NOTES

TAX CONSEQUENCES OF WITHDRAWAL FROM A TWO MAN PARTNERSHIP: SALE OR LIQUIDATION?

The tax treatment of payments to a withdrawing member of a partnership depends on whether the payment is classified as a liquidation or a sale. Recent litigation underscores the necessity to consider further the problem of distinguishing a sale from a liquidation, especially where the withdrawal is from a two man partnership. The theoretical basis for the present statutory framework also merits reexamination.

A liquidation payment made by the partnership for the withdrawing partner’s entire partnership interest is subject to taxation under section 736. Liquidation payments are divided into two categories: subsection (b) payments for the withdrawing partner’s interest in

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1 INT. REV. CODE OF 1954, § 761(d) [hereinafter cited as CODE] reads in pertinent part as follows:

[T]he term “liquidation of a partner’s interest” means the termination of a partner’s entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

2 Treas. Reg. § 1.736-1(a)(1)(i) (1956) states that the liquidation section applies only to payments made by the partnership and not to transactions between the partners. The interest in the partnership includes physical assets, cash, and inventory. Good will may be included if the agreement so provides. CODE § 736(b)(2)(B).

3 CODE § 736 reads as follows:

(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

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

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.
the partnership; and subsection (a) payments constituting any amount not included under subsection (b). Subsection (b) payments receive capital gains treatment, exclusive of payments representing unrealized receivables and goodwill. Subsection (a) payments are considered either distributive shares or guaranteed payments—ordinary income to the withdrawing partner under sections 702 and 707(c), and a deductible business expense to the partnership.

Section 741, relating to the sale or exchange of an interest in the partnership, applies regardless of whether the purchaser is already a member of the partnership. Proceeds from the sale are capital gains to the transferor of the interest, and the payment is not a deductible business expense to the purchaser. The amount paid for the withdrawing partner's interest in unrealized receivables or substantially appreciated inventory is excluded from section 741 and is treated as ordinary income under section 751(a).

Thus when one partner withdraws from a partnership, he and the remaining partners are given alternative means of allocating their respective tax burdens. Problems arise when the withdrawing member desires capital gains treatment, but the buyers wish to expense their payment.

The distinction between a sale and a liquidation is crucial when the tax burden imposed by the two sections is substantially different. This occurs if the transaction is deemed a liquidation in which subsection (a) payments have been received. Theoretically, the key inquiry is whether the purchaser is the partnership itself or the remaining partner as an individual. In practice, however, making this distinction is difficult because the two transactions are economically indistinguishable. In each case the same parties are involved, and the withdrawing

4 The recipient must designate the portion of the payment representing his interest in the partnership property. Generally, the valuation placed upon the withdrawing partner's interest will be regarded as correct. Treas. Reg. §§ 1.736-1(b)(1), (5) (1956).

5 CODE § 736(b)(2).

6 Id. § 741 states:

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

7 Treas. Reg. § 1.471-1(b) (1956).

8 CODE § 731(a)(1) states that the gain shall be recognizable to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership.

9 The only real distinction occurs in the event of partnership bankruptcy where the partnership creditors (a liquidation situation) will rank ahead of the partner's creditors (a sale situation). Cf. United States v. Kaufman, 267 U.S. 408, 412 (1925).
partner receives roughly similar payments. Assets can easily be transferred between the partnership and the individual making the payment, giving one transaction the appearance of the other.

The government's revenue is similar under each classification. Although a liquidation yields a larger tax payment than does a capital gains tax on a sale, the larger payment is somewhat offset by the expense deduction taken by the partnership. Accordingly, the classification of the transaction is likely to be immaterial to the government. But since differing classifications may produce greatly disparate tax burdens on the individuals, clear tests must be developed to differentiate the two categories, thereby enabling the parties to order their relationship with predictability.

