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DETERMINING A PARTNER'S SHARE OF UNREALIZED RECEIVABLES AT THE LIQUIDATION OF THE PARTNER'S INTEREST

BY
STEPHEN UTZ

STEPHEN UTZ DISCUSSES LIQUIDATING A PARTNER'S SHARE OF UNREALIZED RECEIVABLES IN A PROFESSIONAL SERVICE PARTNERSHIP, ACCORDING TO CODE SECS. 736(b) AND 751(b), ALONG WITH THE POSSIBLE TAX RAMIFICATIONS.

The liquidation of a partner's interest in a professional service partnership may be complicated by the variety of agreements partners make with respect to the sharing of client fees. Since service partnerships usually adopt the cash-receipts-and-disbursements method of accounting,¹ their receivables are routinely "unrealized receivables" within the meaning of Code Sec. 751.² Professional partners may thus often have a stake in unrealized receivables during their tenure as partners and afterwards. Moreover, professional partnerships frequently hold accounts receivable that are earmarked in various ways to reflect the roles partners play in generating those accounts.³ For example, there may be an agreement to credit the partner who "brought in the client" with a

larger than usual share of the fees paid by that client, or a partner's reputation may seem to all partners to justify crediting that partner with an exceptional share of fees from clients within a certain industry or from a certain geographical area. Other aspects of a partner's role in creating or maintaining a client relationship may be reflected differentially in the allocation of fees from clients generally. Perhaps most importantly, partners may by agreement share in collections of accounts receivable only as long as they continue as partners, with no right to share in fees collected after they leave the partnership, or a

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partner's right to share in fees may depend on whether he or she contributed accounts receivable earned by him or her before joining the partnership.⁴

Against this background, the treatment of liquidating distributions to professional service partners under the combined regime of Code Secs. 736(b) and 751(b) should be sensitive to the complexities of the business relationship of the partners. The Code Sec. 751 regulations, however, provide peculiarly incomplete guidance for determining a partner's share of unrealized receivables and inventory when a distribution occurs.⁵ In general, a distribution has to be re-characterized only to the extent that a partner either receives Code Sec. 751 property in exchange for his

cent of the sum of all partners' capital accounts, then the partner has a 40 percent share of the partnership's Code Sec. 751 assets. In many cases, this is no doubt a plausible approach. But it must strike many tax experts and taxpayers alike as generally inaccurate to equate a partner's capital share with his or her share of partnership receivables. The combination in the regulation of the examples with the general rule leaves the impression that an inflexible rule may apply.

Frequently encountered arrangements among service partners will be distorted if partners' interests in Code Sec. 751 assets, especially, unrealized receivables, are determined always and only in the manner indicated by the examples. The general rule prescribed by the

regulations instead should be understood as respecting the partnership agreement's allocation of Code Sec. 751 assets, unless the agreement is a sham or abusive. This article defends

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or her "interest in other property" or receives other property in exchange for relinquishing any part of his or her "interest in Code Sec. 751 property."⁶ All the examples in the regulations, however, determine a partner's interests in Code Sec. 751 and other property by reference to the partner's fractional interest in partnership capital.⁷ If the partnership has Code Sec. 751 assets, then the partner's interest in those assets is determined to be that fraction of their value equal to the partner's fractional interest in all partnership capital. If the partner's capital account is 40 per-

cent of the sum of all partners' capital accounts, then the partner has a 40 percent share of the partnership's Code Sec. 751 assets.

The purpose of Code Sec. 751 is to prevent the conversion of ordinary income into capital gain under the default rule of partnership taxation that characterizes as capital gain a partner's income from selling the partnership interest or gain from a liquidating distribution with respect to partnership property. It is commonplace that partnerships are entities for some federal tax purposes and aggregates of their owners for others. If partnerships are enti-

ties for *any* purpose, however, it seems inevitable that they should be such in the context of partnership interest sales and liquidations.⁸ If a partner's interest in a partnership were "disaggregated" on sale or liquidation of the interest, the entity approach would be at most a temporary simplifying feature of the tax regime. This seemingly inevitable feature of the entity/aggregate paradigm immediately suggests the possibility of the "collapsible partnership."

