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TAX PLANNING THE PARTNERSHIP FOR ITS TERMINATION: TAX TREATMENT OF PAYMENTS ON THE DEATH OR RETIREMENT OF A PARTNER

Bonnie Abrams Travieso†

The author explains the operation of section 736 of the Internal Revenue Code, points out areas in which particular care should be taken in planning the termination of a partnership interest, and discusses the advisability of legislative change.

I. INTRODUCTION

Most partnership agreements contain some provision for the termination of a partner's interest upon his retirement or death. Often the partnership agreement provides not only for a payment to redeem the partner's interest in the partnership, but also for an additional payment to serve as a pension or death benefit. Under the Internal Revenue Code of 1939, the eventual tax liability of the recipient of payments and the deductibility of payments by the partnership was uncertain. In order to determine what portion of the payment was a capital expenditure in exchange for partnership property, and what portion was an additional payment which was ordinary income to the recipient and either deductible by the partnership or excludable from the remaining partners' share of partnership profits, it was necessary to determine the "going concern" value of the partnership.¹ This often entailed the difficult task of valuing partnership goodwill. The ultimate allocation of the payments between capital expenditure and ordinary income, thus, was largely unpredictable.

In response to the need for clarification of the tax treatment of such payments, Congress enacted section 736 as part of Subchapter K of the Internal Revenue Code of 1954 (hereinafter the Code). This section enables partners to participate in mutual insurance plans under which they may agree to pay a retiring partner, or the successor in interest of a deceased partner, an amount in addition to the value of that partner's interest in the partnership as a retirement or death benefit. The additional payment is treated as ordinary income to the recipient, and is deductible by the partnership. A valuation of the goodwill of the partnership is unnecessary, unless the partners decide to place a value on goodwill in order to increase

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¹ For a thorough discussion of the tax treatment of payments to retiring or deceased partners, see 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 35, 75 (1975).
the amount of payment that will be treated as in exchange for a capital asset. The Code, thus, now provides an important tool for planning the tax treatment and allocating the tax burden of payments in liquidation of a retiring or deceased partner’s interest.

II. THE PROVISIONS OF SECTION 736

Section 736 is designed to provide a basis for allocating payments in liquidation of a retiring or deceased partner’s interest between that portion which is in exchange for a capital asset and that portion which is ordinary income to the recipient and deductible by the partnership, either as a business expense or as a reduction of each remaining partner’s distributive share of partnership income.

The basic requirement for the application of section 736 to payments to a retiring partner, or to a deceased partner’s successor in interest, is that those payments be “made in liquidation of the interest of [such partner].” The Code defines the term “liquidation of a partner’s interest” as “the termination of a partner’s entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.” Neither the sale of a partner’s interest to the remaining partners, nor a partial liquidation of a partner’s interest, is governed by section 736.

2. The valuation placed on goodwill by an agreement of the partners is regarded by the I.R.S. as correct. Treas. Reg. § 1.736-1(b)(3) (1956).

3. SEC. 736. PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER’S SUCCESSOR IN INTEREST.

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT. — Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP. —

(1) GENERAL RULE — Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under [subsection (a)].

(2) SPECIAL RULES — For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for —

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

4. I.R.C. § 736(b).

5. Id. § 736(a).


8. Id. § 761(d) (emphasis added).
Likewise, unless the partnership agreement or other agreement entered into for the purpose of the liquidation clearly provides that the payments are to be made by the partnership, rather than by the individual partners, section 736 will not apply.\(^9\)

Section 736(a) provides that all payments in excess of the value of the partner's interest in partnership property\(^10\) are either a distributive share of partnership income\(^11\) or a guaranteed payment if determined without regard to partnership income.\(^12\) If the payments are a distributive share of partnership income, they constitute either ordinary or capital income to the recipient, depending on the character of the income to the partnership, and reduce the amount of the distributive shares of the remaining partners.\(^13\) If the amount received is a guaranteed payment, it is ordinary income to the recipient and is deductible by the partnership as a business expense under section 162(a).\(^14\) The taxation of section 736 payments, thus, generally is favorable to the remaining partners and unfavorable to the withdrawing partner.

Under section 736(b), payments made in liquidation of a partner's interest in partnership property are a distribution by the partnership, and section 731 applies in determining the extent and character of gain to the recipient.\(^15\) Section 731(a)(1) provides that there is a recognizable gain to the withdrawing partner to the extent that the amount of the distribution to him exceeds his adjusted basis in his partnership interest. A loss to the withdrawing partner is recognized under section 731(a)(2) if his basis exceeds the amount of payments he receives under section 736(b).\(^16\) The basis of the recipient in property, other than money, received as a section 736(b) payment is determined under section 732.\(^17\) Section 732(b) provides that the basis of a partner in property distributed in liquidation of his interest is equal to his basis in his interest in the partnership, minus "any money distributed in the same transaction." It is unclear whether payments under subsections (a) and (b) of section 736 reduce the basis. It seems logical, in light of the separate treatment given these two categories of payments, that the basis in property received is reduced only by the amount of money received

