Washington Law Review

Volume 94 | Number 1

3-1-2019

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TAXING SELLING PARTNERS

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Abstract: When a partner sells a partnership interest, the resulting gain or loss is treated as capital gain or loss, except to the extent that the partnership holds certain items whose sale would result in gain or loss that was not capital. Seemingly, the purpose of this regime is to prevent taxpayers from obtaining more favorable treatment by selling an interest in a partnership than what would result if the partnership were to sell its underlying assets. But given this legislative aim, the existing tax provisions produce results for taxpayers that are both unduly favorable (in that sale of a partnership interest sometimes receives more beneficial treatment than sale of underlying assets) and unduly unfavorable (in that, in other instances, sale of a partnership interest triggers a less beneficial outcome than the sale of underlying assets).

The design of the partnership tax rules also necessitates piecemeal reform as taxpayers discover new opportunities to benefit from unduly favorable results produced by the partnership tax regime. Most recently, in December 2017, Congress adopted legislative reform to address one such instance involving the sale of a partnership interest by a non-U.S. person.

In addition, the method used by the partnership tax rules requires Congress to update the statute governing sale of a partnership interest to take into account potential ripple effects of unrelated legislative changes. As a result, the design is error prone because, inevitably, Congress overlooks and fails to address these potential ripple effects. Changes enacted by Congress in December 2017 provide at least one example of this phenomenon. In particular, Congress enacted a new restriction on the deductibility of losses incurred in a trade or business. However, Congress did not provide for a corresponding modification to the tax provisions governing sale of an interest in a partnership—creating the potential for another way in which the existing statutory design is unduly favorable.

Some of the problems identified by this Article existed long before the adoption of significant tax legislation in December 2017; one of the problems was partially (but incompletely) addressed by that legislation and one of the problems was created by that legislation. To address each of the failings that it identifies, this Article proposes equating the tax treatment of the sale of a partnership interest with the tax treatment of the sale of underlying assets in all cases.

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INTRODUCTION

The tax treatment of a partner's sale of his or her interest in a partnership is flawed. The apparent aim of the statutory provisions governing the tax treatment of such sales is to ensure that the sale of a partnership interest receives tax treatment equivalent (in most cases) to the sale of the partnership's underlying assets, at least with respect to whether the gain or loss recognized is ordinary or capital.[1] However, rather than simply provide that the selling partner will receive the same treatment that would result from a sale of underlying assets, partnership tax law takes a more convoluted approach, ostensibly aimed at avoiding the need to value each of the partnership's underlying assets.[2] In particular, a partner who sells an interest in a partnership recognizes ordinary income or loss that would result from a sale of underlying assets only to the extent that the partnership holds certain assets ("inventory items" and "unrealized receivables"), the sale of which would lead to the recognition of ordinary income or loss.[3] Any remaining gain or loss recognized by the partner is treated as gain or loss from a sale of the

1. *See infra* Part II (discussing aim of statutory provisions). For some taxpayers, ordinary income generally receives less favorable tax treatment than capital gain. *See infra* note 77 and accompanying text (discussing generally less favorable treatment of ordinary income for some taxpayers).

2. *See infra* Parts I and II.

3. I.R.C. § 751(a) (2018); *see infra* Part I.

partner's interest in the partnership and, thus, receives capital gain or loss treatment.[4]

When enacting the provisions governing sale of a partnership interest in the 1950s, Congress was motivated by the concern that selling partners would convert what would otherwise be ordinary income (resulting from sale of underlying assets) into capital gain (by selling a partnership interest).[5] Yet any discrepancy between the tax treatment of the sale of a partnership interest and the tax treatment of the sale of underlying assets is problematic—not merely the distinction between ordinary income and capital gain. When the two routes of exit receive different tax treatment, sophisticated taxpayers will structure their exits from a partnership to entail either a sale of their partnership interests or a sale of underlying assets,[6] whichever produces the most favorable tax outcome.[7] By contrast, unsophisticated taxpayers will select a route of exit without considering the resulting tax consequences and may, inadvertently, select the route that produces less advantageous tax treatment.[8] Thus, according different tax treatment to the two possible routes of exit produces tax revenue loss (as a result of tax planning by sophisticated parties),[9] unfairness (as a result of unsophisticated taxpayers overlooking the same tax planning opportunities),[10] and may increase tax planning costs incurred by taxpayers who assess relevant tax consequences when structuring their

4. I.R.C. § 741; *see infra* Part I.

5. *See infra* note 76 and accompanying text. For some taxpayers, ordinary income generally receives less favorable tax treatment than capital gain. I.R.C. § 1(h); *see infra* text accompanying note 77.

