February 2018

Drafting Partnership Agreements: The General Lawyer’s Responsibility for Income Tax Consequences under the Internal Revenue Code of 1954

Arthur B. Willis

Follow this and additional works at: http://repository.uwyo.edu/wlj

Recommended Citation
Available at: http://repository.uwyo.edu/wlj/vol9/iss2/3

This Article is brought to you for free and open access by Wyoming Scholars Repository. It has been accepted for inclusion in Wyoming Law Journal by an authorized editor of Wyoming Scholars Repository. For more information, please contact scholcom@uwyo.edu.
DRAFTING PARTNERSHIP AGREEMENTS: THE GENERAL LAWYER'S RESPONSIBILITY FOR INCOME TAX CONSEQUENCES UNDER THE INTERNAL REVENUE CODE OF 1954

ARTHUR B. WILLIS*

In light of the income tax provisions of the Internal Revenue Code of 1954 applicable to partners and partnerships, no general lawyer can fairly and properly disclaim responsibility for income tax consequences of partnership agreements that he drafts. The 1954 Code places great emphasis upon the terms of the partnership agreement, and important tax consequences flow from the inclusion or omission of certain matters. On six occasions, the 1954 Code refers to the "partnership agreement" as determining the tax treatment of partnership transactions. The lawyer who drafts a partnership agreement must assume responsibility for tax consequences that are dependent upon that agreement.

CONTRIBUTION OF PROPERTY TO PARTNERSHIP CAPITAL

Take the case of Mr. Jones. He goes to Mr. Barrister, his general attorney, and tells him that he is about to invest $10,000 cash in a partnership business with Mr. Smith. Mr. Smith will contribute certain real property to the partnership at an agreed valuation of $10,000. The partnership profits are to be shared equally. Mr. Barrister prepares a "routine" short and simple partnership agreement. One month after the partnership is formed, the partners decide to move the business to another location. They find a purchaser who buys the real property for $10,000 cash.

Shortly thereafter, the partnership's taxable year is closed and a partnership return is prepared. Mr. Jones is startled when he discovers that the partnership return shows a gain of $9,000 from sale of the real property and one-half of that amount, or $4,500, is reflected as being taxable to him. He insists that this cannot be right. He points out that had there been no partnership transactions other than the sale of the real property, the partnership assets following the sale would consist of $20,000 cash, of which he would be entitled to $10,000, the amount he originally invested in the partnership. Mr. Barrister agrees with the logic of Mr. Jones' contention, but decides to investigate further.

It develops that Mr. Smith had paid only $1,000 for the real property. It had appreciated in value by $9,000, so that the fair market value was

---

* Member of the California Bar. The Committee on Taxation of Partnerships, Section of Taxation, American Bar Association, is attempting to inform the general attorney of the great importance placed on the drafting of partnership agreements under the Internal Revenue Code of 1954. This will be accomplished through a series of articles written by individual Committee members for publication in Bar Journals and Law Reviews throughout the 48 states. The present article is one of that series.
$10,000 at the time it was contributed to the partnership. Belatedly, Mr. Barrister studies the partnership provisions of the 1954 Code. He discovers that under section 723, the partnership's basis for computing depreciation or gain or loss on sale of the contributed property is the cost (with certain adjustments) of that property to the contributor. Therefore, even though the real property came into the partnership at an agreed valuation of $10,000, the partnership's basis for income tax purposes was only $1,000. When the partnership subsequently sold the property for $10,000 it realized a taxable gain of $9,000.

Section 704(c)(1) of the 1954 Code provides that the taxable gain or loss on sale of property contributed by a partner shall be allocated among the partners in accordance with the partnership agreement. In this instance the partnership agreement provided that all profits or losses were to be divided equally between Mr. Jones and Mr. Smith. Mr. Barrister is forced to the conclusion that Mr. Jones must pay an income tax in his distributive share ($4,500) of the partnership taxable gain, even though he received no economic benefit from the sale of the real property for $10,000.

Mr. Barrister pursues his study of the 1954 Code and discovers that Mr. Jones need not have realized any taxable gain from the sale of the real property contributed by Mr. Smith, had the partnership agreement contained an appropriate provision. Sections 704(c)(2) provides that the partnership agreement may allocate solely to the contributing partner the tax consequences of the difference between his cost of the property and the value at which it was contributed to the partnership. If the partnership agreement had so provided, upon sale of the property the $9,000 difference between Mr. Smith's $1,000 cost and the $10,000 valuation at which it was contributed to the partnership would have been allocated solely to Mr. Smith. Since the taxable gain was $9,000, the entire amount of that gain would have been taxable to Mr. Smith and Mr. Jones would have had no taxable gain. All this could have been, if the partnership agreement had only so provided.

