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Income Tax Aspects of Liquidation of Partnership Interest of Retiring or Deceased Partner[†]

By WILLIAM H. KINSEY*

I.

How does a retired partner or successor in interest of a deceased partner treat for federal income tax purposes the amounts received in liquidation of the partnership interest? Are such amounts or any portion thereof:

- (a) Excludable from income as a return of capital?
- (b) Taxable as capital gain?
- (c) Taxable as ordinary income?

How are such payments treated by the remaining or surviving partners?

The answers to the above questions lie in section 736 of the Code,¹ reading as follows:

Sec. 736(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 or his delegate, 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

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¹ INT. REV. CODE OF 1954.

the partnership agreement provides for a payment with respect to good will.

While the answers lie in section 736, they are far from readily apparent and require some uncovering. Rather than clearly stating the tax consequences of the payments to a retired partner (or successor in interest of a deceased partner), the Regulations² on the subject merely expand upon the statutory distinction between:

"(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under section 731, 732, and, where applicable, 751. See § 1.751-1(b)(4)(ii). The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either—

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(b) *Payments for interest in partnership.* (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange

(a) All payments made in liquidation of the interest of a retiring partner or deceased partner, except those referred to in paragraph (b). Such payments (other than those referred to in (b) below) are considered as a distributive share to the recipient of partnership income, or as a guaranteed payment, and for the purpose of this outline are sometimes referred to as category A payments.

(b) Payments made in exchange for the interest of the partner in partnership property, excluding amounts paid for unrealized receivables and amounts paid for good will of the partnership (unless the partnership agreement expressly provides for a payment with respect to good will). Such payments are considered as a distribution by the partnership, not as a distributive share or guaranteed payment, and for the purpose of this outline are sometimes referred to as category B payments.

To ascertain the tax consequences of category A and category B payments, it is necessary to explore the cross references made in section 736 and the Regulations. Such cross references accord the following tax treatment for distributive shares of partnership income on the one hand, and distributions by a partnership on the other hand:

(a) To the extent considered as a distributive share of partnership income, the payments are taken into account under section 702^a in the income of the retired partner (or successor in interest of the deceased partner) and consequently reduce the amount of the distributive shares of the remaining or surviving partners. Whether such payments constitute ordinary income or capital gain depends upon the nature of the partnership income from which distributed. To the extent considered as guaranteed payments, they are deductible by the partnership and are taxable as ordinary income to the recipient. There are no substantive differences in the tax consequences between payments considered as a distributive share of income, and payments considered as guaranteed payments, except that guaranteed payments are always taxable as ordinary income to the recipient, while the distributive share may be ordinary income or capital gain, depending upon the source of the income. Speaking generally, the tax consequences are the same for these two types of payments—the payments are taxed as income

for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and § 1.751-1(b). The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see § 1.751-1(b) (3) (iii).” U. S. Treas. Reg. § 1.736-1 (1956).

^aINT. REV. CODE OF 1954.

to the recipients, and reduce the income of the surviving or remaining partners.

(b) To the extent considered as a distribution by the partnership, the tax consequences are controlled primarily by section 731.⁴ Under this section no gain or other taxable income is recognized to the recipient, except to the extent that any money distributed exceeds the basis of the liquidated partner's interest in the partnership. Any gain is considered as gain from the sale or exchange of the partnership interest. A partnership interest is a capital asset, so any such gain is capital gain (subject to the exception for unrealized receivables and appreciated inventory items).

Application of the foregoing to the questions propounded above produces the following answers:

1. To the extent that the amounts received are in exchange for the interest of the retiring or deceased partner in partnership property, such amounts are excludable from income as a return of capital up to an amount not exceeding the tax basis of the retiring or deceased partner for his partnership interest. Any excess is taxable as capital gain (assuming the requisite holding period), except payments for unrealized receivables and payments for good will of the partnership, unless the partnership agreement expressly provides for a payment with respect to good will.