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9. Problems arising from this requirement are discussed in section III of this Article. If the transaction is not a liquidation, it is a sale under I.R.C. §741.
10. See I.R.C. §736(b).
11. Id. §736(a)(1).
12. Id. §736(a)(2).
13. Id. §702(b); Treas. Reg. §1.736-1(a)(4) (1956).
16. This loss, presumably, is recognized even though the total payments under §736(a) and §736(b) exceed the retiring or deceased partner's basis in his partnership interest. See Swihart, Tax Problems Raised by Liquidations of Partnership Interests, 44 Texas L. Rev. 1209, 1220 (1966) (interesting analysis of this possibility).
as payment in the same transaction under subsection (b). Payments under section 736(b) are not deductible by the partnership, nor do they reduce the distributive shares of the remaining partners. The taxation of payments under subsection (b), thus, generally is favorable to the withdrawing partner and unfavorable to the remaining partners.

Section 736(b)(2) excludes from treatment payments for two types of partnership property. Subsection (b)(2)(A) provides that amounts paid for the value of unrealized receivables of the partnership are not "in exchange for an interest in partnership property." These payments, rather, are section 736(a) payments. Also excluded from section 736(b) treatment is the amount paid for the goodwill of the partnership, "except to the extent that the partnership agreement provides for a payment with respect to goodwill." This provision allows the partners to determine among themselves the value of the goodwill of the partnership and to decide whether payment for the value determined will be taxed more favorably to the withdrawing partner or to the remaining partners.

If it is determined that a retiring or deceased partner's liquidation payment treated under section 736(b) should be larger than the actual value of his interest in partnership property, provision should be made in the partnership agreement for a payment for the goodwill of the partnership. If the partnership wishes to maximize the deductibility of section 736(b) liquidation payments, no such provision should be included in the partnership agreement.

The liquidation of the interest of one of the partners in a two-person partnership has raised some interesting questions. It might seem that this transaction does not qualify for treatment under section 736, since once one of the partners withdraws there is no longer a partnership to make the liquidation payments. This dilemma is solved by regulation 1.736-1(a)(6), which provides that a

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18. "Unrealized receivables" are defined in I.R.C. § 751(c).
19. Treas. Reg. § 1.736-1(b)(4); see F. E. Holman, 66 T.C. 809 (1976). The other type of property treated under I.R.C. § 751, substantially appreciated inventory items, is specifically included in payments under § 736(b) by Treas. Reg. § 1.736-1(b)(4). It is unclear why these two types of § 751 property are treated differently under § 736. Payments for a partner's interest in substantially appreciated inventory are subject to the provisions of § 751(b); in some cases such payments are ordinary income to the recipient.
22. The sufficiency of a partnership agreement provision for goodwill payments is discussed in section IV of this Article.
retiring partner, or a deceased partner's successor in interest, is a partner until his entire interest is liquidated.\footnote{See Rev. Rul. 507, 1971-2 C.B. 46 (widow receiving payments in liquidation of her husband's interest in a partnership regarded as a partner until husband's entire interest liquidated). For purposes other than discussed in this Article, a partner is considered to have retired when he ceases to be a partner under local law.}

III. LIQUIDATION OR SALE?

Although there may be no difference in economic effect between a sale of a partnership interest to the remaining partners and a liquidation of that interest by the partnership, the tax consequences of a particular transaction vary significantly, depending upon which form is chosen. If, upon the retirement or death of a partner, the remaining partners buy his interest from him or his successor in interest, section 741 treats the payments as those received from the sale or exchange of a capital asset. The remaining partners cannot deduct any part of the payment as a business expense or as a reduction of their distributive shares of partnership income. If, on the other hand, the partnership liquidates the withdrawing partner's interest, the amounts received are allocated between ordinary and capital income, according to the value of the withdrawing partner's interest in the partnership.\footnote{See, e.g., Champlin v. Commissioner, 36 T.C.M. 196 (CCH June 23, 1977). In Champlin, the court found that a partner's interest had been liquidated, rather than sold. The court allocated the consideration by dividing the amount paid for the interest in the partnership from the amount that constituted a guaranteed payment.} The amount paid in excess of that value reduces the taxable income of the remaining partners.

There have been a number of cases dealing with the often difficult problem of distinguishing a sale from a liquidation. From these cases, several guidelines for making that distinction have emerged. In Foxman v. C.I.R.,\footnote{352 F.2d 466 (3d Cir. 1965).} the Court of Appeals for the Third Circuit found that when the terms of the transaction were couched in words of sale and the facts showed that the partners intended to enter into a sale rather than a liquidation, the transaction was governed by section 741, rather than by section 736. In Foxman, after extensive negotiations, three equal partners entered into a contract under which two partners agreed to acquire the interest of the third partner. A partial payment in a lump sum was made upon consummation of the contract. The remainder of the consideration was to be paid in installments, and payment of these installments was secured by a chattel mortgage on the assets of the partnership. The partnership treated all payments above the value of the withdrawing partner's interest in partnership assets as guaranteed payments under section 736(a)(2), and claimed a business deduction in that amount. The retired partner treated all payments in excess of...
his adjusted basis as long term capital gain, on the theory that he had sold his partnership interest to the remaining partners. In holding that the transaction was a sale rather than a liquidation and that, therefore, section 736 was inapplicable, the court of appeals placed heavy reliance on the references to a sale of the partnership interest in the contract and the mortgage. The contract, moreover, was signed by the two remaining partners as individuals, the obligation to purchase the interest was that solely of the remaining partners, and the partnership itself assumed no liability under the contract.27

