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CHAPTER 6

SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

Paradigm 6.1. The sale of a partnership interest is, under § 741, nominally treated as the sale of a capital asset, making the partner's gain or loss a capital gain or loss.

Paradigm 6.2. To prevent the selling partner from converting ordinary income into capital gain, § 751(a) treats her as if the partnership, before the transfer of her interest, had sold an amount of receivables and inventory items equal to her share of those items. This rule forces the selling partner to treat part of the gain from the sale of her interest as ordinary income from the receivables and inventory. It also permit the selling partner to claim an ordinary loss, if there is one, on her share of the ordinary items.

Paradigm 6.3. The transfer of a partnership interest can create differences between the buying partner's inside and outside basis. These differences create potential timing and character problems for the partners. The problems may be avoided by a § 754 election, which via § 743(b) compels an inside basis adjustment with respect to the buying partner's interest in the partnership's assets.

6.01. Introduction

Perhaps more than in any other area of partnership tax, it is necessary to reconcile entity and aggregate theories of the partnership when a partner sells or exchanges her partnership interest. Under a pure entity theory, the partner would be viewed as transferring the

partnership interest itself, independent of her interest in the partnership's assets, much like a shareholder in a corporation might transfer a share of stock in a corporation.[1] A pure aggregate theory approach, on the other hand, would characterize the partner's transfer of the partnership interest as more like the a sole proprietor's sale of a going concern under the business asset fragmentation rule of *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945): the selling partner would be deemed to have sold her share of each partnership asset.[2]

In § 741, Subchapter K adopts predominantly the entity approach to sales of partnership interests. Significant modifications under § 751 prevent the conversion of ordinary income into capital gain. A pure aggregate approach was rejected as too cumbersome because it would require that gain or loss on the sale of a partnership interest be characterized asset-by-asset. A pure entity approach, on the other hand, was rejected as prone to abuse: classifying a partner's gain or loss solely by reference to whether the partner held her interest as a capital or ordinary asset under § 1221 would ignore the underlying asset structure of the partnership and create a significant opportunity to convert ordinary income into capital gain.

Section 751, then, eliminates a device for transforming ordinary income into capital gain: the contribution of ordinary income property to a partnership followed by a prompt sale of the partnership interest. Without a provision like § 751, partners in businesses with heavy concentrations of ordinary income assets (inventory and accounts receivable) would be able to realize capital gain (instead of the ordinary income that would result from continuing in the

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[1] There are subchapter C provisions that moderate the pure entity approach. These provisions were designed to prevent abuse of the corporate structure in the form of incorporation merely to take advantage of the normal corporate tax rate on accumulated and undistributed earnings and the capital gain rate on the disposition of the corporate stock. *See* § 341 ("collapsible corporation" rules). Such provisions have little application after the Tax Reform Act of 1986, when the maximum corporate tax rate of 34% exceeded the maximum effective tax rate of 28% on individuals, and the capital gain tax rate was increased from 20% to 28% on individuals. In short, the incentives have changed so dramatically that § 341 is no longer necessary.

[2] The aggregate approach is supported by the American Law Institute. *See* ALI, Federal Income Tax Project, Subch. K, 22-46 (1954).

partnership) by selling their partnership interests prior to the partnership's disposition of the assets.[3]

(a) Purpose of § 751(a)

To curtail this obvious and undesirable result,[4] § 741 is overridden by the "collapsible partnership rule" of § 751(a), which provides that any portion of the partnership interest selling price attributable to "unrealized receivables" and "substantially appreciated inventory" will be treated as ordinary income. When § 751(a) applies, its effect is to bifurcate the sale of a partnership interest into two distinct components: a § 751 ordinary income component and a § 741 capital gain component. If the partner's share of the § 751 assets should results in a loss, § 751 works to the partner's advantage by classifying the loss as ordinary.

A few observations about the operation of § 751(a) may be helpful before we explore the mechanics. The purpose of § 751(a) is to force each partner to recognize her share of partnership ordinary income from *unrealized receivables* and *substantially appreciated inventory*, collectively referred to as ***§ 751 assets***, on the sale of her partnership interest (just as if the partnership had sold all its § 751 assets immediately prior to her sale of her partnership interest). This approach prevents the permanent conversion of ordinary income into capital gain. The rationale is most easily understood in the case of a partner who sells her entire interest in a partnership that holds only §

[3] For an example of a pre-§ 751 result (§ 751 was added in the 1954 Code), *see* ***Swiren v. Commissioner***, 193 F.2d 656 (7th Cir. 1950), *cert. denied* 340 U.S. 912 (1951), in which a lawyer was allowed to sell his interest in a law practice partnership that contained substantial earned but not yet received or taxed receivables. The lawyer was permitted to report the transaction as a capital gain under § 117 of the Internal Revenue Code of 1939 (the predecessor to current § 1222).