Mr. Barrister has fumbled the ball. Because he wasn't acquainted with the partnership provisions of the 1954 Code, Mr. Jones will have to pay an unnecessary tax of $1,125 (25% of $4,500). Has Mr. Barrister a moral obligation to reimburse Mr. Jones for the $1,125 needless tax?

1. Actually, Mr. Barrister might have some defense in mitigation of his responsibility. Mr. Jones' basis of his partnership interest is increased in the amount of his distributive share ($4,500) of the partnership gain on the sale of the real property. (Section 705(a)(1)(A)). Thus, assuming there were no other transactions following the partnership's sale of the real property, Mr. Jones would have a basis of $14,500 for his interest (representing $10,000 for his cash contribution plus $4,500 as his share of the gain on sale of the contributed property). If the partnership were liquidated, Mr. Jones would be entitled to receive only $10,000 cash. He would have a taxable loss of $4,500 on liquidation of the partnership. This loss would offset the "illusory" taxable gain of $4,500 on which Mr. Jones paid tax when the partnership sold the property. The drawback is that the partnership may not be liquidated for several years. Mr. Jones may refuse to be consoled about the tax that he is "out of pocket", in the hope of a tax benefit at some future date when the partnership is liquidated.
Should he shrug it off on the basis that he warned Mr. Jones he wasn’t a “tax expert”? The very least Mr. Barrister will lose in Mr. Jones’ esteem and that is a very precious asset to a practicing attorney.

**Payments to a Retiring Partner or to a Deceased Partner’s Successor in Interest**

Any carefully drafted partnership agreement will contain some provision for payments to a retiring partner or to the executor or heirs of a deceased partner. In the past it has been extremely difficult to determine which part of the payments is the purchase price for the capital investment of the retiring or deceased partner and which part is a distribution of a continuing interest in partnership profits. The 1954 Code makes it clear that control of the tax incidents of such payments lies in the terms of the partnership agreement.

Under section 736 (b), payments made to liquidate the capital interest of a retiring or deceased partner are considered as being purchase price of his interest. Such payments do not reduce the amount of partnership profits taxable to the continuing partners. As to the retiring or deceased partner, gain or loss is recognized only to the extent that the money paid to him exceeds the basis of his partnership interest.²

Frequently the partners agree that payments should be made to a retiring or deceased partnership in excess of the amount required to liquidate his capital interest in the partnership. Such payments may be for his interest in the good will or going concern value of the partnership. Often such payments are in the nature of mutual insurance for the benefit of a deceased partner. It is with respect to this class of payments that the partnership agreement determines the tax consequences.

If the partnership agreement provides that these extra payments are for the retiring or deceased partner’s interest in good will, they are treated as part of the amount paid in liquidation of his interest in the partnership. As previously noted, this requires the continuing partners to report as taxable income the full amount of the partnership’s income, without reduction for the payments to the retiring or deceased partner.

On the other hand, the payments to the retiring or deceased partner may be made to constitute taxable income to him, thus reducing the amount

---

² Section 731 of the 1954 Code. Special rules are applicable if the partner had unrealized receivables or substantially appreciated inventory. See section 751 of the 1954 Code.
of partnership income taxable to the other partners. If this is the desire of the partners, all that is required is to omit any specification that the payments are for an interest in partnership good will.

This means that control of this significant income tax matter is vested in the partners and in the skill and knowledge of the draftsman. If the continuing partners are in a relatively high income tax bracket they will want as much as possible of the payments to a retiring or deceased partner to be treated as his distributive share of partnership income. Any payments thus treated will be fully taxable to the retiring or deceased partner, and to that extent, the taxable income of the remaining partners will be decreased. Conversely, it would be to the selfish interest of the retiring or deceased partner to have these payments constitute purchase price of his interest rather than distributions of partnership income.