In the relatively early days of federal corporate taxation, shrewd taxpayers discovered the possibility of transforming ordinary income into capital gain by creating an ordinary-income-producing asset within a corporation and then selling or liquidating the corporation—the normal tax treatment of a stock sale or liquidation was that of the sale of capital assets, so that the value of the incorporated asset could be realized as capital gain. Congress adopted the predecessor of Code Sec. 341 to combat this abuse. Code Sec. 341 disallowed capital gain treatment of sale or liquidation gains when the corporate form had been adopted or "availed of" for the *purpose* of avoiding ordinary income treatment. The provision was thus triggered by tax-abusive *intent* rather than by the form or effect of the transactions to which it applied. By 1954, administrative experience with Code Sec. 341 had shown such a "substance" or intent-oriented approach to be of very limited efficacy. Although the legislative history of subchapter K does not elaborately set forth the congressional intent behind Code Sec. 751, it is evident from proposals advanced by the tax bar that the "collapsible partnership" provision of the new

partnership tax regime was meant to be triggered by formal test rather than by a test based on intent or economic substance.⁹

The section treats sales and distributions separately, as seems inevitable given the broadly different treatment in other respects of partnership sales and distributions under subchapter K. Under Code Sec. 751(a), a sale or exchange of a part or all of a partner's "interest" in substantially appreciated inventory and unrealized receivables (these two categories of "hot assets" are defined somewhat more broadly than the terms may suggest¹⁰) for money or other property is treated as an amount realized from the sale of property other than a capital asset. In other words, a portion of the consideration a partner receives on selling all or part of a partnership "interest" (understood as that term is used elsewhere in subchapter K and in state partnership law) must be treated as payment for the value of the partner's stake in the partnership's Code Sec. 751 assets—substantially appreciated inventory and unrealized receivables. Obviously, the rule of Code Sec. 751(a) can be applied only if the partner's "interest" in hot assets can be ascertained, but Code Sec. 751 does not indicate how that "interest" is to be done.

Code Sec. 751(b) recasts any distribution that combines Code Sec. 751 and non-Code Sec. 751 assets, if the distribution does not proportionately represent the distributee's "interest"—through the partnership—in these categories of assets. More particularly, the subsection provides that to the extent that a partner receives Code Sec. 751 assets in exchange for his interest in non-Code Sec. 751 assets or vice versa, the transaction shall be considered a sale

or exchange of the distributed property between the distributee and the partnership. In effect, as the regulations make clear, the usual rules for distributions, found in Code Secs. 731, 732 and 733, do not apply to the extent that a partnership distributes to a partner receives too great a portion of Code Sec. 751 assets or of non-Code Sec. 751 assets. Instead, if the distribution is disproportionate, partnership assets of the class that were under-represented in the actual distribution are deemed first to have been distributed. This deemed distribution is treated in accordance with the usual distribution rules. Then the distributee is treated as having exchanged these assets for the disproportionate portion actually received. The usual distribution rules prescribe the treatment of the rest of the transaction. Again, the rule of this subsection, like that of Code Sec. 751(a), can be applied only if the partner's "interest" in hot assets and other assets can be ascertained.

Example. Partner A receives \$5,000 cash only in exchange for her one-half interest in the property of the AB partnership. Before the distribution, the partnership assets were the \$5,000 cash and \$5,000 in unrealized receivables (in which the partnership had a zero basis). Assume that A would have shared in the receipts from the collection of the receivables and that the value of her interest (\$5,000) reflects this "interest" she has in the receivables. Then Code Sec. 751(b) would recast the distribution as a three-step transaction. A is deemed first to receive a distribution of her one-half share of the receiv-

ables, worth \$2,500. She is deemed then to transfer these back to the partnership for \$2,500 cash. Finally, she receives a cash distribution of \$2,500. The result of the three-step reconstruction of her receipt of \$5,000 cash is accounted for by her taxable exchange of \$2,500 worth of receivables for \$2,500 cash and the distribution of the "other half" of the cash. She recognizes ordinary gain of \$2,500 on the exchange of the receivables for cash. The partnership receives her share of the receivables back with a cost basis of \$2,500. Thus, she is not allowed to escape her "share" of the ordinary gain inherent in the receivables.

