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Notes

The Uncertain Tax Definition of Partnerships: Problems
and Opportunities for Treatment of Terminal Losses

I. INTRODUCTION

Partnerships cannot always be readily distinguished from
debtor-creditor relationships. Since the tax treatment of losses
upon termination of these relationships differs, uncertainty as to
whether a taxpayer will be classified as a partner or a creditor
creates a number of problems and opportunities for the tax
planner.

Consider, for example, the business promoter who invests in
a high-risk enterprise and attempts to arrange the investment
transaction in that form which will maximize his profits if the
enterprise is successful and which will provide him with limited
liability and ordinary loss tax treatment in the event of failure.
One means of attaining these objectives is to set up a “loan”
agreement which provides that the principal be repaid out of
future earnings and that a share of the future profits be paid to
him in lieu of interest. This arrangement may, under state
law, avoid classification as a partnership and the consequent personal
liability of the investor to disappointed creditors of the business.
If the promoter has invested in connection with his trade or
business, he will claim a business bad debt deduction from ordi-
nary income if the business fails.1 However, it is possible that
he might be considered a partner for tax purposes even though
he is not a partner under state law. If so, his loss upon with-
drawal of his interest in the enterprise will be treated as a capital
loss,2 rather than as an ordinary loss, unless certain precautions
are taken.

This Note will first discuss the differences in the distinction
drawn between creditors and partners under state laws and that
drawn under the Internal Revenue Code. Discussion will then
shift to the applicability of the Corn Products doctrine to part-
nerships, the use of section 1231 assets in partnership distribu-
tions, and other devices which may provide a means of securing
ordinary loss treatment for terminal losses upon withdrawal

2. See text accompanying notes 35-38 infra.
from a partnership. These planning techniques, though applicable when the taxpayer is unquestionably a partner, take on added significance when the taxpayer is uncertain as to whether he will be considered a partner or a creditor.

II. DISTINGUISHING PARTNERS FROM CREDITORS

A. STATE LAW

The problem of distinguishing partners from creditors under state law usually arises when a creditor of an unsuccessful enterprise seeks to fix liability for the firm’s debts on one who, though he invested in the enterprise in the form of a loan, has many of the attributes of a partner, such as a share in the profits or a voice in control of the business. Under the Uniform Partnership Act, which has been adopted in 40 states, profit sharing is only prima facie evidence of a partnership relationship, and even this inference is not to be drawn if the share in profits is received as payment of a debt or as interest on a loan.

However, by exercising control over the conduct of the business in addition to sharing in the profits, an investor is likely to be held liable as a partner regardless of his intent. When proceeds or profits are used to repay advances to an enterprise, authorities split as to whether the creditor should be held liable as a partner even though he has no right to exercise control. But when profits are shared in lieu of interest only, modern authorities generally agree that the investor should not be considered a partner unless he participates in the management or control of the business. The most persuasive rationale for holding control to be a sine qua non of partnership liability is that one should not be liable to creditors unless he was in a position to distribute the risks of the enterprise to consumers through his influence over costs and prices. Unfortunately, this rationale has not been articulated by the courts, though it is consistent with results of prior decisions. Instead, courts consider

3. UNIFORM PARTNERSHIP ACT § 7(4) (1915).
4. Id. § 7(4)(a).
5. Id. § 7(4)(d).
7. Id. at 93-97.
8. See Douglas, Vicarious Liability and Administration of Risk II, 38 YALE L.J. 720 (1929), which lays a theoretical framework, consistent with case law, for determining the circumstances under which partnership liability ought to be imposed.
a wide variety of factors in addition to profit sharing and control, which are thought to indicate an intent on the part of the investor to enter a partnership.9

B. Federal Tax Law

The Internal Revenue Code's definition of partnership is even less valuable than the Uniform Partnership Act in distinguishing partnerships from other business forms. The Code simply states:

[T]he term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.10

In only a few instances have courts been faced with difficult problems of distinguishing partners from creditors for tax purposes. Where the elements of profit sharing and the right to control are both present, a partnership has clearly been formed. However, unlike many state jurisdictions, it appears that one will be classified as a partner for tax purposes if he advances funds to a venture in return for a share of the profits even though he retains no right to control.11 In Eugene C. Hartman,12