2. To the extent that the amounts received constitute a distributive share of the partnership income or a guaranteed payment, such amounts are taxable as income to the retiring partner or successor in interest of the deceased partner.

3. The remaining or surviving partners reduce their taxable partnership income by the amount of any payments constituting a distributive share or guaranteed payment to the retiring partner or successor in interest of the deceased partner. Other payments increase the basis of the remaining or surviving partners for their partnership interests, but are not deductible from partnership profits.

Payments received by a retired partner or successor in interest of a deceased partner during any year may not fall exclusively within either category A or category B, but may be composed of portions of each. This necessitates an allocation of the payments. Such is more or less an accounting problem, less important from a tax planning or legal viewpoint than the determination of the aggregate amounts which fall within the two categories.⁵

⁴*Id.* § 731.

⁵With respect to allocation the regulations provide as follows: "(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows—

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payment for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under sections 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a) (1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any

II.

All of the foregoing relates to the tax consequences accorded payments falling within the two categories, but does not help in making the equally important determination as to what particular payments or classes of payments fall within each of the categories. Since payments considered to be made in exchange for the interest of the partner in partnership property fall within category B, and any payments not falling within category B come within category A, the problem is merely one of identifying payments (and the amount thereof) made in exchange for the interest of the partner in partnership property. Section 736(b) (1) states that the determination of such payments shall be made under regulations prescribed by the Secretary. Strangely enough, the Regulations are nearly silent in prescribing a means for identifying payments made in exchange for an interest in partnership property. The most pertinent portions of the Regulations are the sentence in paragraph (b) (1) of the Regulations quoted above⁶ that generally the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct, and the provision in subparagraph (b) (5) (iii)⁷ that the total amount allocated to property under section 736(b) shall not exceed the fair market value of such property at the date of death or retirement. While the total amount

unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of \$6,000 for 10 years for his interest in partnership property, receives only \$3,500 in 1955. In 1956, he receives \$10,000. Of this amount, \$8,500 (\$6,000 plus \$2,500 from 1955) is treated as a distribution under section 736(b) for 1956; \$1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736(a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between—

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i.e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income." U. S. Treas. Reg. § 1.736- (b) (1956).

⁶*Supra*, n. 2.

⁷U. S. Treas. Reg. § 1.736-1(b) (5) (iii) (1956), quoted *supra*, n. 5.

allocated to the property cannot exceed the fair market value of the property at the date of death or retirement, the valuation placed upon the property by the parties in an arm's length agreement will be accepted by the Commissioner. The Regulations give no clue as to what happens if the parties are unable to agree as to the proper amount allocable to property. In a sense, the Commissioner has sidestepped the question and handed it back to the taxpayers with the statement that their mutual agreement will control, subject to certain limitations.

Examples are the best way to illustrate a problem and the solution thereto. Set forth in the footnotes are the examples used in the Regulations.⁹

⁹*Example (1)*. Partnership ABC is a personal service partnership and its balance sheet is as follows:

	Assets		Liabilities and Capital	
	Adjusted basis Per Books	Market Value	Per Books	Value
Cash	\$13,000	\$13,000	Liabilities	\$ 3,000
Unrealized receivables	0	30,000	Capital:	
Capital and sec. 1231 assets	20,000	23,000	A	10,000
			B	10,000
			C	10,000
TOTAL.....	\$33,000	\$66,000	TOTAL.....	\$33,000
				\$66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities (\$1,000) is assumed. In addition he is to receive \$9,000 in the year of retirement plus \$10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is \$30,000 (\$29,000 in cash and \$1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is \$12,000 (one-third of \$36,000, the sum of \$13,000 cash and \$23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is \$11,000 (\$10,000 plus \$1,000, his share of partnership liabilities), he will realize a capital gain of \$1,000 (\$12,000 minus \$11,000) from the disposition of his interest in partnership property. The remaining \$18,000 (\$30,000 minus \$12,000) will constitute payments under section 736(a) (2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is \$10,000, consisting of \$9,000 in cash, plus \$1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5) (iii) of this paragraph, each annual payment of \$10,000 will be allocated as follows: \$6,000 (18,000/30,000 of \$10,000) is a section 736(a) (2) payment and \$4,000 (12,000/30,000 of \$10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the \$6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only \$4,000 of each payment as a distribution, in a series in liquidation of his entire interest and, under section 731, will have a capital gain of \$1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each \$4,000 payment attributable to A's interest in partnership property, \$333 is capital gain (one-third of the total capital gain of \$1,000), and \$3,667 is a return of capital.

Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5) (iii) of this paragraph, all payments received by A up to \$12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of \$1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of \$12,000 shall be treated as a distributive share of partnership income to A under section 736(a) (1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the

Although not expressly stated in example 1, the partnership is on the cash basis, which accounts for the unrealized receivables item. Since receivables of a cash basis taxpayer are not reflected on the books or taken into income until received, they fall within the section 751⁹ definition of unrealized receivables. If the partnership were on the accrual basis, the unrealized receivables would be shown as accounts receivable having a book value equal to the market value.

III.

The examples from the Regulations involve only two types of buy-out arrangements, *i.e.*, (i) a fixed lump sum payable in annual installments and (ii) a fixed percentage of income for a specified number of years in the future. Such buy-out arrangements are not likely to be found in the partnership agreement itself, being more of a kind (particularly (i)) which would be negotiated after retirement or death in the absence of a controlling provision in the partnership agreement.

How does the foregoing apply to common buy-out provisions used in partnership agreements? Set forth below are the resumes of some typical provisions followed by an explanation of the tax consequences resulting therefrom. For the purposes of the following, partner *A* is retiring from the partnership consisting of *A*, *B*, and *C*. The partnership is on the cash basis and has the balance sheet set forth in note 8 *supra* under example 1 in the Regulations. Under the buy-out provisions the remaining partners take over all of the partnership liabilities, and *A* receives the indicated amounts in complete liquidation of his partnership interest:

1. *A* receives an amount equal to his capital account as shown on the books as of the retirement date (excluding any undistributed share of the partnership profits for the calendar year), plus *A*'s undistributed share of profits or losses for the current year computed on an accrual basis as of the retirement date (although the partnership for other purposes uses the cash method of accounting), plus 15 per cent of the partnership profits for each of the three years following the date of retirement or death.

Consequences: *A* receives \$10,000, the amount of his capital account (assuming that the same does not reflect any undistributed profits for the calendar year) and *A*'s \$1,000 share of the liabilities taken over by *B* and *C* is considered as an additional amount received by *A*. All of such \$10,000 (and the \$1,000) will be received by *A* tax free as a return of capital since it is a category B amount received in exchange for *A*'s interest in the partnership property, and such amount does not exceed *A*'s \$11,000 basis for his partnership interest (\$10,000 capital account plus *A*'s \$1,000 share of the liabilities). *A*'s undistributed profits for the calendar year will include his

partnership. At the time of *A*'s retirement, the partners determine the value of partnership good will to be \$9,000. The value of *A*'s interest in partnership property described in section 736(b) is thus \$15,000 (one-third of \$45,000, the sum of \$13,000 cash, plus \$23,000, the value of capital and section 1231 assets, plus \$9,000 good will). From the disposition of his interest in partnership property, *A* will realize a capital gain of \$4,000 (\$15,000 minus \$11,000, the basis of his interest). The remaining \$15,000 (\$30,000 minus \$15,000) will constitute payments under section 736(a) (2) which are taxable to *A* as guaranteed payments under section 707(c). U. S. Treas. Reg. § 1.736(b) (7) (1956).

⁹INT. REV. CODE OF 1954.

share of the profit reflected in the \$30,000 of unrealized receivables, and such will be taxed as ordinary income to *A*, reducing the profits taxable to *B* and *C*. All of the 15 per cent of the partnership profits for the three succeeding years will be taxable to *A* as a distributive share of partnership income, and will reduce the taxable income of the remaining partners.