I

SALE OR LIQUIDATION—THE LACK OF PREDICTABILITY

Distinguishing a sale from a liquidation is most complex in a two man partnership. The first complicating factor is the possible inapplicability of the liquidation sections to the two man situation. Since a liquidation is defined as the termination of a partner's entire interest by means of a distribution to him by the partnership, the Code implies a requirement of at least two remaining partners. Also, under the law of most states, withdrawal of one of two partners means that no partnership survives. If payments are not made by a partnership surviving the transaction, there can be no section 736 liquidation. In addition, section 708(b)(1)(A) states that a partnership will be considered terminated if no portion of the business is carried on by the partners in a partnership. A strict reading of this section compels the conclusion that liquidation is impossible in a two man partnership when payments are made after one partner retires. Does this mean

\[\text{\footnotesize{\textsuperscript{10}}}\text{ Consequently, if there is a dispute as to whether a transaction is a sale or a liquidation, the Commissioner will claim a liquidation with regard to the seller and a sale with regard to the purchaser. If both parties are involved, with the transferor of the partnership interest claiming a sale and the transferee claiming a liquidation, the Commissioner will take inconsistent positions to protect revenue. See Miller v. United States, 67-2 U.S. Tax Cas. \$ 9685 (Ct. Cl. 1967); Charles F. Phillips, 40 T.C. 157 (1963). Thus, the real contest is often between the withdrawing and the remaining partners to determine who is to receive the more favorable tax treatment.\n\[\text{\footnotesize{\textsuperscript{11}}}\text{ CODE \$ 761(d), quoted in note 1 supra.}\n\[\text{\footnotesize{\textsuperscript{12}}}\text{ See, e.g., Uniform Partnership Act \$ 29.}\n\[\text{\footnotesize{\textsuperscript{13}}}\text{ Treas. Reg. \$ 1.736-1(a) (1956).}\n\[\text{\footnotesize{\textsuperscript{14}}}\text{ CODE \$ 708(b)(1)(A).}\n\[\text{\footnotesize{\textsuperscript{15}}}\text{ Swihart, Tax Problems Raised by Liquidations of Partnership Interests, 44 Texas L. Rev. 1209, 1234 (1966).} \]
that two man partnerships receive tax treatment different from that of larger partnerships? Because it seems unfair to condition an individual's tax status solely on the number of his business associates, two regulations have been promulgated to permit liquidation treatment in the two man partnership situation. First, upon the death of one member, the partnership will not be considered terminated if his estate continues to share in the profits or losses of the partnership business. Second, a retiring partner receiving payments under section 736 is considered a partner until his entire interest is liquidated.

The validity of these regulations, however, is questionable. There is no statutory authority for them; indeed they seem to contradict section 708(b). The regulations also conflict with concepts of partnership dissolution developed under state law. If a court decides to ignore the regulations, finding a dissolution under the applicable state law, the possibility of a liquidation is precluded. Such a result is unlikely, however, because of the conceded irrelevance of state partnership law to this area of federal income taxation. The regulations explicitly state that termination of a partnership for federal income tax purposes is not necessarily governed by local law.

There are other difficulties in distinguishing a sale from a liquidation in a two man partnership. There may be a tendency for the remaining partner to commingle his personal and business assets after the dissolution. Thus, it may be difficult to determine whether payments are being made by the business or by the individual. In addition, other tests used to differentiate a sale from a liquidation are inapplicable to the two man partnership situation.

The problems of a two man partnership dissolution are most graphically illustrated by two cases stemming from the same transaction—Charles F. Phillips and Miller v. United States. The Phillips-Miller partnership acted as a sales representative for sporting goods manufacturers. When Phillips retired, Miller retained all partnership assets and agreed to pay Phillips a percentage of the future income received from their main partnership account. The payments thus were being made after the partnership had been dissolved under state

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12 See, e.g., UNIFORM PARTNERSHIP ACT § 29, stating that a partnership is dissolved when any partner "ceases to be associated in the carrying on . . . of the business."
14 See pp. 443-45 infra.
16 67-2 U.S. Tax Cas. ¶ 96685 (Ct. Cl. 1967).
17 40 T.C. at 158.
CORNELL LAW REVIEW

law. Phillips claimed that the proceeds were capital gains, and the Tax Court stressed three facts in upholding this contention: 24 the payments were made by Miller out of his future earnings; Miller signed the agreement as an individual; and the partnership ceased to exist before the payments were made. The contradiction between its third reason and the regulations was ignored by the court. 25 Although the decision turned on the fact that Miller had purchased as an individual, it indicates that in some instances the regulations may be ignored, thereby precluding a finding of liquidation. The applicability of section 736 to a two man dissolution will be severely limited if this result continues to be the law. Prior to Phillips, the judicial tendency was to construe a two man dissolution as a section 741 sale—perhaps covertly subscribing to such a limitation. 26