9. See J. Crane & A. Bromberg, supra note 6, at 31-38.
10. INT. REV. CODE § 761(a).
11. A.L. Stanchfield, 34 P-H Tax Ct. Mem. 1841 (1965); Eugene C. Hartman, 27 P-H Tax Ct. Mem. 881 (1958); see Thompson v. Commissioner, 235 F.2d 599 (9th Cir. 1956); Levin v. Commissioner, 199 F.2d 632 (2d Cir. 1952). But see Arthur Venneri Co. v. United States, 340 F.2d 337 (Cl. Ct. 1965) (issue was liability for uncollectable withholding taxes); Joe Balestrieri & Co. v. Commissioner, 177 F.2d 897 (9th Cir. 1949) (state law applied). One commentator has cited Balestrieri in support of the proposition that the absence of control even where there is a sharing of profits requires a finding of a debtor-creditor relationship rather than a partnership. D. McDonald, ET. AL., FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 19 (1957). However, the case was erroneously decided on the specific ground that California law required control to be a necessary element of joint ventures. The tax definition of partnership is a matter of federal law. See Commissioner v. Tower, 327 U.S. 280 (1946). In the case of joint ventures there is conflicting authority as to whether their existence ought to be determined by state or federal law. Compare Frazell v. United States, 218 F. Supp. 457 (W.D. La. 1963), rev'd and remanded on other grounds, 335 F.2d 487 (5th Cir.), petition for rehearing denied per curiam, 339 F.2d 885 (5th Cir. 1964), with Hubert M. Luna, 42 T.C. 1067 (1964); Beck Chem. Equip. Corp., 27 T.C. 849 (1957). The preferred view is that state law is not determinative. 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.05 n.94.4 (1968 rev. ed.). There is no reason to treat the tax definitions of partnership and joint venture differently.
the taxpayer advanced $5,000 to a transit company to finance the operation of a ferry, and expressly disclaimed any intention of being a partner. The loan was to be repaid out of the profits of the ferry only and thereafter profits were to be split between the taxpayer and company. Though the taxpayer, who had retained only a right to an accounting, exercised no control over the operation, the Tax Court found a partnership to exist:

Where the party receiving the money assumes no obligation for its return and it is subject to the hazard of the business, the parties have been generally held to be joint venturers notwithstanding the money is to be repaid with interest before the net profits are to be divided.\textsuperscript{13}

The argument that control is an essential element to finding a partnership was rejected: “It is well settled that a partner or joint adventurer may intrust performance to another.”\textsuperscript{14}

As with monetary financing, courts have found partnerships to exist in the absence of effective provisions for control when profits were to be shared in return for the contribution of a physical asset.\textsuperscript{15} When the taxpayer's contribution has taken the form of a lease, however, courts have considered control to be a necessary element.\textsuperscript{16} Similarly, control has been thought essential when profits are shared in an employer-employee relationship.\textsuperscript{17}

C. Analytical Considerations

The apparent lack of emphasis on the element of control by courts in finding a partnership for tax purposes cannot be ex-

\textsuperscript{13} Id. at 884.

\textsuperscript{14} Id. This statement by the court, of course, fails to meet directly the argument that control should be a necessary element. The control requirement rarely means more than that one must have a right to exercise control. Thus, one does not abdicate his right to control by entrusting performance to another. However, in Hartman the taxpayer never had even a right to control the operation of the ferry.

\textsuperscript{15} Fishback v. United States, 215 F. Supp. 621 (D.S.D. 1963), in which a taxpayer who had only a right to approve the final plan and to share profits in return for the contribution of land to be developed and subdivided by another was considered a partner. See also Beck Chem. Equip. Corp., 27 T.C. 840 (1957), in which a taxpayer who shared profits for the contribution of an invention was held to be a partner even though the other party had the responsibility for financing, producing and selling the product.

\textsuperscript{16} See Bowe-Burke Mining Co. v. Willecuts, 45 F.2d 394 (D. Minn. 1930); Roland P. Place, 17 T.C. 199, 206 (1951).

plained by theoretical considerations. The general approach taken by tax courts, like state courts, has been to consider a wide variety of elements which are thought to indicate the existence of a partnership. This approach, however, provides no indication of the importance to be attached to each element, and thus no definite standard has emerged. To compound this difficulty, the ultimate test for tax purposes is said to be that of intent. In this regard, courts frequently refer to the statement from the family partnership case of Commissioner v. Culbertson that the only question is “whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”

The Culbertson intent test should be applied only to family partnership situations where the good faith of the parties is in question. Its use in other cases on the existence of partnerships has only generated uncertainty as to the definition of partnership.