6. In a situation in which not all partners are exiting the business, sale by the partnership of its underlying assets may not be a feasible route of exit. In that situation, a selling partner who aimed to obtain the tax consequences of an asset sale might, instead of selling his or her partnership interest, have the partnership distribute to him or her a pro rata interest in each of the partnership's underlying assets and then sell those assets. For an example, see Example 8A, *infra* Section III.D.

7. This is true, in general, of any opportunity to engage in tax planning. For further discussion, see, for example, Heather M. Field, *Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System*, 47 HARV. J. ON LEGIS. 21, 24 (2010) ("[S]cholars . . . generally criticize tax elections as . . . revenue-reducing . . . ."); David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1319 (2001) ("[When tax planning is curtailed] more revenue is collected, so the government is funded without need for other taxes that are less appealing.").

8. Any opportunity to engage in tax planning presents a similar advantage to sophisticated taxpayers. For further discussion, see, for example, Field, *supra* note 7, at 24 ("[S]cholars . . . generally criticize tax elections as . . . inequitable . . . ."); Schizer, *supra* note 7, at 1319 ("Since wealthy and well advised taxpayers have an edge in planning, limiting this advantage [by curtailing tax planning] can lead to a more equitable distribution of tax burdens.").

9. *See supra* note 7 and accompanying text.

10. *See supra* note 8 and accompanying text.

exit from a partnership.[11] Given this more general objection to varying tax outcomes, rather than merely concerning themselves with whether any resulting gain or loss is capital or ordinary, lawmakers ought to be concerned whenever the tax treatment of the sale of a partnership interest produces tax consequences that differ from the tax treatment of the sale of underlying assets.

Congress's approach is problematic because it may be unduly favorable or unduly unfavorable to taxpayers compared to an approach that more accurately equates the tax treatment of a partnership interest sale with the tax treatment of an underlying asset sale. It is unduly *favorable* because the statutory scheme does not always prevent a partner from obtaining more favorable treatment by selling a partnership interest than what would arise if the partnership sold its underlying assets.[12] It is unduly *unfavorable* because selling a partnership interest can sometimes trigger less favorable tax treatment than what would occur if the partnership sold its underlying assets.[13]

In December 2017, Congress adopted tax legislation (the 2017 Tax Act)[14] that partially addressed one specific way in which the approach

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11. Whether or not equating the tax consequences of the different routes of exit would reduce planning costs is not entirely clear. This could occur, or it is possible that taxing the transactions similarly could induce taxpayers to make even more costly modifications to their transactions to obtain more favorable tax treatment. *See, e.g.*, David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1320 (2001) ("[E]ven if some planning is stopped, total planning waste could still increase if those who continue to plan face higher costs."); David A. Weisbach, *Disrupting the Market for Tax Planning*, 26 VA. TAX REV. 971, 973 (2007) ("[A]s the government shuts down the easy to find and use shelters, taxpayers must spend more to find new ones and also more to implement the new ones."); David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215, 239 (2002) ("[B]ecause we cannot perfectly identify shelters, attacks on shelters make those shelters that remain worse."); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in Tax Law*, 84 CORNELL L. REV. 1627, 1670 (1999) ("If a line is too hard to avoid, there may be few shifts, but each shift will have a large cost. Making the line easier to avoid effectively reduces the tax on an activity because it is cheaper to avoid the tax."). *See generally* Philip A. Curry et al., *Creating Failures in the Market for Tax Planning*, 26 VA. TAX REV. 943 (2007) (discussing how policymakers face a trade-off when considering taking steps to attack current tax planning strategies, namely, the trade-off between (i) costs arising from taxpayers' use of those current tax planning strategies and (ii) costs arising from taxpayers' search for new tax planning strategies once the existing methods are attacked).

12. *See infra* Part III for discussion of specific examples.

13. *See infra* Part III.