The important point is this: Once it is realized that control of the taxability of the payments to the retiring or deceased partner lies in the provisions of the partnership agreement, an arrangement can usually be worked out to the mutual satisfaction of all partners. For example, it is likely that the continuing partners would be willing to pay a considerably greater amount over a number of years to the retiring or deceased partner, if such amounts were considered as distributions of partnership income thus, reducing their own taxable income. The retiring partner, or the successor in interest of the deceased partner may be in a much lower income tax bracket than the continuing partners, so that the taxability of the distributions may not be as much of a detriment to him as it is an advantage to the continuing partners. Having this range within which to bargain, an intelligent approach in the partnership agreement will make it possible to work out a plan of payment which will balance the income tax factors to the mutual advantages of the continuing partners and the retiring or deceased partner.

**Revising Previously Executed Partnership Agreements**

There are varying effective dates for the different provisions dealing with taxation of partnerships. (Section 771). The provision dealing with distributive shares of taxable gain or loss on sale of property contributed by a partner is effective only for a partnership taxable year beginning after December 31, 1954. However, if property contributed prior to that date is sold after the effective date, the new provision will apply.

In the example discussed at the first section of this article, the partnership may have been formed several years ago. However, if the property contributed by Mr. Smith is sold after the effective date, and if the partnership agreement does not specifically cover the point, Mr. Jones will be taxable on a $4,500 gain when the partnership sells the property.

Thus, the lawyer has a responsibility for the application of the 1954 Code to partnership agreements drafted in the past as well as for those
he will draft in the future. He should ascertain the extent to which previously prepared partnership agreements will be affected by the 1954 Code and advise his clients of desirable changes. Where property was contributed by a partner and is still owned by the partnership, it may be desirable to have an amendment to the agreement specifically dealing with the allocation of taxable gain upon the sale of that property.

Also, the attorney has the responsibility to call to the attention of existing partnership clients, the changes in the income tax law with respect to payments to a retiring or deceased partner. It is just as important to amend existing partnership agreements to obtain the maximum tax advantage from such payments as it is to properly draft a new one.

**Distribution of Property in Liquidation of a Partner's Interests**

A partnership transaction which has commonly been thought to involve no tax implications is the distribution of partnership property in the retirement of the interest of a partner, or a distribution in complete liquidation of the partnership. There has been a tendency to regard the whole problem as one of determining values of the various properties to be distributed, so that each partner receives a distribution proportionate to his interest in the partnership.

Under the 1954 Code, there are definite tax implications in the distribution of property in the liquidation of a partner's interest. This is particularly true if the partnership has unrealized receivables or inventory with a value substantially in excess of cost. Section 751. In such a situation a distribution of property to a retiring partner, other than a distribution of his prorata interest in all partnership assets, is considered as a sale by the continuing partners of their interests in the distributed property in exchange for the interest of the retiring partner in the remaining partnership properties.

Take the case of White, Black and Brown engaged in the ranching business. The partnership assets consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Ranch</td>
<td>6,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Cattle</td>
<td>0</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$21,000</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

Each of the partners has a basis of $7,000 for his partnership interest. White wishes to retire from the partnership. It is agreed that White will take the cattle which are valued at $12,000 in satisfaction of his partnership interest. In this situation, Black and Brown will be considered to have sold to White for $8,000 their two-thirds interest in the cattle inventory and they will have a total ordinary income of $8,000 from the transaction. White, the retiring partner, will be considered to have his one-third interest
in the ranch and he will have a $1,000 taxable gain on that transaction. Thus, all of the partners will realize taxable gain on the distribution of the cattle in retirement of White’s interest in the partnership.

Perhaps the distribution of the cattle to White is the only practical way to retire his interest. However, if the attorney were acquainted with the partnership provisions of the 1954 Code, it might be possible to work out a distribution to White which would not result in taxable income to all the partners. At least, the partners are entitled to be forewarned of the tax consequences of the proposed distribution to White.

**Conclusion**

This article is not intended to be a comprehensive coverage of the income tax provisions applicable to partnerships in the 1954 Code. Other sources must be consulted for such edification. The sole purpose here is to call to the attention of the general attorney the fact that under the 1954 Code he is necessarily burdened with some responsibility for the tax consequences of the instruments pertaining to partnerships which he drafts.

The partnership provisions of the 1954 Code are moderately complicated. However, they contain no mysteries that cannot be mastered with a reasonable amount of study. The Internal Revenue Code of 1954 offers a challenge to the general lawyer. If he accepts that challenge fairly and fully, he can continue drafting partnership agreements with full confidence in his coverage of the income tax problems. If he fails the challenge and prepares partnership agreements on the principle that he is not responsible for income tax consequences, he will do his clients, himself and his profession a great disservice.