Although both subsections (a) and (b) of Code Sec. 751 assume that we can determine a partner's "interest" in the partnership's hot assets and the partner's "interest" in other assets that underlie the partnership interest, this article is concerned primarily with liquidating distributions, and so the discussion and illustrations that follow will refer primarily to Code Sec. 751(b). The arguments herein apply with equal force, however, to partnership interest sales subject to Code Sec. 751(a).

How is a partner's "interest" in the relevant classes of partnership assets defined? Neither the statute nor the regulation explicitly does so. The regulation gives five examples to illustrate the determination of a partner's interest in Code Sec. 751 and non-Code Sec. 751 property under various circumstances.¹¹ In all the examples, however, it is simply taken for granted that the partner's "one-third" interest in each class of partnership property—Code Sec.

751 or non-Code Sec. 751 property—is determined by the ratio of the partner's capital account to total partnership capital. Indeed, all five examples are premised on this aspect of the facts of Example 2. The opening sentence of the example states that "Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership."¹² Thereafter, Example 2 proceeds smoothly to the conclusion that Partner C's interest in the accounts receivable and inventory, and indeed all other classes of partnership property, must be one-third of each class. The premise is carried forward through the remainder of the regulatory examples, which all deal with the complete liquidation of Partner C's one-third partnership interest.

The regulations never hint that the ratio of a partner's capital interest to total partnership capital may not always be an appropriate indicator of the partner's fractional interest in partnership Code Sec. 751 assets, especially unrealized receivables. This is odd in part because the standard type of partnership that holds unrealized receivables within the meaning of Code Sec. 751 is the cash-method service partnership, whose partners share the revenues of accounts receivable in fixed "profit ratios," without regard to value of their interests in (existing) partnership property, without regard to their capital accounts and without regard to the present value of accounts receivable of potentially very different viability.

Example. Cash-method partnership ABC makes a distribution to partner C in liquidation of his entire one-third *profits* interest in the partnership, at a time when

C's interest in existing partnership capital is nil because C has a zero capital account, the partnership non-Code Sec. 751 assets have fallen in value below their historical or book value and the partnership has no special agreement concerning the partners' respective rights to share in revenues collected with respect to accounts receivable. Partner C's interest in partnership property other than Code Sec. 751 assets has no value at all. Moreover, C's capital account is zero, so that C's fractional interest in partnership capital both for book and fair market value purposes is zero. Nevertheless, C's interest in partnership accounts receivable should be appraised as equal to a third of its present value. It is not evident from the regulation, including the examples, that a cash liquidation distribution to C should be regarded as disproportionate with respect to C's interest in accounts receivable and therefore taxable in accordance with Code Sec. 751(b).

By the same token, a mechanical extrapolation from the regulatory examples can lead to an unrealistic overstatement of a partner's interest in unrealized receivables.

Example. The same partnership makes a cash distribution to partner C in liquidation of his entire one-third *capital* interest in the partnership at a time when C's interest in existing partnership receivables is nil because C has agreed with partners A and B that they alone should be allocated revenues from these receivables because they brought in the clients who own these accounts. C has a one-

third interest in existing partnership capital—which does not include the value of accounts receivable because this is a cash-method partnership—but no interest in partnership accounts receivable. Following the regulation examples, C should nevertheless be treated as having received a disproportionate distribution of cash, because one-third of accounts receivable were not distributed to C in kind. Yet C has no right to share in the collection of these accounts receivable.

Although the regulation nowhere indicates that the determination of a partner's "interest" in Code Sec. 751 assets may have to take into account a possible diversity of partners' rights to share in these assets, it seems obvious that the regulation must allow for such diversity. The result in the foregoing example cannot be correct.