The tax court28 in Foxman previously found that the arrangement was a sale. Judge Raum, in his opinion for the tax court, emphasized the importance of looking to the characterization of the transaction by the parties in order to determine the applicability of section 736:

> It is important to bear in mind the object of “flexibility” which Congress attempted to attain, and we should be slow to give a different meaning to the arrangement which the partners entered into among themselves than that which the words of their agreement fairly spell out. Otherwise, the reasonable expectations of the partners in arranging their tax burdens inter sese would come to naught, and the purpose of the statute would be defeated.29

This emphasis on treating the arrangement in accordance with the expectations of the partners was echoed in Emory v. United States.30 Emory involved a partnership agreement specifically providing that, upon the death of either partner, his “interest in said partnership shall be sold to and purchased by the surviving partner.” When one of the partners died, the specified payments were made to his estate from partnership funds. The district court found that Emory had purchased his dead partner’s interest:

> The Congressional purpose behind alternative methods of taxing the winding up of a partnership appears to be an attempt to allow partners to allocate among themselves the tax burden of partnership income. The partners indicate their decision by the choice of words in the partnership agreement. A strong reason for strictly construing terms such as “sale,” “exchange,” “buy,” “purchase,” and “sell” as denoting a §741 transaction and terms like “liquidation,” “winding up,” “account,” “liquidate,” “settle,” and “adjust” as denoting a §736 transaction is the public need for

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27. Id. at 468.
29. Id. at 553.
certainty in the tax law. Liberal construction of these terms will create unnecessary litigation and confusion as conflicting case law evolves.\(^{31}\)

The court in *Emory* did not base its decision solely on the words used in the partnership agreement, but outlined the other factors it found persuasive. The failure of the agreement to distinguish between payment for the value of the partnership interest and payment in excess of that value was an important consideration. The court asserted that “failure to make this distinction show[ed] an intention to employ a § 741 sale.”\(^{32}\) The court, in addition, inferred that since a section 736 liquidation inherently was based on advanced planning, the failure to indicate an intention that section 736 apply in a given case “strongly suggest[ed] the decision to disregard [section 736].”\(^{33}\)

The willingness of courts to accept the characterization of a transaction specified by the parties involved does have some limit. *Crenshaw v. United States*\(^{34}\) involved a complicated transaction between Crenshaw — the widow and executrix of a deceased partner — and the two remaining partners. In liquidation of her 50/225 interest in the partnership, the two remaining partners transferred to Crenshaw a 50/225 interest in some apartments owned by the partnership. Crenshaw, acting in her capacity as executrix of her husband’s estate, bought this interest in the apartments, and in exchange transferred other property held by the estate to herself. Again acting as executrix, Crenshaw transferred her interest in the apartments for $200,000 cash to a corporation the sole stockholders of which were the remaining two partners. This corporation then transferred the 50/225 interest in the apartments to the partnership in exchange for Crenshaw’s previously surrendered partnership interest. Crenshaw treated these dealings as a liquidation of her partnership interest followed by a tax-free exchange. The Internal Revenue Service argued that, in reality, these transactions consisted of a sale of Crenshaw’s partnership interest for $200,000.

The Court of Appeals for the Fifth Circuit agreed with the I.R.S. and looked through the form of the transaction to its economic effect. The court held that a sale, rather than a liquidation, had occurred because “the relative economic positions of the parties were the same as they ultimately would have been had a direct sale taken place.”\(^{35}\) In overturning the district court, which had held that there had been a valid liquidation,\(^{36}\) the court of appeals explained that

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31. Id. at 1054–55 (citations omitted).
32. Id. at 1055.
33. Id.
34. 450 F.2d 472 (5th Cir. 1971).
35. Id. at 476.
while the proper characterization of the transaction may depend upon whether the participants intended to effect a sale or a liquidation, that intention cannot be conclusively presumed merely because the tax-conscious litigant attaches a particular label to his actions. 37

Other courts have looked to the source of the payments to determine whether section 736 applies. This approach is suggested by the regulations, which state that the provisions of section 736 apply only to transactions between a partner and the partnership itself, and not to transactions between a partner and other partners. 38 In William T. Wheeling, 39 the tax court held that a contract in which two partners agreed to purchase the interest of the third partner was not governed by section 736, even though the actual payments were made by the partnership. The court found determinative that the obligation to make payments was an individual liability of the remaining partners. That payment was made by a check drawn on the partnership account did not change the transaction into a section 736 liquidation. 40