Recognizing the inadequacy of the “intent” test as formulated by the Culbertson majority, Justice Frankfurter, in a concurring opinion, reasoned that for tax purposes the definition of a partnership should be controlled by the standards commonly invoked under state law, disregarding local variants:

The term [partnership] carries its own meaning, just as does “negligence” in the Federal Employers’ Liability Act, because such a common-law concept has a content familiar throughout the country to those to whom the law speaks. The basic criteria which determine its applicability have been so well and so long established that they were implicitly incorporated by the Internal Revenue Code’s definition of “partnership.” Congress has thereby stamped a nationwide meaning upon the term which disregards minor local variants or an occasional legal sport.

This view has considerable appeal. Adherence to it would have prevented the divergence which has occurred between the definition of partnership used by state courts and the definition applied in tax cases. Furthermore, the failure of Congress to elaborate on the meaning of the term partnership may indicate that the term does in fact have a well understood meaning.

Frankfurter’s approach, however, can be criticized on two grounds. First, the criteria applied by state courts, particularly

19. Id. at 742.
the element of control, are essentially tests for determining who is to be liable to the creditors of the enterprise in the event of business failure.\textsuperscript{22} When a similar issue arises in a tax case—for example, when the Treasury attempts to charge a party other than the admitted owner of a business for tax liabilities of the business—such criteria should likewise be applied. Thus, in \textit{Arthur Venneri Company v. United States}\textsuperscript{23} the court properly held that a contractor who loaned money to his subcontractor in return for a share of the profits was not liable for the subcontractor’s uncollectable withholding taxes on the ground that the control element was absent. These same criteria, however, are not necessarily the proper tests for deciding when to invoke the rules set forth in subchapter K of the Internal Revenue Code which govern contributions of property, the determination of distributive shares, liquidations, accounting procedures, sales of partnership interests and the like.\textsuperscript{24} Second, nothing indicates that Congress intended to limit tax courts to a rigid adherence to the definition of partnership used by the state courts. On the contrary, the language of section 761 of the Internal Revenue Code suggests that some business arrangements not enumerated therein might also be subject to partnership tax treatment.\textsuperscript{25}

Fortunately, it is possible to develop a tax definition of partnership which is both reasonably consistent with state law and based on theoretical considerations unique to tax law. For the development of such a definition, it is helpful to focus on the

\begin{itemize}
\item \textsuperscript{22} See Douglas, supra note 8.
\item \textsuperscript{23} 340 F.2d 337 (Ct. Cl. 1965).
\item \textsuperscript{24} It has been said, however, that:
There is no principle in tax law which requires or permits the trier of facts to set up a special concept of partnership for tax purposes or to treat the facts in a tax case differently from the way they should be treated in any other kind of litigation.
\item \textsuperscript{25} Section 761 uses the word “includes.” Tootal Broadhurst Lee Co., 9 B.T.A. 321, 324 (1927), aff’d, 30 F.2d 239 (2nd Cir.), cert. denied, 279 U.S. 861 (1929) indicates in a different context that when the word “including” is not followed by words of an excluding nature such as “only” the clauses are not to be considered all-inclusive. Moreover, Treas. Reg. § 1.761-1 (1956) adds that the Code definition of partnership is “broader” than the common law definition. While the meaning of that statement is uncertain, it may imply that the term partnership includes similar organizations referred to by a different term such as joint ventures. On the other hand, it may indicate that the Treasury supports a definition of a partnership which is broader than the common rules used by most state courts. See Sullivan, \textit{Conflicts Between State Partnership Laws and the Internal Revenue Code}, 15 Tax L. Rev. 105 (1959).
\end{itemize}
case of A. L. Stanchfield. In that case, the taxpayer advanced large sums of money to his son-in-law's construction company. These advances were evidenced by promissory notes and were carried on the taxpayer's books as loans receivable. In lieu of interest, the taxpayer was to receive one half of the net profits of a current construction contract. When the company encountered financial difficulties, the taxpayer contributed a few minor managerial services. In reply to the Commissioner's contention that the uncollectable advances were nonbusiness bad debts, the taxpayer argued that he was a partner, despite having previously denied partner status in another legal proceeding. Therefore he claimed an ordinary loss or, in the alternative, a business bad debt deduction. The Tax Court, influenced by the services rendered by the taxpayer on behalf of the partnership, held him to be a partner even though he could not exercise control over company policies.

