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Federal Income Taxation of Partnerships (Book Review)

Benjamin Harrow

FEDERAL INCOME TAXATION OF PARTNERSHIPS. By Paul Little. Boston: Little Brown and Co., 1951. Pp. xxv, 469. $12.50.

The tax fraternity is fortunate in now having available a new treatise on the income taxation of partnerships, one of the more troublesome areas in the administration of the income tax law. The problems stem from the legal nature of a partnership as it affects the taxation of income. Common law knows a partnership to be an aggregate of individuals who are cotenants of each asset held by the partnership. Under this theory the partnership may not be treated separate and apart from the partners. Modern economic development has necessitated considerable modification of this theory of partnerships, and has superimposed upon it the entity theory which treats the partnership, in some instances, as a juristic entity separate and apart from the individual partners. The tax law seems to be torn apart by the impact of both theories with the result that Congress, the courts, and of course the taxpayers are in a state of confusion. It is not always clear under what theory a case will be or should be decided. To determine the income of a partnership business the partnership is treated as an entity but the income, itself, is then taxed to the partners as individuals, the partnership itself not being taxed. This is quite different from the tax treatment of a corporation which is taxed as a separate entity even though the stockholders are also taxed on any corporate income distributed to them as individuals.

The tax consequences of a dissolution and termination of a partnership create special problems. If a corporation dissolves and distributes its assets to its stockholders there is a completed tax transaction,[1] resulting in an immediate gain or loss to the stockholders, represented by the difference between the cost of the stock to them and the fair market value of the assets they receive in the liquidation. But if the partnership dissolves and terminates it is not a separate entity for that purpose, and there is no completed tax transaction unless the assets have been reduced to cash. A partner's interest in a firm, after much litigation and confusion, has finally come to be recognized as a capital asset, separate and apart from the assets of the firm. A distribution of the assets to the partners thus becomes a recovery of that capital interest. If what the partner receives is all in the form of cash, he may have a capital gain or loss. If he receives property in kind, no tax results until the subsequent sale of the property by the partner. However, upon receipt of the property in kind its basis for subsequent gain or loss is determined by relating it to the capital interest of the partner, since that is really what the partner is receiving, and not the basis of the property to the firm. Some strange computations may result from this attempt to impose the entity and aggregate theories on partnership distributions.

Suppose the partners in such a distribution receive the inventory of the firm. Normally the sale of stock in trade-inventory, results in ordinary gain subject to normal and surtax rates. Does the distribution of the inventory and subsequent sale by the partners convert ordinary income into capital gain?

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[1] Except in the case of a dissolution covered by the provisions of Section 112-b(7) of the Internal Revenue Code.

To this reviewer that is exactly what happens since the sale of the inventory by the partner becomes a recovery of his capital interest in the firm. When the firm sells the inventory it is done in the regular course of its trade or business. When the individual partner sells it, it is not in the course of a trade or business. Unfortunately, the author did not treat this phase of the tax aspects of partnerships although the subject does merit study.

The distribution of partnership property in kind to a partner may lead to some weird results. The regulations provide that the distributee realizes no gain or loss upon the distribution. The Commissioner, applying the aggregate theory has found this situation to be a sale or exchange of the partner's interests in the distributed asset, and in that way determined the income taxable to the remaining partners. The allocation of a new basis to the distributed asset related to the partner's capital interest is troublesome. In considering adequate solutions, the author might have found some help in accounting theory and practice.

The mere enumeration of some of the problems of taxation attaching to partnerships indicates the scope of research and thought that must be done in this area of the law of taxation. The excellent analysis of the problems noted, and others, offered by Mr. Little is thus doubly welcome. The author not only presents the problems, documented with relevant cases, but he offers his own suggestions for resolving the conflicts. Thus, for example, he suggests that the partnership be treated as an entity for the purpose of purchasing property from a partner.

Because of the complexity of the problems involved, it is sometimes difficult to present the issues clearly. The author was probably conscious of this fact, and has attempted to avoid its consequences. Thus, much space has been devoted to the presentation of illustrative examples of the questions raised, together with their probable solutions. Unfortunately, however, the author has not been entirely successful in his efforts to dispel the confusion, and the average reader, unfamiliar with the problems considered, will miss the significance of some of them.

The book contains an excellent bibliography of the material which is available on the many problems discussed by the author. In addition, an appendix contains an outline of the American Bar Association Symposium on the Taxation of Partnerships. The symposium represents the work of a committee which attempted to deal with some of the problems created by the coexistence of the entity and aggregate theories of Partnership.

BENJAMIN HARROW.*

* Professor of Taxation, St. John's University School of Law.