Does exactly the same property have to be distributed? What if the property is improved before it is distributed? Do the improvements to the property have to be handled separately? What if a partner contributes the components and the partnership distributes the finished product? 49 A bit of good news: I.R.C. § 737 does not apply to the deemed distribution of property under I.R.C. § 708, to partnership conversions or spinoffs, or to partnership incorporations (without a

43. See id. § 1.737-1(d).
44. See id. § 1.737-2(a). I.R.C. § 707(b)(2) applies to the sale or exchange of property which in the hands of the transferee is property other than a capital asset. The gain is characterized as ordinary income to the transferor if the sale or exchange is between a partner and a partnership, where the partner, directly or indirectly, owns more than 50% of the capital or profits interest in the partnership. The same rule applies if the sale or exchange is between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profits interests in the partnerships. Unfortunately, I.R.C. § 707(b)(2) can apply in the case of I.R.C. § 704(c)(1)(B) transactions. See infra notes 55-60 and accompanying text.
45. See Cuff 1, supra note 28, at 36.
47. My research assistant would like me to note that the rules have a similar effect on tax professors' research assistants.
49. See Cuff 1, supra note 28, at 42-55. If a partner contributes an interest in an entity, the interest is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership. See Treas. Reg. § 1.737-2(d)(2) (1995). This regulation also has its hyperlexis impact. For example, how are new liabilities treated? See Cuff 1, supra note 28, at 44-47.

https://digitalcommons.law.ou.edu/olr/vol49/iss3/2
distribution of property to the partners).\textsuperscript{50} There is a hyperlexis impact to even these exemptions, but I won't belabor them here. The point has been made.\textsuperscript{51}

2. I.R.C. § 704(c)(1)(B)

I.R.C. § 704(c)(1)(B) has its own entertaining features. In many ways I.R.C. § 704(c)(1)(B) is the more curious of the two code sections. Here no hidden exchange has occurred. A partner contributes property to a partnership, and the partnership, for all anyone knows for perfectly valid business reasons, distributes that property to someone else. It is possible that the contributing partner wants to sell the property to the ultimate distributee. The disguised transaction would thus be a contribution of property by one partner and cash by another, followed by a distribution of property to the cash contributor and cash to the property contributor. But at the point I.R.C. § 704(c)(1)(B) applies, the property contributor has received nothing, and there has been no sale of the property, so the partnership has received nothing either. Why generate a taxable transaction? A logical time to tax the contributing partner is when the cash is distributed to him. We do not need any new rules for that result. I.R.C. § 707(a)(2)(B) already sufficiently provides for this tax treatment. If the fact that I.R.C. § 707(a)(2)(B)'s two-year rule is only presumptive and makes taxation too uncertain, make the two-year rule mandatory.\textsuperscript{52} Recall also that even without a law change, I.R.C. § 707(a)(2)(B) is not Congress's only weapon. I.R.C. § 731(a)(1) requires gain recognition if the distribution is of money and exceeds the taxpayer's basis in his partnership interest, as will often be the case where the cash distribution is disproportionate.\textsuperscript{53} In the case of any such disproportionate cash distribution, I.R.C. § 751(b) generally addresses ordinary income avoidance.\textsuperscript{54}

I.R.C. § 704(c)(1)(B) should complicate the application of I.R.C. § 751(b). Assume that an unrealized receivable contributed by one partner is distributed to another partner. Further assume that the unrealized receivable appreciated in value while held by the partnership (perhaps it bears a favorable rate of interest, or the chances of collection improved). On the distribution, I.R.C. § 704(c)(1)(B) only taxes the original gain to the contributing partner. The remaining gain is taxed under I.R.C. § 751(b) principles, making for some fairly complex calculations.\textsuperscript{55}

\textsuperscript{50} See Treas. Reg. § 1.737-2(b), (c) (1995). A distribution of property by the transferee partnership to a partner who was formerly a partner of the transferor partnership is subject to I.R.C. § 737 to the extent it would have applied if the transferor partnership had distributed the property. See id. § 1.737-2(b)(3).

\textsuperscript{51} See Cuff 1, supra note 28, at 39-41.

\textsuperscript{52} See supra notes 21-24 and accompanying text.

\textsuperscript{53} See supra notes 12-15 and accompanying text.