Example. A and B are equal law partners. They admit C as a partner with a one-third share in the collection of new and existing firm receivables as long as C remains a partner, but if C leaves the partnership, C is to have no share in the later receipts on receivables generated while C was a partner. During C's tenure as a partner, the partnership acquires an office building with recourse debt, and C's capital account reflects C's one-third share of the purchase price of the building. Partner C has a one-third interest in all partnership receivables, but that interest is extinguished when C leaves the partnership. C receives a cash payment measured by his share of the then-value of the office building. Following the regulatory examples blindly, one

might conclude that the cash payment is to be characterized as a disproportionate distribution under Code Secs. 736(b) and 751(b). Applying Code Sec. 751(b), a portion of C's gain is therefore characterized as ordinary, though it in fact represents only C's share of the Code Sec. 1231 gain on the building.

Of course, the characterization under Code Sec. 751 will not matter if the partner's cash payment for partnership property is very small, as may be the case generally for service partnerships. But it seems likely that many service partnerships have property like the office building that may result in Code Sec. 736(b) payments. Whether these payments are treated as including ordinary gain will depend almost exclusively on whether the departing partner is treated as having an interest in unrealized receivables.

The treatment suggested in the example should not be controversial unless the agreement among the partners may have been entered into in order to lower the aggregate tax liability of the partners. One approach would be to ascertain the partners' interests in Code Sec. 751 and non-Code Sec. 751 property by reference to the partnership agreement if its prescription concerning these interests really governs the partners' division of the net worth of the partnership when a partner's interest is liquidated, and if, when adopted, the agreement's provisions concerning liquidation interests in particular classes of assets was not likely to reduce the partner's tax liabilities in the aggregate. This standard is obviously similar to the "substantial economic effect" standard prescribed by Code Sec. 704(b) and the regulations thereunder for partnership allocations.

Agreements to share current collections from pre-existing receivables and to relinquish claims against post-departure collections obviously can serve a reasonable business purpose in a partnership of changing composition.¹³

Example. Suppose that in the previous example the ABC partnership agreement had from the outset prescribed that on C's withdrawal the partnership should pay C an amount equal to the product of C's profit ratio and the fair market value of partnership assets other than receivables. Suppose further that the partners' aggregate tax liabilities could not foreseeably have been reduced by such a provision. Then the thesis of this article is that the partnership agreement should be allowed to determine the extent of C's interest in Code Sec. 751 and non-Code Sec. 751 property.

If a partner apparently loses his or her interest in unrealized receivables on leaving the partnership, and the fair market value of the partner's share of the value of partnership property is determined under the partnership agreement only by reference to assets other than receivables, a cash liquidating distribution should not be characterized in part as a payment for unrealized receivables.

The standard proposed in the foregoing paragraphs can be adapted to provide a general way of treating partners' interests in Code Sec. 751 and non-Code Sec. 751 property. Under the revised Uniform Partnership Act, partners are free to agree that they shall have different interests in specific items of partnership property.¹⁴

Obviously, there is no direct statutory or regulatory authority for considering the tax situations of the

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respective partners and the *ex ante* likelihood that an agreement concerning unrealized receivables will save them taxes in the aggregate. Code Sec. 751 has been part of subchapter K since 1954 and the regulations implementing the section are of long standing as well. What tinkering Congress has done with the section primarily affects the definition of substantially appreciated inventory and unrealized receivables, not the manner in which a partner's share of such property should be determined.

The "anti-abuse" regulation, Reg. §1.701-2, may at first sight appear to ground an approach like that proposed here. But the general language used in the regulation to define its scope indicates that substance-over-form analysis is not to be applied

to aspects of subchapter K that are intended primarily to allow form to control the tax treatment of a transaction.¹⁵ As the anti-abuse regulation says, "certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income." Reg. §1.701-2(a)(3). Code Sec. 751 is certainly a "mechanical" provision that satisfies this description. It was designed, by all accounts, to avoid the more substance-oriented approach taken with respect to collapsible corporations in Code Sec. 341.¹⁶ Moreover, Reg. §1.701-2(d) Ex. 4 indicates that at least Code Sec. 751(e) was intended to be interpreted as sanctioning form over substance in the context of tiered partnership structures set up for the purpose of reducing partners' aggregate tax liability.