14. Although the media has frequently referred to this legislation as the "Tax Cuts and Jobs Act," that shortened name for the legislation is technically incorrect. *See, e.g.*, Eli Watkins, *Senate Rules Force Republicans to Go with Lengthy Name for Tax Plan*, CNN (Dec. 19, 2017, 10:14 PM), https://www.cnn.com/2017/12/19/politics/tax-bill-name-delay/index.html [https://perma.cc/VBN5-VT3C] (shortening name of tax plan bill did not have budgetary impact and therefore could not pass senate with a simple majority).

produces unduly favorable outcomes.[15] Prior to the changes, a non-U.S. person[16] who held an interest in a partnership that conducted a trade or business in the United States could obtain more favorable treatment by selling an interest in the partnership than what would occur if the partnership sold its underlying assets.[17] Congress adopted a narrow solution[18]—one that addressed only this instance of unduly favorable treatment.[19] Moreover, even in the context of this particular fact pattern, Congress's solution would still allow the non-U.S. person to obtain more favorable treatment by selling the partnership interest in some cases.[20]

A better solution—one that addresses all instances of unduly favorable and unduly unfavorable treatment—would grant a selling partner the same treatment that follows from a sale of the partnership's underlying assets.[21] Such a reform, by design, would ensure that the tax treatment of the sale of a partnership interest was precisely the same as the treatment of a sale of the partnership's underlying assets.

It might be tempting to write off the law's shortcomings as a necessary evil—Congress opted to avoid the need to value every underlying asset of a partnership[22] and an unfortunate but unavoidable side-effect of doing so is some lack of precision.[23] In other words, some discrepancies between the tax treatment of the sale of a partnership interest and the tax treatment of a sale of underlying assets will necessarily arise unless Congress requires valuation of every underlying asset at the time of the sale of a partnership interest.[24] Given that the results are sometimes more favorable to taxpayers[25] and sometimes less favorable to taxpayers[26] than a technique that precisely mirrors the results of a sale of the partnership's underlying assets, perhaps the deviations balance out so that, on net, not much revenue is lost. This assumption, however, is likely mistaken.

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15. H.R. REP. NO. 115-466, at 88–90 (2017) (Conf. Rep.); *see infra* Section III.A for further discussion.

16. "Non-U.S. person" refers to an individual who, or entity that, is not a "United States person" as defined in I.R.C. § 7701(a)(30) (2018).

17. *See infra* Section III.A.

18. H.R. REP. NO. 115-466, at 88–90 (2017) (Conf. Rep.).

19. *See infra* Section III.A.

20. *See infra* Section III.A.

21. *See infra* Part IV.

22. *See infra* Part II.

23. *See infra* Part III.

24. *See infra* Part III.

25. *See infra* Sections III.A, III.B, III.C.

26. *See infra* Section III.D.

Sophisticated taxpayers will plan their affairs to take advantage of the ways in which the law is unduly favorable.[27] Only unsophisticated taxpayers who fail to engage in adequate tax planning will bear the burden of the additional tax liability when the current law's approach produces unduly unfavorable results.[28] Thus, adopting reform that avoids both unduly favorable and unduly unfavorable results would likely mitigate tax revenue loss as well as allay the unfairness that results from imposing higher tax burdens on unsophisticated taxpayers. Equating the tax treatment of the two routes of exit could also reduce planning costs.[29]

In addition to eliminating the potential for unduly favorable or unduly unfavorable results arising under the existing partnership tax provisions, this Article's proposal obviates the need for Congress to make ad hoc changes to the rules governing the sale of a partnership interest in order to update the law to take into account the ripple effects of legislative changes to other tax provisions.[30] Any time Congress adopts a provision that leads to any item of gain or loss being treated less favorably than the gain or loss that would arise from sale of a partnership interest, there is a risk that Congress might inadvertently fail to make corresponding changes to the provisions governing the tax treatment of a sale of a partnership interest.[31] Those instances offer additional opportunities for partners to obtain more favorable treatment by selling an interest in a partnership in lieu of causing the partnership to sell its underlying assets.[32] Changes enacted by Congress as part of the 2017 Tax Act provide at least one example of this phenomenon.[33] As part of that Act, Congress enacted a new restriction on the deductibility of losses incurred in a trade or business, but it did not provide for a corresponding modification to the tax provisions governing sale of an interest in a partnership—creating another way in which the

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27. In this way, the ability to obtain tax benefits by structuring a partner's exit from a partnership with tax consequences in mind is no different from any other instance in which taxpayers, by making either explicit or implicit tax elections, can affect the tax treatment of a given transaction. *See supra* notes 7, 8 and accompanying text. In a situation in which not all partners are exiting the business, sale by the partnership of its underlying assets may not be a feasible route of exit. In that situation, a selling partner who aimed to obtain the tax consequences of an asset sale might, instead of selling his or her partnership interest, have the partnership distribute to him or her a pro rata interest in each of the partnership's underlying assets and then sell those assets. For an example, see Example 8A, *infra* Section III.D.