\textsuperscript{54} Under I.R.C. § 751(b), if as a result of a non-pro rata distribution the partnership and the partner exchange interests in ordinary income and nonordinary income property, a phantom, taxable exchange is deemed to occur which is designed to insure that all the partners recognize their fair shares of ordinary income.

I.R.C. § 704(c)(1)(B) and its recently promulgated regulations have generated many unresolved questions. For example, I.R.C. § 704(c)(1)(B) taxes the contributing partner as if the property is sold by the partnership to the distributee partner. If I.R.C. § 704(c)(1)(B) is designed to address disguised sales by a contributing partner, it makes more sense to consider the sale as being made by that partner. If the partnership is the selling party, a host of new issues arise. I.R.C. § 707(b)(1) disallows losses on sales between a partnership and a partner owning directly or by attribution more than 50% of the partnership.\(^{56}\) I.R.C. § 707(b)(2) provides that if there is a sale of property between a partnership and a partner owning over 50% of the partnership directly or by attribution,\(^ {57}\) any gain recognized to the transferee is ordinary income provided the asset is other than a capital asset in the hands of the transferee.\(^ {58}\) Do these provisions apply to the I.R.C. § 704(c)(1)(B) deemed sale?\(^ {29} \) The regulations answer this question in the

---

\(^ {56}\) I.R.C. § 707(b)(3) attributes partnership ownership according to the constructive stock ownership rules found in I.R.C. § 267(c). Conforming the language of section 267(c) to partnership interests, the section states:

1. A partnership interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;
2. An individual shall be considered as owning the [partnership interest] owned, directly or indirectly, by or for his family;
3. The family of an individual shall include only his brothers and sisters . . . , spouse, ancestors, and lineal descendants; and
4. A partnership interest constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1) or (2) . . . , be treated as actually owned by such person, but [a partnership interest] constructively owned by an individual by reason of the application of paragraph (2) . . . shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

I.R.C. § 267(c) (1994) (alterations replacing "stock" with "a partnership interest" derived from application of I.R.C. § 707(b)(3)).

\(^ {57}\) As was the case with I.R.C. § 707(b)(3), I.R.C. § 1239 also turns to section 267(c) for guidance in attributing partnership interest ownership to an individual. See I.R.C. § 1239(c); supra note 56.

\(^ {58}\) I.R.C. § 707(b)(2) overlaps with I.R.C. § 1239, which presumably also applies in an I.R.C. § 704(c)(1)(B) transaction.

\(^ {59}\) See Terence Floyd Cuff, Final Regulations on Partnership Contributions and Distributions Will Snare the Unsuspecting, 13 J. PARTNERSHIP TAX'N 91, 94-95 (1996) [hereinafter Cuff 2].

Section 707(a) permits the recognition of the resulting gain or loss on the sale of an asset between partner and partnership. See I.R.C. § 707(a) (1994). However, the opportunity for abuse is evident. A partner can sell to his partnership an asset that generates a paper loss, without losing control of the asset, all the while recognizing a loss for federal income tax purposes. Section 707(b) curbs this to some extent by disallowing losses from sales or exchanges of property between a partnership and a person owning more than a 50% interest in that partnership. See id. § 707(b)(1).

Creative opportunities also exist for sales of assets that generate a gain. A partner can sell a capital asset to his partnership and recognize a capital gain. The partnership in turn receives the asset with a stepped up basis for depreciation calculation. A partner, who is in a higher tax bracket than the maximum capital gains rate, can receive a corresponding pass through depreciation deduction that has a tax value exceeding his tax on the capital gain. To reduce this opportunity for abuse, both I.R.C. § 707(b)(2) and I.R.C. § 1239 characterize the gain from the sale of property between a partnership and

https://digitalcommons.law.ou.edu/olr/vol49/iss3/2
affirmative. 60 This treatment often yields a novel result. A direct sale by the contributing partner can often ignore I.R.C. § 707(b). 61 A disguised sale cannot. One could perhaps argue that it is a fair penalty for nefarious activities, i.e., trying to disguise a sale, except for one fact: I.R.C. § 704(c)(1)(B) is entirely too mechanical. It applies regardless of any nefarious motives. Thus, a legitimate business distribution to a partner four years after a contribution cannot only give the contributing partner phantom income, but the section can characterize it as ordinary income. Conversely, I.R.C. § 707(b)(1) can disallow a loss. This is just one example of how a new code section not only creates complexity on its own but can interact with other code sections to increase that complexity geometrically.