2. *A* receives the same amounts as in 1 above, except that instead of 15 per cent of the profits for the three succeeding years, *A* receives an amount equal to one-third of the profits of the partnership for the preceding calendar year, payable in two equal annual installments.

Consequences: Each such annual installment is taxable to *A* as a guaranteed payment and is deductible by the remaining partners.

Query: Suppose that under 1 or 2 above, *A* contends that the value of his share in the partnership property includes one-third of the \$3,000 excess in present market value of the partnership capital assets over book value (excess of \$23,000 over \$20,000). If such contention is sustained, \$1,000 of the current partnership profits or future profits going to himself would be taxable as a partnership distribution in exchange for his interest in partnership property with the result that such \$1,000 would be taxable to *A* as capital gain rather than ordinary income and would not be deductible by the remaining partners. Unless such a contention is made by *A*, the present market value of the capital assets is immaterial since it does not affect the amount payable to *A* under the buy-out provision, the amount being keyed to book value (capital account) rather than actual value.

3. The same as 1 above, except there is added to the capital account of *A* (excluding current year's profits) *A*'s share (one-third) of the appreciation in value of the capital assets.

Consequences: *A* receives \$12,000 as a partnership distribution in exchange for his interest in partnership property, such \$12,000 being the \$10,000 book value of his capital account, plus \$1,000 as his share of the \$3,000 excess of the market value of the assets over the book value (excess of \$23,000 over \$20,000) plus the \$1,000 of assumed liabilities. Of this amount, \$11,000 is a nontaxable return of capital (the amount of *A*'s basis for the partnership interest), and the remaining \$1,000 is taxable as capital gain. The other sums are taxed in the same manner as explained under 1.

4. The same as 3 above, except the buy-out provision contains a sentence expressly stating that the 15 per cent of the partnership profits payable to *A* for the three succeeding years constitutes payment for *A*'s interest in the good will of the partnership.

Consequences: This good will provision converts into capital gain for *A* his 15 per cent of the future profits which otherwise would be taxed to *A* as a distributive share of income. Such profits taxable as capital gain to *A* are not deductible by the remaining partners. This means that they pay the income tax on all the partnership profits, including *A*'s 15 per cent, and also pay *A* his full 15 per cent unreduced by the income taxes thereon. This costly tax result is dictated by the provision in section 736(b) (2) (B) that good will is a part of partnership property where the partnership agreement provides for a payment with respect to good will. Also, the Regulations provide that, generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or de-

terminated by formula, shall be regarded as correct. A's basis for his partnership interest would be exhausted by the amount of his capital account, so that all of the 15 per cent of the profits would be in excess of his basis and taxable as capital gain.

IV.

Prior to the issuance of the Regulations, a question existed as to whether section 736 applied to a two-man partnership. The section refers to distributions by the partnership after retirement or death, but after the retirement or death of one of the partners in a two-man partnership there no longer remains a partnership to make the distributions. This question has been neatly eliminated by a paragraph of the Regulations¹⁰ which makes it clear that section 736 and the Regulations apply to a two-man partnership.

V.

What effect should section 736 and the regulation have upon the drafting of partnership buy-out provisions? The reliance in the Regulations upon the valuation for the interest in partnership property established at arm's length by the mutual agreement of the partners is an open invitation for the partners to solve their tax problems in their partnership agreements. The partners should formulate their wishes in regard to:

- (1) Category A payments—The amounts distributed in liquidation of the interest of a retired or deceased partner which shall be taxed to the recipient as a distributive share of income or as a guaranteed payment upon which the recipient (and not the remaining or surviving partners) pass the income taxes; and
- (2) Category B payments—The amounts distributed in liquidation of the interest of a retired or deceased partner which shall constitute a return of capital to the recipient or shall constitute capital gain to the extent such amounts exceed the basis for the liquidated partnership interest, and which amounts shall not reduce the taxable income of the remaining or surviving partners so that the remaining or surviving partners pay the income taxes upon the partnership profits used to pay such amounts.