28. *See supra* text accompanying note 10.

29. Whether equating the tax consequences of the different routes of exit would reduce planning costs is not entirely clear. *See supra* note 11.

30. *See infra* Section III.E.

31. *See infra* Section III.E.

32. *See infra* Sections III.B, III.E.

33. *See infra* Section III.B.

existing statutory design potentially produces unduly favorable results.[34] To reduce the risk of this type of error occurring in the future, Congress should simply provide that a selling partner receive the same treatment that results from a sale of the partnership's underlying assets. Doing so would automatically account for potential future changes in the federal tax code and eliminate any risk that a future Congress would fail to update the statute to take into account unrelated changes.[35]

For all of these reasons, the tax treatment of selling partners should be modified to provide that a selling partner will receive the same treatment that would result from a sale of the partnership's underlying assets.[36] As mentioned above, existing law's failure to require such treatment appears to stem from concern about the complexity that such treatment would entail—in particular, the resulting need to value each of the partnership's assets.[37] However, concerns about additional resulting complexity are overstated because any work required of taxpayers by this proposal is either already required by tax law or, as a practical matter, may be undertaken for non-tax business reasons.[38]

This Article is not the first to propose treating the sale of a partnership interest in this manner. The American Law Institute, for example, proposed this technique in 1984.[39] Scholars have also expressed their approval of this treatment.[40] This Article contributes to the existing discussion of the tax treatment of selling partners by shedding new light on the problems that arise from the failure to equate the tax treatment of the sale of a partnership interest with the tax treatment of the sale of underlying assets, particularly as demonstrated by recent legislative changes.

This Article proceeds as follows. Part I describes the current tax treatment of selling partners. Part II explains the rationales that underlie the existing rules. Part III discusses the shortcomings of current law and supplies specific examples of ways in which current law produces unduly

34. *See infra* Section III.B.

35. *See infra* Section III.E.

36. *See infra* Part IV.

37. *See infra* Part II.

38. *See infra* Part IV.

39. AM. LAW INST., FEDERAL INCOME TAX PROJECT – SUBCHAPTER K: PROPOSALS OF THE AMERICAN LAW INSTITUTE ON THE TAXATION OF PARTNERS 22–36 (1984) ("Fragmentation of Gain and Loss on Disposition of a Partnership Interest").

40. *See* Bradley T. Borden, *Aggregate-Plus Theory of Partnership Taxation*, 43 GA. L. REV. 717 (2009); Philip F. Postelwaite, Thomas E. Dutton & Kurt R. Magette, *A Critique of the ALI's Federal Income Tax Project—Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423, 580–81 (1986).

favorable and unduly unfavorable results. Part IV proposes and evaluates potential reform that bestows upon a selling partner the same tax treatment that would result from a sale of the partnership's underlying assets.

I. CURRENT LAW

The tax treatment of selling partners reflects the combined influence of the entity view of partnerships and the aggregate view of partnerships.[41] Under the entity view, a partnership is treated as something separate from its partners, and, therefore, a partner's interest in a partnership is characterized as something separate and apart from the partner's allocable share of the underlying assets and liabilities of the partnership.[42] Under the aggregate view, a partnership is treated as simply an aggregate of its partners, and, therefore, a partner's interest in a partnership is deemed to be merely an interest in an allocable share of the underlying assets and liabilities of the partnership.[43]

The method for characterizing the gain or loss recognized on sale or exchange of an interest in a partnership reflects a compromise between the two views.[44] Section 741 of the Internal Revenue Code sets forth an entity approach to characterizing the gain or loss, and § 751(a) of the Internal Revenue Code provides for an aggregate approach overlay.[45] In particular, under § 741, except as otherwise set forth in § 751, gain or loss on the sale of an interest in a partnership will be treated as gain or loss from the sale or exchange of a capital asset.[46] Section 751(a) requires looking through to the partnership's underlying assets but only if the

41. *See, e.g.*, WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02[3] (2018) ("The entity approach . . . predominates in the treatment of transfers of partnership interests as transfers of interests in a separate entity rather than in the assets of the partnership. []Aggregate notions come into play in this area as well, however, particularly in connection with § 751(a), which examines the character of partnership assets in determining the tax consequences to the transferor of a partnership interest . . . .").