3. I.R.C. § 708

This latter principle is also demonstrated by I.R.C. § 704(c)(1)(B)'s interaction with I.R.C. § 708. Under I.R.C. § 708, a partnership terminates if more than 50% of the partnership interests are sold or exchanged within twelve months. Upon the termination, the partnership is deemed to distribute its properties to the new and continuing partners, typically on a pro rata basis. These partners are thereafter deemed to have recontributed the properties back to the partnership. 62 Under the regulations the distribution does not trigger I.R.C. § 704(c)(1)(B), but the re contribution subjects all of the partners to I.R.C. § 704(c)(1)(B) in the future. 63 In other words, since under I.R.C. § 708 all partners are treated as having made a contribution of property to the partnership, when under I.R.C. § 708 the property deemed contributed by one partner is later actually distributed to another partner, I.R.C. § 704(c)(1)(B) applies. 64 The regulations provide that I.R.C. § 704(c)(1)(B) only applies on the I.R.C. § 708 re contribution to the extent, in effect, it did not already apply to a partner at the time of the I.R.C. § 708 termination. 65 Presumably this means that any previously existing I.R.C. § 704(c)(1)(B) gain is allocated to the partner who originally, actually contributed the property to the partnership. Any

a person owning more than a 50% interest in the partnership, as ordinary income. I.R.C. § 707(b)(2) applies if the property is other than a capital asset in the hands of the transferee. I.R.C. § 1239 applies if the property in the hands of the transferee is subject to the allowance for depreciation.


61. I.R.C. § 707(b) only applies to sales and exchanges between a partner and a partnership or between two commonly controlled partnerships. See supra notes 44-55.


65. Specifically, the regulation provides that I.R.C. § 704(c)(1)(B) applies on the I.R.C. § 708 re contribution only "to the extent that the pre-termination built-in gain or loss, if any, on such property would not have been allocated to the contributing partner under section 704(c)(1)(A) and § 1.704-3 on a sale of the contributed property to an unrelated party immediately before the termination." Treas. Reg. § 1.704-4(a)(4)(ii) (1995).
appreciation occurring after the original, actual contribution should be allocable to all the partners pro rata after the I.R.C. § 708 transaction. However, the regulations do not make that clear.

A property may be subject to two different I.R.C. § 704(c)(1)(B) time frames. To the extent I.R.C. § 704(c)(1)(B) already applies at the time of the I.R.C. § 708 termination, the time frame may be the balance of the five-year term. To the extent that the I.R.C. § 708 recontribution triggers I.R.C. § 704(c)(1)(B), a new five-year term should start. What if the appreciation inherent in the property goes down, but there is still appreciation? Presumably, only the original contributor has exposure under I.R.C. § 704(c)(1)(B). What if the property declines in value so much that it has a loss inherent in it? I.R.C. § 704(c)(1)(B) should apply to all of the partners for five years after the I.R.C. § 708 recontribution, but since a loss is involved they may not mind.

The analysis above assumes that the distribution under I.R.C. § 708 is pro rata. While that is commonly assumed to be the case, it is not necessarily a foregone conclusion. There is some ambiguity in the I.R.C. § 708 regulations in this regard. Moreover, some have argued (with some support from I.R.C. § 704(c)(1)(B)'s legislative history) that any property actually contributed by a partner prior to the I.R.C. § 708 termination should be deemed to be distributed to that partner under I.R.C. § 708. If true, only the original contributor is affected by the provision of the I.R.C. § 704(c)(1)(B) regulations providing that I.R.C. § 704(c)(1)(B) is triggered by the deemed I.R.C. § 708 recontribution.

Through the application of I.R.C. § 708, I.R.C. §§ 704(c)(1)(B) and 737 can go on applying well past the original five-year term. Indeed, I.R.C. §§ 704(c)(1)(B) and 737 could continue to apply indefinitely, provided there were repeated I.R.C. § 708 terminations. There are other problems to address as well. On the deemed distribution of property under I.R.C. § 708, a partner's basis is first allocated to cash and I.R.C. § 751 assets, and then to any other assets that are distributed. On any