Paul J. Kelly 41 involved the withdrawal of a partner from an accounting partnership. Judge Raum, writing for the tax court, noted the ambiguity in the document in question and stated that it is noteworthy that Chamberlin, Kelly and Trainor — as practicing certified public accountants for many years — each had extensive knowledge of Federal income taxation. . . . Consequently, the inference is strong that the confusion and the ambiguous nature of the . . . agreement were not the result of ignorance or oversight, but were intentional. . . . It is indeed unfortunate where, as here, taxpayers having expertise in the field of Federal taxation abuse the freedom which Congress permits them in determining the tax consequences of business transactions by obscuring such transactions in confusion and ambiguity. 42

The court held that the transaction involved was a liquidation, notwithstanding that the agreement was signed by the two remaining partners as individuals, that the partnership was not a party to that agreement, and that there were other indications that the partners were individually responsible for payment. That the

37. 450 F.2d at 477.
39. 23 T.C.M. 778 (CCH 1964).
40. Cf. Karan v. Commissioner, 319 F.2d 303 (7th Cir. 1963) (court held that § 736 was not applicable to payments for partner's interest in goodwill of partnership, because remaining partner made the payments out of his own funds).
41. 29 T.C.M. 1090 (CCH 1970).
42. Id. at 1106.
The language of sale was not used and that the withdrawing partner was paid by a check drawn on the partnership overshadowed any characteristics of a sale. The court also found that, although the partners guaranteed the loan with which the partnership made the payments, the partnership itself was the borrower, and as such was primarily liable on the loan.

The first consideration, then, for any partnership desiring to take advantage of section 736 is carefully to draft any agreement so that it contains the language of a liquidation, rather than that of a sale. Reference to the contemplated transaction as a "liquidation" should be made with the specific provision that the payments are to receive section 736 treatment. Liability for such payments should be borne solely by the partnership rather than by the partners. It should be remembered, finally, that courts will disregard a sham liquidation if the economic result of a transaction is that of a sale.

IV. PAYMENTS FOR GOODWILL

Section 736(b)(2)(B) provides the partnership with a valuable planning tool in its allocation of liquidation payments between ordinary income and capital gain. This provision specifies that "payments in exchange for an interest in partnership property shall not include amounts paid for . . . good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will." If the partnership agreement specifies that certain amounts are in payment for the goodwill of the partnership, these amounts are in exchange for partnership property under section 736(b), and are capital gain. If no mention is made of partnership goodwill, the payments in excess of the withdrawing partner's interest in partnership property other than goodwill are ordinary income. The valuation placed by the partners on the goodwill of the partnership, if reasonable, will be regarded by the I.R.S. as correct.

Many partners, thus, can decide among themselves the value of the partnership goodwill and then decide whether the withdrawing partner or the partnership should bear the greater tax burden for goodwill payments. As a leading commentator in the field of partnership taxation has pointed out:

The deliberate Congressional purpose for this ambivalent treatment of partnership good will is to grant flexibility to the partners. They can decide among themselves whether

43. But see William T. Wheeling, 23 T.C.M. 778 (CCH 1964).
44. The regulations limit this treatment to payments for goodwill "in excess of its partnership basis." Treas. Reg. §1.736-1(b)(3). If the partnership has a basis in the goodwill of the partnership, then, to that extent, the payments for goodwill are treated under § 736(b).
45. Treas. Reg. §1.736-1(b)(3).
the good will is to be treated as an item of partnership property, with beneficial tax results to the retiring partner or to the successor of the deceased partner and with concurrent adverse tax consequences to the continuing partnership. They can also agree among themselves, if they wish, to omit any reference to payments for an interest in partnership good will, and to substitute income payments under § 736(a), which will be fully taxable to the retiring partner or the successor of the deceased partner and fully deductible by the continuing partnership.46

No definition of the term “good will” is provided by the Code or the regulations. Willis suggests that such things as the value of patents, formulas, and customer lists, as well as other intangibles, are includible. Since the regulations indicate a readiness to accept the valuation placed upon the partnership goodwill by the partners, it is fairly safe to conclude that any reasonable estimate of the value of items included in the determination of the total goodwill value of the partnership will be accepted by the I.R.S.

In order for payments for partnership goodwill to be treated under section 736(b), the partnership agreement must provide that a particular amount represents partnership goodwill. The term “partnership agreement” is defined in section 761(c) as including “any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year.”