The remaining or surviving partners benefit to the extent that the payments fall within category A and the retiring or deceased partner benefits to the extent that the payments fall within category B. The over-all tax is usually less to the extent that the payments fall within category A, since under category B the remaining or surviving partners pay the income tax on any profits from which the payments are made, and then the recipient also pays a capital gain tax to the extent that the payments exceed the basis

¹⁰"A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b)." U. S. Treas. Reg. § 1.736-1(a) (6) (1956).

of the retired or deceased partner for his partnership interest. Furthermore, a retiring partner or successor in interest of a deceased partner is likely to be in a lower income tax bracket than the remaining or surviving partners.

There are some limits beyond which the parties cannot go in allocating income between categories A and B. Such limitations are very broad in view of the statements in the Regulations that the Commissioner will be governed by the valuations upon partnership property specified in an arm's length agreement. As to a lower limit, there is no advantage in allocating to the liquidated partner's interest in property a sum less than such partner's basis for his partnership interest, and the Commissioner should not object to any allocation of a sum equal to such basis arrived at by the agreement of the parties. As to an upper limit, the Regulations provide that the allocation cannot exceed the fair market value of the property on the date of death or retirement, but by express agreement good will can be included as part of the partnership property. This gives considerable leeway for the upper limit since any valuation in excess of the fair market value of the tangible assets can be expressly allocated to good will. As before stated, however, as a general rule there is less over-all advantage taxwise in allocating an amount to the interest in partnership property than there is to a contrary allocation which makes the amount taxable to the recipient and deductible by the remaining parties.

Obviously, a more satisfactory solution to the problem can be worked out at the time of drafting the partnership agreement, before any partner knows which end of the buy-out provision he will be on. After death or retirement, a satisfactory agreement is harder to reach because of the divergent tax interests of the retiring partner or the successors in interest of the deceased partner, and the remaining or surviving partners.

To assure the anticipated tax results on any payments for which the parties desire the tax consequences of category B, the agreement should expressly state that such payments, or the valuations forming the basis therefor, represent or constitute the interest of the retiring or deceased partner in the partnership property. In regard to payments seeking the tax consequences of category A, the agreement should expressly state that such payments constitute a distributive share to the recipient of partnership income, and that the recipient (rather than the remaining or surviving partners) will be liable for any income taxes thereon. Such a provision will preclude any possibility of the problem raised in the query following example 2 under III above. The buy-out provision should avoid like the plague any reference to good will unless the tax consequences thereof are fully understood and are in accord with the intent of the parties. As previously explained, any express reference to good will has a definite and sometimes lethal effect upon the tax consequences of the liquidating distributions.¹¹

Set forth in the footnote is a valuation paragraph used by the author in a recent partnership agreement incorporating the beforementioned suggestions.¹²

¹¹See example 4 under III above, p. 174.

¹²Purchase Price for Partnership Interest—The amount payable in liquidation of the interest of a retiring or deceased partner shall equal:

(a) The capital account of the retired or deceased partner, excluding any undistributed share of the partnership profits or losses for the current year; plus or minus—

(b) The retiring or deceased partner's share of undistributed profits or losses for the current year. Such profits or losses shall take into account all income items and other deductions customarily reflected under the cash basis method of accounting employed by the partnership, and in addition such profits shall reflect any receivables and any incurred wages or other payables, as of the date of retirement or death; plus—

(c) Ten per cent of the net income of the partnership as computed for federal income tax purposes during each of the three calendar years immediately following the year in which retirement or death occurs. Such share of the profit for each of said years shall be payable on or before April 20 of the following year. The portion of the valuation specified in paragraph (a) above shall represent the interest of the retiring or deceased partner in partnership property. Any share of the profits or losses specified in paragraph (b) above, and any share of the profit payable pursuant to paragraph (c) above, shall constitute a distributive share of partnership income to the recipient so that the recipient (and not the remaining or surviving partners) shall be liable for and pay any income taxes thereon."

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