66. To keep matters simple, I am assuming the property is not depreciable. Depreciation affects I.R.C. § 704(c)(1)(A) gain. See Treas. Reg. § 1.704-3(b)(1), (2) ex. 1(i) (as amended in 1995).
68. See Treas. Reg. § 1.708-1(b)(1)(iv) (1960). The regulation provides that when a partnership is terminated by a sale or exchange, the partnership is deemed to distribute its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties. See id. The question is what is a partner's interest in a partnership property which that partner contributed to the partnership. If gain on the sale will be allocated to the partner under I.R.C. § 704(c)(1)(A) and a distribution of the property to another partner will result in gain under I.R.C. § 704(c)(1)(B), there is an argument that the partner holds the entire interest in the property at least if it has not appreciated while held by the partnership. If so, on the deemed distribution of the property by the partnership under I.R.C. § 708, the property should be deemed to be distributed to the contributing partner.
70. See I.R.C. § 733(e) (1994).
liquidation, including an I.R.C. § 708 liquidation, a partner can take a higher basis in the distributed asset than that which the partnership had. On the I.R.C. § 708 retribution the partnership takes a carryover basis in the asset under I.R.C. § 723. The basis step-up to the distributee partner could eliminate any gain inherent in property before the I.R.C. § 708 termination and thus the gain to which I.R.C. § 704(c)(1)(B) once would have applied. Conversely, it could increase the I.R.C. § 704(c)(1)(B) gain. Was either result intended? Likely the answer is no. These anomalies are less likely to occur if property contributed by a partner is viewed as being distributed to that partner. The bases are more likely to match up properly, which is in part the argument for having the I.R.C. § 708 distribution made in that fashion. However, while this approach may solve one problem, it will create another. If there is a disproportionate distribution of a partnership's I.R.C. § 751 assets, presumably including a deemed distribution under I.R.C. § 708, I.R.C. § 751(b) can apply.

With the application of I.R.C. § 704(c)(1)(B) to I.R.C. § 708 transactions, the law is far afield from where it started. The original motivation was to prevent the partnership contribution and distribution rules from being used to disguise sales and other taxable transactions. In the case of a pro rata I.R.C. § 708 distribution, all the continuing partners are brought into I.R.C. § 704(c)(1)(B) not because of any improper purpose, not even because of any actual contribution of property, but because of a deemed contribution. Indeed, the partners who purchased their partnership interests may never make a contribution to the partnership but are nevertheless brought within I.R.C. § 704(c)(1)(B). The I.R.C. § 704(c)(1)(B) rules are applying blindly, pulling perfectly innocent partners into their maw, not because of any hidden property sale, but because of the mechanical operation of two code sections. Clearly, the application of I.R.C. § 704(c)(1)(B) in the I.R.C. § 708 context does not make a lot of sense. It is, however, a classic demonstration of hyperlexis principles. The law is feeding on itself.

The problematic application of I.R.C. § 708 has generated the rare beneficial hyperlexis effect. To fix the fix, the Service has proposed regulations to replace the current distribution-retribution rules of the existing I.R.C. § 708 regulations. Under the proposed regulations, if a partnership is terminated under I.R.C. § 708, the partnership is deemed to transfer all of its assets and liabilities to a new partnership. Immediately thereafter, the terminated partnership is deemed to distribute an interest in the new partnership to the purchasing and continuing partners, who would substitute the basis in their old partnership interest for the basis

---

71. See id. Basis is first allocated to cash and I.R.C. § 751 assets. Any remaining basis is allocated to other distributed assets, in proportion to their respective basis to the partnership, even if that means giving the partner a higher basis than that of the partnership in the distributed assets.


73. See Prop. Treas. Reg. § 1.708-1(b)(1)(iv). In the preamble to the proposed regulation the Service specifically states that the manner in which the existing I.R.C. § 708 regulations apply to I.R.C. § 704(c)(1)(B) transactions motivated promulgating the proposed regulatory change.