Tax consequences should be based on the nature of one's business activity rather than on whether he is engaged in such activity as would make him liable to third parties. Thus, the Stanchfield court properly looked to general evidence of participation in the business rather than whether the control standard had been met. The distinction between "participation" and "control" cannot always be clearly drawn. Control, as used to fix liability for business losses under state law, appears to require an ability to influence both costs and prices. Thus, the mere contribution of services which cannot significantly affect cost and pricing policy and the exercise of negative powers, such as the right to veto, are insufficient. But when participation is extensive and it relates to important aspects of the business operation, it becomes the practical equivalent of a share in control.

Therefore, a tax definition of partnership under which partners are distinguished from creditors by the features of profit sharing and significant participation would be fundamentally consistent with the definition of partnerships employed by most state courts. Unfortunately, the Stanchfield court was willing to find a partnership when the taxpayer's participation was slight. In performing services only after the company had run into financial difficulty, the taxpayer's activity was characteristic of a creditor attempting to protect his investment rather than of one personally involved in the conduct of the enterprise.

27. See Douglas, supra note 8.
In the cases where partnerships have been found to exist in the absence of either the control element or significant participation by the taxpayer, the courts have generally been guilty of inquiring into the existence of a partnership when that inquiry was unnecessary. In Hartman, for example, the issue was merely whether the taxpayer had a right to receive certain income from the ferry operation. The court, by unnecessarily undertaking to determine whether taxpayer was a partner, rendered a perverse definition of partnership. The court could have reached the same result by the doctrine of constructive receipt without determining whether or not the taxpayer was a partner.

In Fishback v. United States, the case for inquiring into the existence of a partnership was somewhat stronger since the issue was whether the taxpayer was holding land for sale to customers. Thus, the issue of whether the taxpayer was a partner in the firm which made the ultimate sales was an appropriate threshold question. Nevertheless, there was no compelling reason to analyze the facts in partnership terms since the court could have simply looked at the taxpayer's activity with respect to the property independently and reached the same result. In Stanchfield, however, the inflexible nature of the distinction between business and nonbusiness bad debts made inquiry into the existence of a partnership essential. Since participation is not a factor which aids in determining whether one is in the business of lending money, the degree of participation by the taxpayer in his son-in-law's business would not have aided the court in determining whether the debt was business or nonbusiness.

Though, as a general rule, the tax definition of partnership should require the element of either significant participation or control, an exception must be made for those investment arrangements which are analogous to limited partnerships. Limited partnerships, in which the element of control by the limited partners must be absent by definition, contemplate that the limited partners will receive a proportionate interest in the capital of the business—an interest which could not be considered a debt in either substance or form. It follows that relationships similar to limited partnerships, which have always been included

within the meaning of the term partnership under section 761, should be accorded the same treatment even though they fail to comply with the state limited partnership provisions. For example, in Thompson v. Commissioner the court properly denied a bad debt deduction to one who signed what purported to be a limited partnership agreement even though the limited partnership certificate required by state law was never obtained. The court reasoned that in order to constitute a bad debt, the transaction must have first created an "unconditional obligation to repay." Presumably the same result would be reached even in the absence of any intent to form a limited partnership so long as the substance of the transaction is similar to that in Thompson. Thus, if an agreement clearly contemplates that an investor is to have a proportionate interest in the capital of the business as well as a share in the profits, he should be considered a partner for tax purposes regardless of whether he exercises control or participates in the business.

III. ACHIEVING ORDINARY LOSS TREATMENT

Many promoters who withdraw from relationships similar to those in Stanchfield or Hartman and who are unaware of the possibility that they may be considered a partner for tax purposes though they are considered creditors under state law are likely to treat the losses they have suffered as either business or nonbusiness bad debts, whichever appears most applicable to them. If the promoter applies for a business bad debt deduction from ordinary income and the Commissioner determines that he is a partner, he may have missed an opportunity to cast his withdrawal transaction in such a form as to assure ordinary loss treatment for his terminal losses. Tax planning techniques which obtain ordinary loss treatment for terminal losses incident to a partnership liquidation are likely to be of special interest to business promoters in these situations.