This tendency to find a sale has been reversed in recent years. Ironically, the major decision supporting the liquidation regulation involved the same transaction as the Phillips case. In Miller v. United States, 27 the continuing partner claimed a deduction under section 736(a) for the payments that Phillips had successfully treated as capital gains three years earlier. The Court of Claims found a section 736 liquidation and specifically mentioned both the applicability of regulation 1.736-1(a)(6) and the Phillips court’s failure to consider it. 28 The court stressed that the language of the agreement, stating that the partnership was dissolved and its assets distributed, indicated a lack of intention for a sale. A few minor decisions previously had allowed liquidation treatment in a two man situation, 29 but Miller is the first decision that clearly follows the regulation.

The Phillips-Miller dichotomy emphasizes the need for developing predictable tests to determine whether a transaction is a sale or a liquidation. The lack of clear standards fosters divergent results since each side of a single transaction may be treated differently. This is logically

24 Id. at 160-61.
26 See Karan v. Commissioner, 319 F.2d 303 (7th Cir. 1963); Kinney v. United States, 228 F. Supp. 656 (W.D. La. 1964), aff’d per curiam, 258 F.2d 738 (5th Cir. 1966). In language somewhat more conclusory than convincing, both of these cases held that the transactions involved were sales.
27 67-2 U.S. Tax Cas. ¶ 9685 (Ct. Cl. 1967).
28 Id. at 85,302-04.
29 Andrew O. Stilwell, 46 T.C. 247 (1966), found a liquidation, but since no continuing payments were involved, the question of the validity of the regulation was not raised. Finkelmeier v. United States, 66-1 U.S. Tax Cas. ¶ 9152 (S.D. Ohio 1965), involved continuing payments to a widow of a deceased partner. A jury found a liquidation, thereby supporting Treas. Reg. § 1.708-1(b)(1)(f)(a) (1956).
unacceptable; the same transaction should not be a sale to one party and a liquidation to the other, depriving the government of revenue in both instances. Moreover, predictability is essential. The differing tax consequences of each transaction require that the individuals be given guidance as to where tax burdens will fall. The confusion created by the Phillips-Miller split is compounded by the fact that divergent lines of authority have been created. The Miller case arising in the Court of Claims did not overrule the Tax Court holding in Phillips. Consequently, a similar split could arise in the next disputed dissolution, and forum shopping will be encouraged.

II

TESTS TO DIFFERENTIATE SALES AND LIQUIDATIONS

Several tests have been proposed to differentiate a sale from a liquidation: the economic consequences test, the maker-of-the-payments test, the source-of-the-payments test, the primary obligation test, and the intent-of-the-parties test. No one test has been consistently applied, nor have most courts clearly defined the criteria they deem determinative. Indeed, the economic consequences test, defining a transfer to all remaining partners on a pro rata basis as a liquidation, has never been specifically applied. In a two man situation where the remaining partner is the purchaser, this test would invariably create a liquidation, since the distribution to the one remaining partner would necessarily be pro rata. This result limits the available choice in a two man partnership in a manner completely opposite that contemplated by Phillips.

The most widely cited case on the sale-liquidation problem is David A. Foxman. Two partners purchased the interest of a third partner for a cash payment made by personal checks, a note in the partnership name, a partnership automobile, and some personally owned stock. The court, misapplying the primary obligation test, found the partners personally bound under the contract and held the transaction to be a section 741 sale. The fact that the partners were only secondarily liable on the note was ignored. The Foxman result is, however, compatible with section 761(d), which defines a liquidation as the termination of a partner’s entire interest by a partnership dis-

31 41 T.C. 535 (1964), aff’d, 352 F.2d 466 (3d Cir. 1965).
32 Id. at 552.
tribution. Thus the court may have implicitly relied on the fact that part of the payment was the buyers' personal stock. In *William T. Wheeling*, the partners' individual liability as primary obligors was again stressed in finding a section 741 sale. Because the contractual liability went beyond the joint liability imposed by local partnership law, it was held to create a new individual obligation.