74. See id.
in the new one under I.R.C. § 732(c).\textsuperscript{75} One benefit of this change is that there no longer is a deemed contribution of assets by the partner which could trigger I.R.C. § 704(c)(1)(B), and thus the problem discussed above would no longer exist. If that were the only benefit, nothing more than a traditional hyperlexis effect would be involved: One change necessitating another change. However, there are other problems with the existing I.R.C. § 708 regulations which the proposed rule also repairs. I will leave a more detailed discussion of these problems to other, more specialized efforts,\textsuperscript{76} but in brief: Currently, if the deemed I.R.C. § 708 distribution of money exceeds a partner's basis in his partnership interest, the partner realizes a gain under I.R.C. § 731(a)(1), notwithstanding the fact that he never actually receives any cash, assuming the business of the partnership is continued. The amount of any deemed money distribution can be increased, and therefore the problem exacerbated, by any deemed distribution of money under I.R.C. § 752(b)\textsuperscript{77} resulting from a shift in the manner in which liabilities are shared (sort of a deemed-deemed distribution). As discussed above, there also can be a shifting of basis.\textsuperscript{78} A partner's basis in the partnership interest is first allocated to money and I.R.C. § 751 assets and then to other assets.\textsuperscript{79} The allocation to the other assets is made in proportion to their respective bases to the partnership.\textsuperscript{80} Assume a new partner purchases a 51% partnership interest for $1 million and receives by way of an I.R.C. § 708 distribution equipment with a basis and fair market value of $100,000 and a depreciable life of five years and real estate with a basis of zero, a fair market value of $900,000, and a depreciable life of thirty-nine years. Since the partnership's basis in the real estate is zero, the partner's partnership interest basis of $1 million is allocated exclusively to the equipment, and the partnership takes that stepped-up basis in the equipment on the deemed recontribution to the partnership.\textsuperscript{81} Both of these problems would also be eliminated by the new I.R.C. § 708 regulation since the partners would no longer receive a deemed distribution of partnership assets, only the interest in the new partnership.\textsuperscript{82} The proposed regulation is a true rarity. It not only mends, it simplifies the law a bit.

\textsuperscript{75} See id.

\textsuperscript{76} For an excellent article discussing the proposed I.R.C. § 708 regulation, see Richard M. Lipton, Partnership Deemed Terminations Will Be Simpler Under New Proposed Regulations, 85 J. TAX'N 133 (1996).

\textsuperscript{77} Under I.R.C. § 752(b) (1994), a partner is deemed to receive a distribution of money to the extent her share of partnership liabilities are decreased.

\textsuperscript{78} See supra notes 70-72 and accompanying text.

\textsuperscript{79} See I.R.C. § 732(c) (1994).

\textsuperscript{80} See id. § 732(c)(2). This same rule would apply to the allocation to the I.R.C. § 751 assets if the partner had insufficient basis to take a full carryover basis in those assets. See id. § 732(c)(1).

\textsuperscript{81} I.R.C. § 732(d) can force the equivalent of an I.R.C. § 754 election if basis is shifted from nondepreciable to depreciable assets. It does not appear to apply where there is a shift between depreciable assets with different depreciable lives. See Treas. Reg. § 1.732-1(d)(4)(ii) (1960); Lipton, supra note 76, at 135.

\textsuperscript{82} See supra notes 62-81 and accompanying text. Under the rules discussed above, a partner would take the same basis as she had in her partnership basis in the old partnership, assuming no liability shift.
D. Philosophies

Is it appropriate to repeal much of the effectiveness of the tax-free distribution rules for partners who contribute property? Some feel the answer to this question is yes and, unsurprisingly given hyperlexis principles, have proposed highly complex alternative systems to address the problem, gutting much of subchapter K in the process. True, under subchapter K some exchange of interest in properties might be achieved on a tax-free basis. However, ordinarily the transactions are so attenuated with time and risk that it is hard to see how much tax avoidance could go on. For example, even without I.R.C. § 737, any distribution to the contributing partner within two years subjects the transaction to scrutiny under I.R.C. § 707(a)(2)(B). Any partner willing to wait over two years to make a tax-free exchange is taking a big risk that property values will change in an unfavorable way, as is the partnership (and values are hardly locked in stone for the first two years). It is unlikely that either a partner or a partnership will bind itself to such an exchange over a two-year time period without additional guarantees, guarantees that could trigger sale treatment under the I.R.C. § 707(a)(2)(B) regulations. True, the two-year rule of I.R.C. § 707(a)(2)(B) regulations is presumptive, not automatic. If lack of certainty is the concern, make it automatic rather than burden taxpayers with I.R.C. §§ 704(c)(1)(B) and 737 and their additional breadth and complexity.