32. See Francis L. Burns, 13 B.T.A. 293 (1928); Taubman, Limited Partnerships, 3 CORP. PRAC. COM. 15 (Feb. 1962). But see Annie Stevens Woodruff, 38 B.T.A. 739 (1938), nonacquiesced in, 1939-1 CUM. BULL. 69, in which the court refused to apply the general partnership rule which provides for nonrecognition of gain or loss on partnership distributions in kind to limited partnerships. There is no justification for such a distinction between ordinary partnerships and limited partnerships. P. LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS § 8.10, at 178 (1952).
33. 235 F.2d 599 (9th Cir. 1956).
34. Id. at 602.
The return of a portion of the taxpayer's investment from an enterprise under circumstances similar to those involved in *Stanchfield* might be considered a distribution in liquidation of a partnership interest under section 736(b) of the Internal Revenue Code. Liquidating distributions bring into operation the general rules for recognition of gain or loss set out in section 731. Under this provision, gain or loss is recognized if the distribution consists entirely of money, unrealized receivables or inventory. Any gain or loss that is recognized on such a distribution is considered gain or loss from the sale or exchange of a partnership interest and, subject to certain exceptions, is treated as a capital gain or loss. Thus, if the investor, erroneously believing himself to be a creditor, accepts cash in liquidation of his interest he will be held to a capital loss for the difference between the adjusted basis of his partnership interest and the amount distributed.

Since the above result is likely to be considerably less satisfactory to the taxpayer than if the loss is characterized as a business bad debt, the taxpayer should examine the possibilities of shaping the liquidating transaction in such a way as to achieve ordinary loss treatment regardless of the tax characterization of his relationship.

A. USE OF SECTION 1231 ASSETS

The taxpayer can obtain ordinary loss treatment for terminal losses by receiving an item of depreciable property used in the trade or business as described in section 1231. When any amount of property other than unrealized receivables or inventory items is included in a distribution, no gain or loss is recognized. The basis of such property in the hands of the distributee-taxpayer is equal to the adjusted basis of his interest in the partnership reduced only by the amount of money distributed to him in the

35. A distribution in liquidation of a partnership interest differs from the sale of a partnership interest which is governed by section 741. If the enterprise continues to operate after taxpayer's withdrawal, the question may arise as to whether the payments made to taxpayer were distributions in liquidation of his interest or constituted a sale of his interest to the remaining partners. For a discussion of the problems of distinguishing liquidations from sales, see Swihart, *Tax Problems Raised by Liquidations of Partnership Interests*, 44 Tex. L. Rev. 1209, 1223-41 (1966).
38. Id.
39. Id.
same transaction. The sale of section 1231 property, unlike other assets, can result in ordinary loss to the taxpayer. Thus, the distributee-taxpayer can shift what would otherwise be a capital loss into an ordinary loss merely by shaping the transaction to include section 1231 property. Also, by holding the property, he can postpone recognition of the loss until such time as he chooses to sell it.

Furthermore, through a non-pro rata distribution of the partnership's section 1231 property, the total amount of the partnership's loss which can be treated as an ordinary loss by the individual partners is greater than it would be under a pro rata distribution of such assets. This can be illustrated by the following example: A and B are equal partners of a partnership which has an adjusted basis of $200,000 and assets consisting of $40,000 cash, section 1231 property with a market value of $30,000 and a basis to the partnership of $60,000, and capital assets with a value of $30,000 and a basis to the partnership of $100,000. If A receives the $40,000 cash and section 1231 property with a basis of $20,000 and a value of $10,000, the basis of such property to A upon distribution would equal the adjusted basis of his partnership interest ($100,000) less the amount of money included ($40,000), or $60,000. Upon sale of the property as a section 1231 asset at its market value of $10,000, A would realize an ordinary loss of $50,000. B's basis, however, must be allocated to the properties distributed to him in proportion to their adjusted bases to the partnership. Thus, the capital assets distributed to him would have a basis of $71,429 while the section 1231 assets would have a basis of $28,571. Upon the sale of this property, B would realize a capital loss of $41,429 and an ordinary loss of $8,571 respectively. If, on the other hand, the distribution was pro rata, each partner would allocate a basis of $30,000 to section 1231 property and $50,000 to capital assets. Upon the eventual sale of the property, each would realize an ordinary loss of $15,000.