The primary obligation test may be unreliable since it emphasizes form rather than substance. The party actually bound may not be the one making the payments, and the form of the agreement may not correspond to the parties' understanding of the tax consequences.

In *Karan v. Commissioner*, the court purported to look at the source of the payment as the proper test, finding a sale on the ground that the payment came from the remaining partner's personal funds. This conclusion was reinforced because the individual was bound on a note for the purchase price. The source-of-the-payments test looks more at the substance of a transaction than at its outward form. Since the main statutory distinction between a sale and a liquidation is whether payments are made by the partnership or by individuals, this test may be the most realistic. Its major difficulty is the problem of proving the source of the payment. If an advance cutoff date is used to prevent pre-transaction transfers of assets, this problem is not insurmountable.

*Fitzgerald Atkinson* found a sale based on the supposed intention of the parties. Since the agreement specifically said "sell," and since partnership liquidation procedures were ignored, the court found an intent to treat the transaction as a sale. The partnership was dissolved before the transaction was completed and a corporation was formed to purchase Atkinson's assets. Although the correct decision was reached, the court's reasoning was imperfect because there was no actual partnership to be bound or to act as the source of the liquidation payments.

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33 Swihart, supra note 15, at 1291.
34 1964 P-H Tax Ct. Mem. ¶ 64,128.
35 Id. at 862.
36 See 52 Geo. L.J. 651 (1964) for a note criticizing the Foxman decision on this basis.
37 319 F.2d 303 (7th Cir. 1963).
38 Id. at 306.
39 For example, this could be accomplished through a regulation stating that any transfer of assets within two years of the agreement will be ignored for tax purposes.
40 1964 P-H Tax Ct. Mem. ¶ 64,137.
41 Kinney v. United States, 228 F. Supp. 656 (W.D. La. 1964), aff'd per curiam, 358 F.2d 738 (5th Cir. 1966), involved a similar situation where a corporation was formed from a two man partnership with the remaining partner purchasing all the corporate stock.
Since the statutory framework gives the partners a choice in casting their transaction, intent should be determinative. But three practical problems minimize the utility of this test: (1) the parties, if unable to agree on the tax consequences, may purposely draw a vague agreement and take their chances in court; (2) the partners may be poorly informed, inadvertently hiding their intentions in vague language; and (3) the parties may be completely unaware of the tax consequences and thus have no specific intent with regard to the manner of taxation. Consequently, intent may best serve as an ancillary rather than a primary test.

The maker-of-the-payments test is similar to the primary obligation test in its emphasis on form over substance. The test may be inaccurate since the party making a payment is not necessarily the source of the funds. In a two man situation, it is difficult to call the partnership the maker of the payment since the partnership exists only by virtue of a treasury regulation. Further, a source test is more logical here since the assets of the former partnership are likely to be the actual source of the funds.

Although analysis of the relatively few decisions on the sale-liquidation problem reveals that no one test has been consistently applied, two underlying factors are crucial: (1) the source of the payment, and (2) the language of the agreement which defines the obligor. Most cases would reach the same result if these factors were deemed determinative. The major exception would be the Phillips-Miller dichotomy which is complicated by the problem of regulation 1.736-1(a)(6).

III

FLEXIBLE TAX PLANNING—MORE ILLUSORY THAN REAL

The partnership amendments to the Internal Revenue Code of 1954 reflect Congress’ desire to introduce greater simplicity, flexibility, and equity into partnership taxation law. Presumably, the tax burden on dissolution is to be allocated by the partners bargaining at arms’ length. The partnership sections afford tax options roughly similar to the corporate sections. A section 741 sale is analogous to a shareholder’s

A sale was found through rather confused reasoning which equated a liquidation with a dissolution. Id. at 661-63. However, an application of the source-of-the-payments test would have produced a similar result. An intent test was also applied in Bolling v. Patterson, 61-1 U.S. Tax Cas. ¶ 9417 (N.D. Ala. 1961).

43 Miller v. United States, 67-2 U.S. Tax Cas. ¶ 9685, at 85,301 (Ct. Cl. 1967).
sale of his stock to a third party, both receiving capital gains treatment. A section 736 liquidation is analogous to stock sales to the corporation where, as in section 736, the distribution is either ordinary income or a capital gain, depending on whether it is classified as a dividend, a liquidation, or a redemption.