Is the time frame irrelevant? Is any potential for tax-free property exchanges so offensive that it needs to be aggressively addressed? If partnerships were primarily being used to end-run I.R.C. § 1001, perhaps the loss to the fisc would be so great that an aggressive response even with all of its complexities could be justified. The reality is, however, that mixing bowl transactions are of more interest to speakers at tax seminars and to writers of law review articles than to practitioners structuring actual transactions. One commentator noted that mixing bowl transactions "may have been a great tax loophole in theory, but, in fact, that loophole is virtually impossible to exploit in the real world." Further, if tax-free

83. See Gergen, supra note 12; see also John P. Steines, Jr., Commentary, Unneeded Reform, 47 TAX L. REV. 239 (1991) (criticizing Professor Gergen's proposals in part based on their extraordinary complexity); Curtis J. Berger, Whither Partnership Taxation, 47 TAX L. REV. 105 (1991) (proposing to require corporate-like treatment of the distribution of property, meaning that the partnership would be required to recognize gain inherent in distributed property, except in the case of I.R.C. § 708 terminations and when the property is distributed to the partner who contributed it).
84. See Treas. Reg. § 1.707-3(c)1 (1992); see supra notes 20-23 and accompanying text.
85. See Treas. Reg. § 1.707-3(b) (1992); see supra notes 20-25 and accompanying text.
86. Under I.R.C. § 1001(a), gain or loss from the sale or other disposition of property is measured by the difference between the amount received and the adjusted basis. Under I.R.C. § 1001(c) that gain or loss is recognized for tax purposes unless the Code elsewhere provides otherwise.
87. Roundtable Discussion on Partnership Taxation with William S. McKee, Blake D. Rubin, and R. Donald Turlington, 12 A.B.A. SEC. TAXN 48, 48 (1993). Turlington states that "[t]here is a lot more smoke than fire in this particular type of transaction. It is true that mixing bowl transactions have become the rage of speakers on the Subchapter K circuit. But they certainly have not become the rage of business men and women who are trying to buy and sell assets. Mixing bowl transactions may have been a great tax loophole in theory, but, in fact, that loophole is virtually impossible to exploit in the real
exchanges are the worry, a total revamping of subchapter K would be in order. From that perspective, I.R.C. §§ 704(c)(1)(B) and 737 are mere fig leaves.

Subchapter K and its tax-free contribution and distribution rules have been around for a long time. They have not provided a method to bankrupt the fisc. I.R.C. §§ 704(c)(1)(B) and 737 are an overreaction. There is a tendency for academics and other commentators to look at things from the perspective of how the current system can be abused. It is true that abuses are possible. But perhaps a more helpful approach is to ask not only whether abuses are possible but also whether the likely abuses are of sufficient severity to justify a statutory change. Further, as the above discussion demonstrates, the interaction of different code sections creates new complexities and ambiguities likely uncontrolled at the time of the new statute's passage. Inevitably, solving one problem can create a host of others. If the underlying problem involves relatively few transactions with relatively little revenue loss, it is probably better to live with the problem than to try to fix it. The mixing bowl transactions that I.R.C. §§ 704(c)(1)(B) and 737 address were not common enough to justify the heavy-handed approach used. To make matters worse, many innocent transactions are also subject to these code sections. I.R.C. §§ 704(c)(1)(B) and 737 represent an inappropriate fix and should be repealed.

III. Section 736

Historically, when someone purchased a business, payments made for the goodwill of the business could not generate tax deductions. Any such payment had to be capitalized and could not be amortized. The advent of I.R.C. § 197 improved things from the taxpayer's perspective, permitting goodwill to be amortized over fifteen years. However, long before I.R.C. § 197 came into being, subchapter K provided a means to circumvent the general rule. Prior to 1993, if a partner's interest in a partnership was liquidated, payments attributable to partnership goodwill could be effectively deducted. The only limitation was that the

world." Id. at 48. At page 49 Rubin states that "many more mixing bowl partnerships have been discussed than actually done." Id. at 49.

88. For a perspective of an academic that looks more at the former, see Rebecca S. Rudnick, Enforcing the Fundamental Premises of Partnership Taxation, 22 HOFSTRA L. REV. 229 (1993).

89. Suggestions for the repeal of I.R.C. §§ 704(c)(1)(B) and 737 have been made by others in the academy. See Hanna, supra note 55, at 529.

90. The regulations provide that the price paid for a business is to be allocated to its tangible and intangible assets to the extent of their fair market value. See Temp. Treas. Reg. § 1.1060-1T(d) (1988). Any amount paid in excess of the fair market value of the partnership's assets, is allocated to goodwill or going concern value. See id. § 1.1060-1T(e).