In spite of this definition, the tax court, in *Jackson Investment Co.*,47 concluded that an amendment to a partnership agreement, entered into in order to effect the withdrawal of one member of the partnership, was not part of the partnership agreement for the purposes of section 736(b)(2)(B). That case involved a partnership whose original partnership agreement contained no provision for payments for the goodwill of the partnership. In order to effect the retirement of one of the partners, an amendment was executed by the three partners, providing for a payment to the retiring partner of $60,000, in part for his interest in the fair market value of all net assets of the partnership, and in part as “a guaranteed payment, or a payment for goodwill.” The partnership deducted the latter payments as a business expense. The I.R.S. argued that these were payments under section 736(b) and, therefore, were not deductible by the partnership. The tax court refused to treat the agreement as an amendment to the partnership agreement, but instead regarded it as a covenant not to compete. The tax court allowed the deduction by the partnership. In a strongly worded dissent, Judge Raum argued that this holding was contrary to the intent of Congress in enacting section 736 — to permit the partners themselves, in a field in which

46. 1 A. Willis, Partnership Taxation 612-13 (2d ed. 1976).
47. 41 T.C. 675 (1964).
the partners' interests with regard to tax liability are antagonistic to one another, to fix such liabilities among themselves through arm's length bargaining.\textsuperscript{48}

The Court of Appeals for the Ninth Circuit overturned the tax court's decision, and ruled that part of the payment to the retiring partner was a section 736(b) payment for goodwill.\textsuperscript{49} Citing Judge Raum's dissent and the definition of "partnership agreement" provided by section 761(c), the court of appeals refused to "thwart whatever may be the clear intent of the parties," and found that the amendment was part of the partnership agreement. In response to the argument that the amendment was ambiguously worded, the court of appeals looked to the intent of the parties to determine whether the payment was to be a guaranteed payment or a payment for goodwill. The court found that the agreement was intended to provide a payment for goodwill and, therefore, held that the payment was not deductible by the partnership as a section 736(a)(2) guaranteed payment.

Though courts will attempt to carry out the intention of partners in determining what tax treatment liquidation payments should receive, that intention must be communicated in the partnership agreement with sufficient specificity. \textit{Smith v. C.I.R.}\textsuperscript{50} involved a four-person partnership formed for the exploration of petroleum. The partnership agreement provided for the expulsion of a partner by majority vote and for payments for the expelled partner's interest in partnership property; plus a "premium" consisting of a specified percentage of the capital account of the partnership. When one of the partners was expelled,\textsuperscript{51} he reported the amount received that was attributable to the "premium" as capital gain under section 736(b)(2)(B), on the theory that it was a payment for goodwill provided for in the partnership agreement. The Court of Appeals for the Tenth Circuit affirmed the decision of the tax court\textsuperscript{52} and approved that court's interpretation of section 736(b)(2)(B) as requiring specific reference in the partnership agreement to a payment for goodwill. The court of appeals reasoned that this interpretation was most in accord with the intent of Congress:

\begin{quote}
If intent is to be determined by something other than the plain language of the partnership agreement, uncertainty and confusion will becloud the issue and the efforts of Congress to clarify a complex situation will go for naught. Important, also, is the fact that this result treats fairly both the expelled partner and the remaining partners as the tax
\end{quote}

\begin{footnotes}
\begin{enumerate}
\item Id. at 684.
\item Commissioner v. Jackson Inv. Co., 346 F.2d 187 (9th Cir. 1965).
\item 313 F.2d 16 (10th Cir. 1962).
\item Section 736 applies to both voluntary and involuntary liquidations. See F.E. Holman, 66 T.C. 809 (1976).
\item V. Zay Smith, 37 T.C. 1033 (1962).
\end{enumerate}
\end{footnotes}
consequences are determined in advance by the contract to which they all agreed.\textsuperscript{53}

V. ALLOCATION OF PAYMENTS

Once it has been determined what portion of the amount received in liquidation of a partner's interest falls within section 736(a), and what portion within section 736(b), a further allocation might have to be made. If the payments are made over a period of more than one taxable year, it must be determined what portion of each installment is a section 736(a) payment, and what portion a section 736(b) payment. The regulations provide some rules for making this allocation.\textsuperscript{54} These rules can be illustrated most clearly by the use of an example.

A retires from the ABC Partnership at a time when the fair market value of his interest in partnership property is $50,000. The partnership agreement provides for payments of $16,000 each year for five years and further provides that $10,000 of the total payment is for partnership goodwill. Regulation 1.736-1(b)(5)(i) provides that when the amount of payments is fixed, the amount of section 736(b) payments for each year is determined by multiplying the entire yearly payment by a fraction, the numerator of which is the total amount of section 736(b) payments and the denominator of which is the total amount of section 736 payments. In the example under consideration, the payment of $16,000 per year consists of $12,000 in section 736(b) payments and $4,000 in ordinary income under section 736(a). This allocation is arrived at by multiplying the amount of a yearly payment ($16,000) by $60,000, the total amount of section 736(b) payments ($50,000 for partnership property, plus $10,000 for partnership goodwill), and then dividing the result by $80,000, the total liquidation payment. If the partnership agreement provides for payment of twenty-five percent of the partnership profits for five years as payment in liquidation, then under regulation 1.736-1(b)(5)(ii) the payments first will be treated as section 736(b) payments, and then as ordinary income payments under section 736(a), once the full amount of section 736(b) payments has been made.