40. Id. § 732(b).
41. See S. SUSEY & W. WARREN, FEDERAL INCOME TAXATION 1145 (1960); 6 J. MERTENS, supra note 11, §§ 35.54 n.5.
42. INT. REV. CODE § 732(b).
43. Id. § 732(c) (2).
44. B's basis of $100,000 must be allocated between capital and section 1231 assets in the ratio of 100,000 (the basis of the capital assets to the partnership) to 40,000 (the basis of the remaining section 1231 assets to the partnership). Hence, the properties take on a basis of $71,429 and $28,571 (respectively).
45. $71,429 less a market value of $30,000.
46. $28,571 less a market value of $20,000.
and a capital loss of $35,000. Thus, in the case of a pro rata distribution, a total of $30,000 is deducted from ordinary income of the partners compared with a total ordinary loss of $58,571 in the case of the non-pro rata distribution. Since the partners themselves can control the allocation of the particular assets, the benefits of ordinary loss treatment can be shifted to the partner who can best utilize them.

It is also desirable to minimize the amount of property other than section 1231 property which is distributed to the party seeking to maximize his ordinary loss treatment. The reason for this is that any remaining basis, after accounting for money, unrealized receivables and inventory items, is allocated to other distributed properties in proportion to their adjusted bases to the partnership. Thus, inclusion of other forms of property may greatly reduce the amount of the basis of section 1231 property which can eventually be recognized as ordinary loss.

There are two potential pitfalls which the taxpayer must avoid when attempting to utilize section 1231 assets in a liquidating distribution. First, he should be certain that the particular items of property have been held by the partnership for at least six months prior to the distribution. Otherwise, courts might consider such property an inventory item under a literal reading of section 751(d)(2)(B). That section includes within the definition of inventory items, “any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231.” (Emphasis added.) Depreciable property held less than six months would not be a “capital asset” since section 1221(2) specifically excludes property used in a trade or business which is subject to a depreciation allowance. Nor would such property be “property described in section 1231” since section 1231 refers only to property held more than six months. Moreover, the description contained therein is stated in section 1231(b) to apply only “for purposes of this section . . . .” Thus, the taxpayer would be unable to fulfill the six month holding requirement for section 1231 treatment by using the asset in a trade or business of his own for only a portion of that period. Professor Willis believes that this interpretation is technically correct, even though he considers it a distortion of the

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47. As mentioned in the text A could realize an ordinary loss of $50,000 and B an ordinary loss of $8,571.
intended operation of section 751 and an apparent drafting error.\textsuperscript{49}

Second, it has been suggested that section 731, which affords nonrecognition of loss for liquidating distributions containing property, might not be read literally if the liquidation contains a purely nominal amount of property.\textsuperscript{50} Since the taxpayer may be attempting to optimize the total ordinary loss available from the liquidating transaction by taking only a single piece of section 1231 property with the money distributed to him, thereby making more of such property available to the other partners, he should be aware of this possibility. However, section 731, which was based on a Congressional intent “to reduce to a minimum the cases involving recognition of gain or loss,”\textsuperscript{51} is quite explicit in postponing the recognition of a loss unless “no property”\textsuperscript{52} is distributed. Even more absolute language is used in the regulations which accompany section 731\textsuperscript{53} and in the Senate committee report.\textsuperscript{54}

\begin{footnotesize}
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\item 49. A. Willis, Handbook of Partnership Taxation 197-98 (1957).
\item 50. Jackson, et al., The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1189, 1228 n.87 (1954) states:
\begin{quote}
It should be noted that under a literal interpretation of this rule a bag of peanuts could receive a million dollar basis, if a partner with a very high basis for his partnership interest merely received that property in liquidation. However, in a situation involving de minimis property, the million dollar loss would probably be recognized.
\end{quote}
\item 6 J. MERTENS, supra note 11, § 35.54, at 189 comes to the same conclusion: “In order to avoid absurdity the Secretary and the courts would seem to be entitled to disregard de minimis distributions of property.”
\item 52. Int. Rev. Code § 731(b).
\item 53. According to the regulations:
\begin{quote}
Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables . . . , and inventory items . . . . If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. (emphasis added).
\end{quote}
\item 54. 3 U.S. Code Cong. & Ad. News, supra note 51, at 5031. The House version would have recognized loss on liquidating distributions regardless of whether property was included. The American Law Institute proposed draft provided for recognition of loss on liquidation distributions whenever the realized loss exceeded twice the value
\end{itemize}
\end{footnotesize}
Under the present distribution rules of subchapter K, nothing prevents taxpayers from converting terminal capital losses into ordinary losses by means of a distribution of section 1231 property. While the present incidence of tax avoidance through such elaborate distribution schemes may well be minor, the loophole could be closed without prejudice to legitimate business motives. Congress could add a provision that distributions made for tax avoidance purposes will be subject to the rules governing sales of partnership interests. Such a provision, also covering avoidance possibilities other than those discussed above, would be similar to section 704(b), relating to tax avoidance purposes in the determination of distributive shares. A second remedy would be to add a clause limiting the distributee's basis in section 1231 property to the adjusted basis of such property in the hands of the partnership whenever the value of the total liquidating distribution is less than the adjusted basis of his partnership interest.