92. See I.R.C. § 197(a) (1994). This code section actually should be a revenue raider. The revenue losses for the ability to amortize goodwill are most likely more than offset by revenue gains resulting from the fact that covenants not to compete also are amortized over 15 years. See Glenn F. Mackles, 15-Year Amortization of Purchased Intangible Assets—Some Winners, Some Losers, 79 J. TAXN 332, 334 (1993). Previously, they could be amortized over the term of the covenant. See BITTKER & MCMAHON, supra note 14, ¶ 14.4[5].

partnership agreement could not contain a provision providing for payments for goodwill. This circumstance is often called "unstated goodwill." Payments to a retiring partner attributable to unstated goodwill might come from partnership profits or they might be fixed in amount. In the former case, I.R.C. § 736(a) treated the retiring partner as receiving a distributive share of partnership income (of whatever character), reducing the shares taxable to the continuing partners and giving them the equivalent of a deduction. In the latter case, I.R.C. § 736(a) treated the retiring partner as receiving a guaranteed payment, characterized as ordinary income. The guaranteed payment was deductible to the partnership.

Unlike some of the transactions discussed in this article about which commentators have complained, the provisions of I.R.C. § 736(a) were commonly used.

Goodwill can, of course, be "stated." In that case the partnership agreement specifically provides that payments to a retiring partner include payments for partnership goodwill. Payments for stated goodwill are given distribution treatment. Distribution treatment means no deduction to the partnership for goodwill payments. Instead, moneys distributed first recover a partner's share of the partnership goodwill. Any money distributed in excess of basis normally generates capital gain to the distributee partner.

If negotiations were at arm's length and no preexisting agreement was in place, the retiring partner would have to be paid more to get him to agree to accept, for example, guaranteed payment and ordinary income treatment instead of the more favorable recovery of basis followed by capital gain. Often the continuing partners could justify paying more in order to obtain a current deduction. It was also not unusual for the partners to agree at the outset to leave goodwill unstated.

A substantial potential for abuse also existed. A putative purchaser of a business first formed a partnership with the owner. Initially the purchaser made a cash contribution to the partnership, and the owner contributed the assets of the business. Under the partnership agreement goodwill was unstated. The partnership then liquidated the interest of the original owner, arguably receiving a deduction for the payments made for unstated goodwill. A direct purchase of the business assets by the buyer would have required goodwill to be capitalized (and now amortized over fifteen years under I.R.C. § 197). It should be noted that I.R.C. § 197 did not level the playing field, since payments to retiring partners are usually made over.

94. See id.
95. See id. § 736(a)(1), (b)(2).
96. See id. §§ 736(a)(2), (b)(2), 707(c); Treas. Reg. § 1.736-1(a)(4), (b)(3) (as amended in 1965).
97. See I.R.C. §§ 707(c), 162 (1994); Treas. Reg. § 1.736-1(a)(3), (4) (as amended in 1965);
100. See id. § 731(a)(1) (subject to I.R.C. §§ 736(a), 751(b)).
101. See id. §§ 731(a)(1), 1222, 1223.

102. See supra notes 98-100 and accompanying text; see also H.R. REP. NO. 103-111, at 782 (1993). Also, for a thorough discussion on the tax treatment of transactions between withdrawing and remaining partners after the changes brought about by the enactment of Omnibus Budget Reconciliation Act of 1993, see James E. Tierney, Reassessing Sales and Liquidations of Partnership Interests after the Omnibus Budget Reconciliation Act of 1993, 1 FLA. TAX REV. 681 (1994).
periods far shorter than fifteen years. Thus, the payments for unstated goodwill were deductible over far shorter periods as well.

Permitting payments for goodwill to be commonly deducted in the partnership context when that treatment is not available in other contexts never made much sense. Reform had been in order for some time, and it was finally instituted in 1993. A simple solution was to amend I.R.C. § 736 to eliminate the special treatment given to goodwill.

As is unfortunately common, Congress did not take the simple approach. Instead it instituted the reform only for partnerships in which capital is a "material income producing factor" and for payments to limited partners. Under these circumstances, payments to a partner for goodwill can no longer be effectively deducted. Instead, such payments fall under the distribution rules discussed above. For payments to general partners in partnerships in which capital is not a material producing factor, i.e., service partnerships, the old rules continue to apply. The committee report provides that "general partners in service partnerships do not ordinarily value goodwill in liquidating partners." Of course, under the old rule they did not have to. It is also true that in service partnerships, goodwill is often tied more to the individual partners rather than the partnership as such. Thus, service partnerships often do not have much in the way of goodwill that needs to be valued, but that circumstance does not invariably apply. Some service partnerships, including many of the large law and accounting firms, do have significant goodwill apart from their partners. Moreover, why make a special rule for service and nonservice partnerships? It only makes the code more complicated and is not needed. Service partnerships without partnership goodwill should not have too much difficulty demonstrating the purpose of the payments.