Regulation 1.736-1(b)(5)(iii) provides that the partners may agree among themselves to a different allocation of installment payments than would be made under the rules of regulation 1.736-1(b)(5)(i) and (ii). Any allocation decided upon by the partners will be honored when the total amount allocated to section 736(b) payments does not exceed the fair market value of the partner's interest in partnership property at the time of his death or retirement. The opportunity for allocating payments differently than

\textsuperscript{53} 313 F.2d at 20–21; accord, Norman E. Ritter, 23 T.C.M. 1302 (CCH 1964), aff'd, 376 F.2d 255 (5th Cir. 1967).

\textsuperscript{54} Treas. Reg. § 1.736-1(b)(5).
as provided by the regulations is an important planning tool. For example, if the installment payments are dependent upon partnership income, the partnership will not be able to deduct any payments until the total amount of section 736(b) payments has been made, unless the partners agree upon a method of allocating payments in which each installment consists of some section 736(a), as well as section 736(b), payments. In most cases, it will be advantageous to the recipient of payments and the remaining partners to agree to such an allocation. Even in cases in which the amount of payments is fixed and, therefore, is automatically divided between section 736(a) and section 736(b) treatment, there may be reasons to provide for a different allocation. A retiring partner may, for example, want to keep his ordinary income low in order not to reduce his social security payments after retirement.

A retiring partner or the successor in interest of a deceased partner also can elect to allocate a portion of his basis in his partnership property interest to each yearly installment, when the total of section 736(b) payments is a fixed sum.55 This election can be made in the sole discretion of the recipient of section 736 payments, and the decision need not be made until he files his income tax return for the first year in which such payments are received. Once the election is made, it will remain in effect for all years in which payments are received, although the regulations do not specifically state that such an election is irrevocable. If this election is not made, or if the section 736(b) payments are not fixed, no gain will be recognized to the recipient until the total of section 736(b) payments exceeds his adjusted basis for his interest in partnership property. If the election is made, the recipient of section 736(b) payments may report as capital gain for a particular year the difference between (1) the portion of the payment for that year allocable to section 736(b) and (2) the portion of adjusted basis attributable to that portion of his interest in partnership property. If, for example, the total section 736(b) payment is $60,000, the $12,000 of each of five yearly installments is treated as a section 736(b) payment, and the partner's adjusted basis for his interest in partnership property is $40,000, then he can elect to recognize $4,000 gain in each of the five years in which he receives payments from the partnership. This is determined by finding the difference between the amount of the yearly payment allocable to section 736(b) ($12,000) and the proportionate part of the withdrawing partner's adjusted basis ($8,000, which is one-fifth of the total adjusted basis) allocable to each yearly payment.

VI. PLANNING CONSIDERATIONS

The opportunity for tax planning provided by section 736 should be considered carefully by any partnership that wishes to provide its

55. Id. § 1.736-1(b)(6).
partners with retirement or death benefits. By incorporating a provision for liquidation of a partner's interest by the partnership upon his death or retirement, rather than one for the sale of that interest to the remaining partners, the tax burden and benefits emanating from such payments can be allocated between the parties by mutual agreement. These arrangements are usually easier to affect at the outset of the partnership, when it is difficult to predict which of the partners will die or retire first. If the special treatment of goodwill as a capital asset is to be taken advantage of, provision to that effect should appear in the partnership agreement. The goodwill provision could be based on a specific percentage of the net worth or income of the partnership, in order to allow for changes in the fortunes of the partnership.

It should be borne in mind that the overall tax burden generally is less when payments are treated under section 736(a), because the remaining partners will usually be in a higher tax bracket than the withdrawing partner. Section 736(b) payments, moreover, are taxed twice — as income to the partners when initially earned, and then as capital gain to the extent that the section 736(b) payment exceeds the withdrawing partner's basis in his partnership interest. It may facilitate negotiations if a portion of the tax savings from the treatment of certain payments under section 736(a) is passed on to the withdrawing partner, in the form of a larger section 736(a) payment or as a section 736(b) goodwill payment.56

Careful consideration also should be given to the period of time over which the payments are made, and to the allocation between section 736(a) and (b) that is made for each installment. Because of the uncertainty of the law relating to the deductibility of section 736(a) payments by a successor in interest of the liquidating partnership,57 it is wise not to extend payments over an extensive period of time.58 If it is desirable to stretch payments over a longer period of time in order to provide continued income to the retiring partner and to reduce the burden on the partnership, an allocation can be made which treats the initial payments as ordinary income payments under section 736(a) and the latter payments as capital payments under section 736(b). Though this allocation helps to insure that the maximum deduction for the section 736(a) payments is obtained, it may place an unduly large tax burden on the recipient.

56. An interesting demonstration of the mechanics of such a trade-off appears in 1 A. WILLIS, PARTNERSHIP TAXATION 624-27 (2d ed. 1976).
57. If a partnership is a "continuing partnership" of the liquidating partnership under I.R.C. §708(b)(2)(A), then, presumably, the payments continue to be deductible by that partnership. Rev. Rul. 75-154 states that individual former partners can deduct payments made pursuant to §736(a) if the former partnership could have deducted such payments. The deductibility of such payments by a corporation, partnership, or other entity is uncertain. See discussion of proposed changes to §736 in section VII of this Article infra.
58. Willis recommends that payments not be extended for over five years. 1 A. WILLIS, PARTNERSHIP TAXATION 638 (2d ed. 1976).
during the early years of payment in which he receives only ordinary income payments. All competing interests must be taken into consideration in determining the time period for, and allocation of, payments under section 736.