B. ABANDONMENT

If the taxpayer's withdrawal from the partnership is charac-

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55. See text accompanying notes 41-50 supra.
56. See statement of A. Willis, chairman, Advisory Group on subchapter K, U.S. Congress, House Committee on Ways and Means, in Advisory Group Recommendations on Subchapters C, J & K of the Internal Revenue Code 73 (1959). The advisory group did not recommend such a provision but suggested that it might be added if the possibilities for tax avoidance under the group's proposal were considered significant.
terized as an "abandonment" rather than either a "distribution" or a "sale or exchange" of his interest, he is not subject to the loss calculations required by subchapter K. Prior to addition of the distribution sections to the 1954 Code, courts held that when the partnership agreement required any withdrawing partner to forfeit his interest, such partner was entitled to a deduction from ordinary income. Thus, the investor whose "loan" is to be repaid only out of the profits of the business could treat his loss as ordinary under section 165(c) because he would not be entitled to a distribution upon termination of the enterprise. Similarly, if the withdrawing partner has a right to payment out of the assets of the enterprise but the firm's liabilities exceed those assets upon his withdrawal, the taxpayer should be allowed a deduction from ordinary income so long as he is not liable to creditors under state law.

Just as use of section 1231 assets achieved an ordinary loss for taxpayer when the business has remaining assets, treatment of the withdrawal as an abandonment may secure ordinary loss when the business has nothing left. However, if the taxpayer has liabilities to creditors, as one would likely have if considered a partner under state law, which are assumed by the other partners upon his withdrawal, a distribution rather than an abandonment would occur and the taxpayer would be held to have sustained a capital loss. The reason for this result is that "[a]ny decrease in a partner's share of the liabilities of a partnership . . . shall be considered as a distribution of money to the partner by the partnership."

C. APPLICATION OF THE CORN PRODUCTS DOCTRINE TO PARTNERSHIPS

When a taxpayer engaged in a trade or business as an indi-

58. See Rev. Rul. 66-93, 1966-1 Cum. Bull. 165. (when a limited partnership became insolvent, placed in receivership and terminated during the same year as the loss and the limited partners are unable to recover any part of their respective capital contributions to the partnership, the limited partners are considered to have sustained an ordinary loss under sections 165(a) and (c)(1)). There is no substantive distinction between the limited partner described above and the investor considered a partner for tax purposes who is also unable to recover a share of his contribution so long as he would not have been liable to creditors under state law.
59. Andrew O. Stillwell, 46 T.C. 247 (1966) (offering no opinion as to the continued vitality of Gannon and Hutcheson).
60. INT. REV. CODE § 752(b).
individual or partner makes a loan for the purpose of supporting
his own business (usually to insure a source of supply), any
losses incurred are usually deductible as business bad
debts.61 However, even if the taxpayer is considered taxable as a partner
rather than a creditor, it is arguable that the gain or loss recog-
nized in a cash distribution to him should be regarded as ordi-
nary.

Following the doctrine announced by the Supreme Court in
Corn Products Refining Company v. Commissioner,62 courts have
allowed business expense or ordinary loss deductions when de-
bentures or stocks are purchased to secure a source of supply or
a steady customer and later sold at a loss.63 In rejecting a literal
reading of the language of section 1221, the Corn Products Court
held that property not specifically excluded from the definition
of a capital asset contained in that section could nevertheless be
excluded if the property is held by the taxpayer incidental to his
business rather than for investment purposes. The Court justi-
fied this departure from the language of section 1221 on the
ground that “Congress intended that profits and losses arising
from the everyday operation of a business be considered as ordi-
nary income or loss rather than capital gain or loss.”64

If this policy was intended to preclude a literal application
of all Code sections which provide for capital asset treatment,
there is no reason to deny ordinary loss on a cash partnership
distribution when the partnership interest was purchased for
a purpose like securing a source of supply. The Code, however,
expressly provides that gain or loss recognized on a partnership