The elimination of favorable treatment for goodwill for all partnerships permits Congress to take a more radical step toward simplification: the outright repeal of I.R.C. § 736. There is little reason for I.R.C. § 736 without the special provision for goodwill. I.R.C. § 736 insures that money payments for unrealized receivables are given ordinary income treatment. However, that provision is redundant and adds complexity to the code. I.R.C. § 751(b) also contains a provision which

103. To the extent an I.R.C. § 754 election is in effect, I.R.C. § 197 may be available to amortize basis created in goodwill by the payments over 15 years.
104. See supra notes 98-100 and accompanying text.
106. See supra notes 95-97 and accompanying text.
108. See id. § 736(b)(2).
109. Actually, I.R.C. § 751(b), designed to prevent taxpayers from converting ordinary income into capital gains, has itself been the subject of substantial criticism. I.R.C. § 751(b) is a highly complex provision, and is another sledgehammer approach to what is, at least for partnerships of unrelated partners, not a widespread problem. In most circumstances, partners of unrelated partners are not likely to permit a shift of ordinary income and capital gains amongst themselves, since the benefit to one will be a disadvantage to the other. Those few circumstances where such partners might agree, such as where one has an expiring net operating loss carry forward, are too few in number for such a complex statutory
provides that money distributions to partners attributable to unrealized receivables are given ordinary income treatment. This provision would apply to payments to retiring partners but for the special rule of I.R.C. § 736. Why have the rule in two places, especially since I.R.C. § 751(b) can already apply to retiring partners? I.R.C. § 751(b) also provides for ordinary income treatment to retiring partners, and all other distributees, to the extent a money distribution is attributable to substantially appreciated inventory. There is no need to have these rules in two places for payments to retiring partners and in one place for other distributees. The repeal of I.R.C. § 736 insures that the rules are in one place for everyone. The regulations under I.R.C. § 751(b) would have to be amended to provide a methodology for determining what portion of a payment is covered by I.R.C. § 751(b) when payments are made over time, a comfortably surmountable obstacle.110

Whether or not capital is a material income-producing factor, I.R.C. § 736(a) not only applies to payments for unrealized receivables but also to premium payments (i.e., payments in excess of the fair market value of the interest being retired).111 There is no obvious reason for this. If a partner sells the partnership interest to a third party for more than its fair market value, the excess is capital gain.112 Why is the result different if the partnership pays a premium? If I.R.C. § 736 is repealed, premium payments fall under the distribution rules, which means that if the partner recovers an amount in excess of basis, any gain is capital in nature,113 the same result as on a sale. It seems unlikely that the characterization change represents much cost to the fisc. Thus, premium payments do not constitute a basis for the continued existence of I.R.C. § 736.

The changes to I.R.C. § 736 are yet another example of how little thought seems to be given to making the code simple and comprehensible. Hyperlexis rules. The repeal of I.R.C. § 736 would be a helpful step toward more simplification and less hyperlexis.114

111. See Treas. Reg. § 1.736-1(a)(3) (as amended in 1965); WILLIS ET AL., supra note 67, § 156.05.
113. See id. § 731(a)(1).
114. The author wishes to thank Professor Robert Keller of the University of Maryland School of Law for what now does not appear before the conclusion.
IV. Conclusion

Acknowledging hyperlexis is an act of humility. Law changes should be made only after recognizing the propensity for human error. Tomorrow's circumstances may make today's brilliant idea seem foolish and shortsighted. A legal utopia is not within our ken. Yet, while we acknowledge the truth of that statement, not too far beneath the surface seems to reside a belief that it can be achieved. Why else do we create laws at such a prodigious pace and seemingly respond to every ill with at least a proposal for a new law? The test should not just be whether the proposed change constitutes an improvement but whether the underlying problem is substantial. It might be best to have a presumption against a law change. If that presumption is overcome, the bias should be in favor of simplification — with the realization that a complex system which cannot be understood or properly enforced is not fair, regardless of its nominal equity.