The most important consideration when negotiating a section 736 liquidation agreement is that any benefit to the partnership under section 736(a) results in a detriment to the withdrawing partner. Any benefit in tax treatment derived by the withdrawing partner from payments receiving section 736(b) capital treatment, moreover, results in a larger tax burden to the remaining partners. This interplay should be recognized by all parties to the transaction, and should be used to fashion an arrangement which will balance effectively the competing interests of the parties and will result in the lowest possible total income tax liability on the payments. Each partnership must take into account its own resources and requirements, and the expectations of its partners, in determining how to use section 736 to its greatest advantage.

VII. PROPOSED CHANGES TO SECTION 736

Shortly after the enactment of the Internal Revenue Act of 1954, the House Ways and Means Committee appointed an advisory group to make recommendations for changes in subchapter K. The report of the advisory group was issued in late 1957, and many of its recommendations subsequently were adopted by the Trust and Partnership Income Tax Revision Act of 1960, passed by the House of Representatives but not the Senate. 59 Contained in the Act were several changes to section 736. 60 These changes were studied by the


60. "SEC. 776. AMOUNTS PAID TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

(a) AMOUNTS CONSIDERED AS DISTRIBUTIVE SHARES OR GUARANTEED PAYMENTS.

(1) AMOUNTS TO WHICH SUBSECTION IS APPLICABLE. — Amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered —

(A) As a distributive share of partnership income to the recipient if the amount thereof —

(i) is determined with regard to the income of the partnership, and

(ii) is paid, or payable, on or before the fifteenth day of the fourth month following the close of the partnership taxable year with respect to which such amount is determined, or

(B) as if they were a guaranteed payment described in section 707(b) if subparagraph (A) is not applicable.

(2) TIME AMOUNTS PAYABLE ARE TAKEN INTO ACCOUNT.

(A) AMOUNTS CONSIDERED AS DISTRIBUTIVE SHARES. — Any amount considered under paragraph (1) (A) as a distributive share of partnership income shall be taken into account by the partnership and by the recipient as of the last day of the partnership taxable year with respect to which such amount is determined.

(B) AMOUNTS CONSIDERED AS GUARANTEED PAYMENTS. — Any amount considered under paragraph (1) (B) as a guaranteed
payment shall be taken into account by the partnership and by the recipient as of the last day of the partnership taxable year in which such amount was paid or payable.

“(b) AMOUNTS CONSIDERED AS DISTRIBUTIONS.

“(1) GENERAL RULE. — Amounts payable in liquidation of the interest of a retiring partner or a deceased partner shall be considered as payable in a distribution by the partnership, and not as a distributive share or guaranteed payment under subsection (a), to the extent that, under regulations prescribed by the Secretary or his delegate, such amounts (other than amounts described in paragraph (2)) are attributable to the interest of such partner in partnership property.

“(2) AMOUNTS NOT CONSIDERED AS COMING UNDER SUBSECTION. — For purposes of this subsection, amounts attributable to an interest in partnership property shall not include amounts payable with respect to

“(A) unrealized receivables of the partnership (as defined in subsection (c) (4)), or

“(B) goodwill of the partnership, except to the extent the partnership agreement provides for a payment with respect to goodwill.

“(c) RULES FOR APPLICATION OF SECTION.

“(1) EXCEPTION WHERE ALL AMOUNTS ARE PAYABLE IN 12-MONTH PERIOD. — If all amounts payable in liquidation of an interest in a partnership are payable within a 12-month period, such amounts shall be considered as a distribution by the partnership, and subsections (a) and (b) shall not apply.

“(2) AMOUNTS PAID IN MONEY AND OTHER PROPERTY. — Where amounts paid in liquidation of a partner's interest are amounts to which both subsection (a) and subsection (b) are applicable and are amounts paid both in money and in other property, such money shall first be deemed to be in payment for the amount to which subsection (a) is applicable, and only to the extent such money is in excess of such amount shall it be deemed to be part of the amount to which subsection (b) is applicable.

“(3) SECTION 776(a) AMOUNTS PAID AFTER TERMINATION OF PARTNERSHIP. — If upon termination of a partnership any person continues to pay amounts in liquidation of the interest of a retiring partner or deceased partner to which subsection (a) was applicable

“(A) The retiring partner, or successor in interest of the deceased partner, shall include in gross income under section 61(a) (as amounts having the same character as if subsection (a) (1) (B) of this section applied) any such amounts received from such person.

“(B) If the person making such payment

“(i) is an individual,

“(ii) was a partner of the partnership immediately before the retirement or death,

“(iii) is under a binding legal obligation to make such payment, and

“(iv) is operating a trade or business as a sole proprietor, then such individual shall be entitled to deduct as a trade or business expense under section 162 (a) such amounts which are paid or accrued.