61. See Lewis, Deductibility of Losses Arising from Business Ven-
tures, S. CAL. 1966 TAX. INST. 625, 642–52.
63. John J. Grier Co. v. United States, 328 F.2d 163 (7th Cir.
1964) (stock of lessor purchased to avoid objection to assignment of
lease held incidental to business and not for investment); Hagan v.
United States, 221 F. Supp. 248 (W.D. Ark. 1963) (sole purpose of in-
vesting in stock was to protect and retain a reliable purchaser of em-
ployer's products); Journal Co. v. United States, 195 F. Supp. 494 (E.D.
Wis. 1961) (loss sustained by taxpayer in newspaper publishing busi-
ness on sale of stock it acquired in paper mill for purpose of obtaining
newspoint held deductible as ordinary business expense); Smith & Wel-
to secure a source of supply held to be a business expense); Missisquoi
Corp., 37 T.C. 791, 795–96 (1962) (debentures purchased to secure a
source of supply); McMillan Mortgage Co., 36 T.C. 924 (1961) (stock
purchased as a condition of making sales held a business expense not a
capital asset); Electrical Fittings Corp., 33 T.C. 1026 (1960) (stock pur-
chased to secure a source of supply).
distribution is to be considered a sale or exchange of a partner-
ship interest, and thus, treated as a sale or exchange of a capital
asset under section 741. While apparently no cases have chal-
lenged the literal reading of section 741, it has been suggested
that the literal interpretation should not be followed where a
person is engaged in the business of holding partnership inter-
ests for sale to customers. It is doubtful that Congress, by en-
acting section 741, intended to supersede the general policy of
ordinary income treatment in such situations. Though Corn
Products was addressed only to section 1221, the policy behind
instituting what was in effect an amendment to that section
applies with equal force to section 741.

D. WHEN TO FILE AS A PARTNERSHIP

Unlike the partner who must claim his operating losses as
the partnership incurs them, the creditor must wait until the
debt is uncollectable before he can claim his deduction. There-
fore, in addition to the capital treatment of terminal losses, a
surprise determination by the Commissioner that taxpayer is a
partner for tax purposes could result in a denial of loss deduc-
tions for years barred by the statute of limitations. For this
reason, a taxpayer in doubt as to his status would often be wise
to amend his return at the time he withdraws his investment
from the enterprise. If successful, the operating losses of the en-
terprise could be spread over several years rather than lumped
in a single bad debt deduction.

The question of whether to file a partnership return initially
when the taxpayer enters into the transaction and is uncertain
as to how the taxing authorities might classify him for tax pur-
poses is more complicated. By filing a partnership return at this
time the possibility that some losses might be barred by the
statute of limitations is avoided. However, state courts have

65. INT. REV. CODE § 731.
66. 6 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.55 n.54
(1968 Rev. ed.).
67. It should be pointed out that such a strategy should not be fol-
lowed if there are outstanding creditors of the firm who have not been
satisfied at the time of taxpayer's withdrawal and there remains a possi-
bility that they will attempt to hold taxpayer liable as a partner in a
subsequent state court proceeding. As indicated by the cases cited in
note 68 infra state courts often look to the fact of filing a partnership
tax return as evidence of intent to be a partner. Thus, the filing of a
partnership return could increase the possibility that taxpayer would
be held liable. Taxpayer should be able to ascertain whether there are
likely to be unsatisfied creditors at the time he withdraws from the firm.
frequently considered the filing of a partnership return significant evidence of an intent to form a partnership.\(^6\) Thus, in a doubtful case, the filing of a partnership return could defeat the taxpayer's expectations of limited liability in a state proceeding if the business failed. Such a consequence could obviously be far more disastrous to the taxpayer than the possibility that a later determination that the taxpayer was a partner could prevent the taxpayer from claiming losses from barred years. Moreover, since most businesses either succeed or fail in their first few years of operation, the likelihood that substantial losses could be barred is likely to be minimal.

IV. SUMMARY

A satisfactory test by which partners can be distinguished from creditors for tax purposes has not yet emerged. On the basis of existing case law it appears that many investors who would be considered creditors under state law will be classified as partners under the Internal Revenue Code. Recognizing the uncertainty of these classifications, the taxpayer can increase his chances of obtaining ordinary loss treatment of his terminal losses through several tax planning devices, especially the use of section 1231 assets.

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