[4] The need for abuse prevention arises because capital gains have historically been treated more favorably than ordinary income. Although the 1986 Tax Reform Act eliminated favorable rates for capital gain, classification of income as "capital" still is advantageous because it can be offset, dollar for dollar, by the taxpayer's capital losses (which do not offset ordinary income in an amount exceeding $3,000 per year). If the favorable treatment of capital gains were eliminated, § 751 would not be necessary to prevent abuse and so could be repealed, removing one of the most complex provisions in Subchapter K

751 assets. A partnership interest is a capital asset under § 741; the partner sells her entire interest; and the partner will recognize currently the income from the sale. If the partner is not taxed currently on her share of ordinary income from the partnership's § 751 assets, the opportunity will be lost forever. The partnership's ordinary income is not adequately taxed to the purchasing partner, because the purchaser's outside basis reflects the fair market value of the assets.[5]

With this background, § 751(a) becomes quite mechanical. Though its application is rather complex, all it does is:

1. Identify the presence of partnership § 751 assets;

2. Determine the selling partner's share of those assets; and

3. Divide the selling price of the partnership interest into § 751 ordinary income (or loss) and § 741 capital gain (or loss) components by allocating part of the amount realized and part of the asset basis to the partner's share of the partnership's § 751 assets.

Note that § 751(a) forces the selling partner to recognize her share of partnership ordinary income from § 751 assets *before* the partnership actually sells the assets and realizes the income.

Why the draconian approach? Why not simply wait until the partnership realizes the income before requiring the purchasing partner to be taxed on it? The reason is that the ordinary income must be taxed to the selling partner[6] at the time she disposes of her

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[5] For further discussion of why the ordinary income is not taxed adequately to the buyer, who nonetheless may be unhappy with the tax result, *see* Sections 6.01(b) and 6.03.

[6] For discussion of the § 751 consequences of nonliquidating property distributions to partners, *see* Chapter 7. For discussion of liquidating distributions to partners, *see* Chapter 8. Where distributions alter the partners' aggregate shares in the partnership's § 751 assets, the statute requires an immediate recognition of ordinary income as a solution to the problem. In this context, the issue is not taxing the partner's share of ordinary income from § 751 assets as a now or never proposition but rather preventing the partners from assigning the character of the gain from the sale

partnership interest or it never will be taxed to her. It also would not be permanently taxed to the other partners: the buying partner may be taxed in the year the partnership sells the assets, but recoups the tax burden in the form of an outside basis increase that creates a capital loss or reduces gain on the partner's sale of the interest.[7]

(1) Selling Partner

Section 751(a) prevents the selling partner from using § 741 to convert her share of the gain from her share of partnership § 751 assets into capital gain on the sale of all or part of her partnership interest. It also permits the selling partner to claim an ordinary loss, if there is a loss, with respect to the § 751 property. Because the primary focus of § 751 is anti-abuse, most of the discussion in this chapter is of the gain situation.

Two examples, set out in Section 6.03(b), illustrate the application of § 751 to the selling partner. Example 6.1 assumes a disposition of a partner's entire partnership interest. Example 6.2 assumes a disposition of less than the entire interest. As both examples illustrate, § 751(a) forces the selling partner to recharacterize as ordinary income, to the extent of the selling partner's share of the partnership's § 751 assets, what otherwise would be § 741 capital gain.

(2) Purchasing Partner

When the partnership subsequently sells the § 751 assets, the purchasing partner may be taxed on her distributive share of the partnership's gain on the assets. Even though the selling partner was taxed at the time of sale, the partnership does not take a stepped-up basis in her share of the § 751 assets and will recognize gain. The purchasing partner ordinarily is taxed on her share of the partnership gain: even though she paid market value for a share of the § 751 assets, and has an outside basis sufficient to prevent gain recognition, the partnership got no basis step-up when the interest was transferred. Whether the purchasing partner is taxed on the previously-taxed § 751 gain depends on the existence of a partnership § 754 election.

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of partnership assets according to the tax rates or circumstances of the partners.

[7] For further discussion, see Sections 6.01(b) and [illegible]

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Examples 6.1 and 6.2 illustrate how the § 754 election helps the buyer of a partnership share avoid this second round of taxation.[8]

(3) Effect of § 754 Election

If a § 754 election is in effect, the purchasing partner will not be taxed on her share of the partnership's gain from the sale of § 751 assets. Because this gain has already been taxed (as ordinary income) to the selling partner, it makes sense not to tax the new partner. But if the § 754 election is not in effect, the purchasing partner will be taxed on her share of the partnership's gain. Examples 6.1 and 6.2 illustrate the impact of the § 754 election.

Although a purchaser is taxed currently if there is not a § 754 election in effect, the income inclusion causes a correlative increase in her outside basis under § 705. This increase means that some day she will have a capital loss (or reduced capital gain) on the disposition of her partnership interest. For that reason, the tax burden is only transient. But the purchasing partner's ability, some unidentified time in the future, to claim a capital loss on eventual sale or liquidation of her partnership interest is small comfort if the partner must pay tax currently on the partnership's ordinary income from the sale of the § 751 assets. Because § 1211(b) permits the use of capital losses only to offset capital gains plus $3,000 of ordinary income under § 1211(b), it may be a long time before the new partner is able, via the increased capital loss, to recoup the tax paid. This inequity is not mitigated by the unlimited carryover allowed for unused capital losses under § 1212(b). The time between the ordinary income taxation and the full benefit of the capital loss deduction makes the present value of the deduction significantly lower than the value of the current tax. Whether the partnership has made a § 754 election, or whether it is willing to do so, may be an important consideration in the purchasing partner's decision to buy.

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[8] As explained more fully in Sections 6.01(b) and 6.03, the income incorrectly taxed to the purchaser is only transient (at least in theory), because it increases the purchaser's outside basis. On disposition of her interest, the purchasing partner will have either a capital loss or a reduced capital gain. The § 754 election steps up the basis of the purchasing partner's share of the § 751 assets and eliminates the transient income. The § 754 election is described in Section 6.03(d).