“(4) UNREALIZED RECEIVABLES. — For purposes of this section, the term 'unrealized receivables' means, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payments for

“(A) goods produced (or delivered, in the case of a partnership predominantly engaged in a distributing trade or business), to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

“(B) services rendered.

The proposals on section 736 in these bills addressed several issues not covered by present law.

Subsection (c) of section 776 of H.R. 9662 provides certain rules for the application of the section. Among these is (c)(3), dealing with the treatment of payments made by "any person" after the termination of a partnership. It provides that payments under section 736(a) continue to be includable in the ordinary income of the recipient and deductible as a trade or business expense by the taxpayer when they are made by an individual who is a partner in the partnership immediately before the retirement or death, and the payor is under a legal obligation to make the payments, and operates a business as a sole proprietor. There is no comparable provision in current section 736, and the current regulations do not deal with the treatment of payments after termination of the partnership.62

It is questioned whether the proposed section is unduly restrictive in granting deductions for these payments. There seems to be no valid reason why a successor corporation or a newly formed partnership should not be allowed to deduct payments for which the old partnership was liable under section 736. A deduction should be allowed by any individual or entity that has a binding obligation to make such payments as part of its trade or business.

Changes were also included in both bills to protect a partner unaware of the different tax consequences of liquidation and sale of his partnership interest. Under current law, any amount paid in liquidation of a partner's interest which exceeds the fair market value of that partner's interest in partnership property is ordinary income under section 736(a). If the partner sells, rather than liquidates, his interest, all amounts received are in exchange for a capital asset under section 741.63 It is quite possible that a withdrawing partner will not comprehend this substantial difference in tax consequences that depends upon what form the transaction takes. Section 776(c)(1) of H.R. 9662 attempts to protect withdrawing partners from unexpectedly harsh tax treatment in cases in which the liquidation closely resembles a sale. That section provides that if all amounts payable in liquidation are payable within a twelve-month period, the payments are a distribution by the partnership, and section 736(a) and (b) will not apply. Section 44 of H.R. 11,450 provides that section 736(a) only applies if the payments are made in money and consist of more than one payment in more than one partnership year, or if the agreement explicitly provides that the payments constitute either a distributive share of partnership income or a guaranteed payment. Though these proposals protect the withdrawing partner, they do nothing to protect the remaining

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62. See note 57 supra.
63. These amounts are also subject to the provisions of §751.
partners from a sophisticated partner who withdraws from the partnership. The withdrawing partner could negotiate with his partners knowing that they expect to be able to deduct part of the payments as a business expense or as a distributive share, and then have the agreement drafted in such a way as to prevent any ordinary income to the recipient or deduction by the partnership. Section 736 contemplates that partners will negotiate the terms of the liquidation by trading off an advantage to the remaining partners against an advantage to the withdrawing partner. Arbitrarily to protect one of these parties from his own ignorance, but leave the other parties prey to the same pitfalls, compromises the equity of the transaction and needlessly complicates the law. There has been no indication in the more than twenty years since the enactment of section 736 that it has been used to exploit unwary partners on either side of the transaction.

Another change recommended by the advisory group and contained in H.R. 11,450 is that the allocation of part of the payment for goodwill not be limited to the partnership agreement, but be allowed at any time, including after the death or retirement of the partner whose interest is liquidated by any agreement between the parties involved. In light of the Ninth Circuit Court of Appeals' decision in *Jackson Investment*,64 which honored a provision for goodwill in an amendment to the partnership agreement entered into at the time of the liquidation, this change in the law hardly seems necessary. The necessity that the provision for goodwill be contained in the partnership agreement rather than in any other document is not unnecessarily burdensome and insures that all partners are aware of and agree with the terms of the provision for goodwill. Since it results in an increase in the tax burden of the remaining partners, they should all agree to such a provision. No change, therefore, should be made in the requirement that partners provide for a goodwill payment in the partnership agreement.

The other proposed changes to section 736 needlessly complicate what is one of the simpler and more useful sections for tax planning purposes in subchapter K. Section 736 was designed to enable partners to provide for pension and death benefits beyond the value of the actual partnership interest, at the least cost to the remaining partners. It achieves that purpose with laudable simplicity and should not be tampered with, in the absence of any compelling evidence of a need for change.

VIII. CONCLUSION

Too often, provisions in partnership agreements about the retirement or death of a partner and the payments to be made to him or his successor are drafted without adequate consideration of tax

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64. Commissioner v. Jackson Inv. Co., 346 F.2d 187 (9th Cir. 1965).
implications. By virtue of section 736 of the Code, partners are given some latitude in choosing how to treat the partner and the partnership upon such event. They are permitted to weigh the competing interests of the withdrawing or deceased partner's desire to maximize capital gains and the potential benefits to the partnership in claiming deductible expenses for ordinary income distributions to retired or deceased partners. No partnership agreement should be drafted without an understanding of these provisions, interpretations of them, and their limitations as suggested, to some extent, by the proposed revisions to them.