Unfortunately, as the Phillips-Miller split demonstrates, this flexible approach has undermined the predictability of the tax consequences of partnership dissolution. If the language of the agreement is sufficiently boiler-plated, indicating a clear choice of one alternative, and if payment is made out of the corresponding source, the result is fairly predictable. The danger remains, however, that regulation 1.736-1(a)(6) may be ignored, thereby defeating the partners' intent. The degree of predictability further decreases as the transaction moves away from a precisely worded agreement. Because of the dangers of a Phillips result and the possibility that the partners' intent is not discernible, the flexible framework must be reexamined to determine whether it accomplishes any worthwhile purpose.

By assuming the tax consequences of a transaction, a party, in effect, agrees to pay more for the purchase or to receive less for the sale of his partnership interest. It would be unrealistic to assume that this differential is not reflected in the purchase price. A vendor sells for less if he knows that he will be taxed at the lower capital gains rates rather than at ordinary income rates. The vendee pays more if he can deduct part of the purchase price from ordinary income. In each case, the price paid is the fair market value of the seller's interest, but this fair market value varies with the tax consequences of the transaction. The net economic result of a sale or a liquidation is the same; the only difference is the size of the check that each party writes to the government. The economic consequences are significant only when one party is unaware of the tax variable, when both parties are unaware, or when a court reaches an unpredictable result. Thus a tax

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44 A dividend is defined in Code § 316 and is treated as ordinary income under § 61(a)(7).
45 Liquidations are defined in Code § 346 and are given capital gains treatment under § 331.
46 A redemption is defined in Code § 317(b) and is given capital treatment if the requirements of § 302(b) are met.
47 The Foxman court stated that the attempt at simplicity and predictability has failed. 41 T.C. at 551.
48 For discussions of how to achieve the desired results, see Hewitt, How to Tailor Partnership Buy-out Agreements for Desired Tax Effects, 23 J. TAXATION 168 (1985); Lewis, Tax Aspects of Sale or Termination of a Partnership Interest, 45 TAXES 324 (1967). See also Swihart, supra note 15, at 1250-52.
structure developed to permit flexible tax planning actually produces economic differentials only when the results are unplanned.

CONCLUSION

The solution to this dilemma is two-fold: (1) Decrease the number of cases where the results are unplanned; and (2) subject all unplanned cases to equal tax treatment. The source-of-the-payments test appears to be the most accurate of the judicially formulated tests, because it looks beyond the form of the agreement to determine the actual derivation of the purchase price.\(^{49}\) The selection and consistent application of this test would increase predictability in cases where planning was attempted and would provide consistent results where the tax consequences were unplanned. This approach, however, would be merely a stopgap measure.

A more permanent result might be achieved by amending the regulations to classify as a section 736 liquidation all dissolutions where the remaining partners purchase pro rata.\(^{50}\) This need not destroy whatever flexible tax planning is available under present law. It is still possible to achieve increased capital gains treatment within section 736 by stipulating that part of the payment is for good will.\(^{51}\) Thus some flexibility is present, even if liquidation is the only available alternative. Mandatory use of section 736 means that payments for a partnership interest will be given capital gains treatment,\(^{52}\) but distributive shares and guaranteed payments will be taxed as ordinary income.\(^{53}\) This corresponds to corporate taxation principles; income distributions (dividends) and capital distributions (liquidations or redemptions) are taxed at different rates. It also alleviates the problem of unpredictability which results from a flexible tax program that, in reality, has accomplished nothing.

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\(^{49}\) See pp. 443-45 supra.

\(^{50}\) See H.R. 9662, 86th Cong., 2d Sess. § 201 (1960). The Senate Finance Committee recommended a similar result in a proposed amendment to this bill. See S. Rep. No. 1616, 86th Cong., 2d Sess. 103-04 (1960). Swihart recommended this as a solution to the problem of distinguishing sales from liquidations. Swihart, supra note 15, at 1240.

\(^{51}\) Code § 736(b)(2)(B).

\(^{52}\) Id. § 736(b).

\(^{53}\) Id. § 736(a).