Thus, even taking the "anti-abuse" regulation into account, there is no reasonably straightforward authority for imposing the "substance"-oriented restriction discussed above. As has been men-

tioned, and as the anti-abuse regulation itself confirms, Code Sec. 751 was apparently intended to be applied mechanically. If the determination of a partner's separate interests in Code Sec. 751 assets and in non-Code Sec. 751 assets presupposes that something like the "substantiality" (in the sense of the Code Sec. 704(b) regulations) of the partnership agreement must first be analyzed, the application of Code Sec. 751 will be anything but mechanical.

What alternative is there? It has been suggested already that the general rule might be to respect partnership agreements, insofar as they determine the partners' "interests" in underlying partnership assets, regardless of the timing and apparent motivation of these agreements. If so, deliberate manipulation of partnership agreements will at least sometimes frustrate the purposes of Code Sec. 751.

There is of course nothing to prevent the IRS from invoking the anti-abuse regulation to prevent an abusive appeal to a partnership agreement in the Code Sec. 751 context. Yet if this were to become a routine administrative practice, the purpose

and justification of the anti-abuse regulation should itself be called into question. Taxpayers certainly should not hesitate to test this position, if the IRS should adopt it. Indeed, there is at least implicit authority for a mechanical deference to the terms of a partnership agreement, regardless of motivation. Even a clear tax-avoidance motive may deserve respect, as far as one can tell from the legislative background and interpretative history of Code Sec. 751.

In brief, the puzzles left unresolved by Code Sec. 751 and the regulation it authorizes are serious and pervasive in the context of some cash-method and especially professional service partnership liquidations. The intended mechanical approach that is evident in the design of Code Sec. 751 cannot deal fairly with *bona fide* variations in the manner in which service partners may share in accounts receivable. A "substance over form" approach seems at odds with the legislative intent behind the provision, forming part of the pattern of "form over substance" features in subchapter K, the existence of which even the anti-abuse regulation acknowledges.

ENDNOTES

¹ Throughout the history of the income tax in this country, the government usually has regarded the cash method of accounting as presumptively valid, subjecting deviations from it to higher scrutiny under the "clear reflection of income" standard. STEPHEN F. GERTZMAN, *FEDERAL TAX ACCOUNTING*, at 3-5 to 3-7 (1993). Since professional service firms generally cannot justify the adoption of any other accounting method, given the uncertainties that beset their collection of accounts receivable, the overwhelming majority of at least small professional firms have no choice but to use the cash method.

² Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1986, as amended.

³ See, e.g., The Revised Uniform Partnership Act 4 (1998) makes it clear that the presumptions of partnership ownership of property held in the partnership name can be contracted away. See STEPHEN UTZ, *FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS* 388 (1995).

⁴ See *S.B. Schneer*, 97 TC 643, Dec. 47,803 (1991) (partner's contribution of unrealized receivables on joining partnership held not to violate anticipatory assignment of income doctrine).

⁵ See Reg. §1.751-1(b).

⁶ *Id.* Reg. §1.751-1(b)(1).

⁷ *Id.* Reg. §1.751-1(g) Ex. 1-6.

⁸ The Commissioner long refused to acknowledge the entity approach to the partnership in large part out of concern over the potential conversion of ordinary income into capi-

tal gain. See Arthur B. Willis, *Handbook of Partnership Taxation* (1957), at 178-79 (citing pre-1954 cases for the government's litigation position on the issue).

⁹ Stephen Utz, *supra* note 3. §11.01 (1995).

¹⁰ See Code Sec. 751(c), (d).

¹¹ Reg. §1.751-1(g) (examples).

¹² *Id.* Reg. §1.751-1(g) Ex. (2)(a).

¹³ Alan R. Bromberg & Larry E. Ribstein, 2 Bromberg and Ribstein on Partnership ¶7.08 (1988 & Supp. 1999).

¹⁴ See *supra* note 3.

¹⁵ See Stephen Utz, *supra* note 3, at 376-77.

¹⁶ S. Rep. No. 1622, 83d Cong., 2d Sess. 98 (1954); see W. McKee, W. Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners* ¶16.02[1].