42. *Id.* ¶ 1.02[2] ("An entirely different scheme of taxation results if partnerships are considered entities separate from the partners. Viewed in these terms . . . transfers of partnership interests would generally be taxed without regard to the character or basis of the entity's assets.").

43. *Id.* ¶ 1.02[1] ("If a pure aggregate approach to the taxation of partners and partnerships were applied, Subchapter K would be largely unnecessary. Each partner would be directly taxable on a share of partnership income and would be viewed as owning a direct interest in each partnership asset. . . . The sale of a partnership interest would be treated as the sale of undivided interests in partnership assets, with the amount realized by the seller fragmented, asset-by-asset . . . .").

44. *See id.* ¶ 1.02.

45. *Id.*

46. I.R.C. § 741 (2018).

partnership holds "unrealized receivables"[47] or "inventory items"[48] (unrealized receivables and inventory items are commonly referred to as "hot assets").[49] The selling partner will realize ordinary income or loss equal to the net amount of income or loss that would have been allocated to the selling partner with respect to the transferred interest upon disposition by the partnership of all hot assets for fair market value, immediately prior to the disposition of the selling partner's interest.[50] Any remaining realized gain or loss from sale of the partnership interest is capital gain or loss.[51]

At this stage, some concrete examples are in order.

> **Example 1**. Two individuals, Rebecca and Paula, operate a business through an entity treated as a partnership for tax purposes. Rebecca and Paula share equally in all gains and losses of the partnership. The partnership holds inventory, the sale of which would give rise to ordinary income or loss if sold by the partnership, and the partnership holds a capital asset, the sale of which would give rise to capital gain or loss if sold by the partnership. In particular, assume Rebecca and Paula each contributed $50,000 to the partnership upon formation. Assume the partnership acquired the capital asset for $25,000 and the

47. "Unrealized receivables" include any rights to payment for goods or services if collection of the payment or selling the right would give rise to ordinary income. *See* I.R.C. § 751(c). In addition, the term "unrealized receivables" is defined to include an expanding hodgepodge list of other items the sale of which gives rise to tax items other than exclusively capital gain or loss pursuant to other provisions of the code. *See id.* In the case of some of these other items, in some instances, only a portion of the resulting gain would be ordinary if the asset were sold by the partnership and in those cases, I.R.C. § 751 provides that only that portion is ordinary when the partner sells his or her interest in the partnership. For example, this is true of the depreciation recapture recognized on sale of certain depreciable assets. *See id.* ("For purposes of this section and sections 731, 732, and 741 . . . such term [unrealized receivables] also includes . . . section 1245 property (as defined in section 1245(a)(3)) . . . but only to the extent of the amount which would be treated as gain to which section . . . 1245(a) . . . would apply if (at the time of the transaction described in this section or section 731, 732, or 741, as the case may be) such property had been sold by the partnership at its fair market value.").

48. "Inventory items" include property described in I.R.C. § 1221(a)(1) ("stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business") and any assets that would be characterized in that fashion if held directly by the selling partner. *See* I.R.C. §§ 751(d), 1221(a)(1). Inventory items also include certain other assets, the sale of which gives rise to ordinary income. *See id.* § 751(d).

49. *Id.* § 751(a).

50. Treas. Reg. § 1.751-1(a)(2) (2018).

51. *Id.*

inventory for $75,000. The capital asset declines in value to $15,000, and the inventory appreciates in value to $105,000.

If the partnership in Example 1 sells its underlying assets and liquidates, the partnership recognizes $30,000 of ordinary income from sale of the inventory.[52] The partnership itself is not subject to entity-level tax on this income, but rather the partnership allocates it to Rebecca and Paula so that they take the income into account when computing their individual taxable income.[53] Because the partners share equally in all gains and losses in Example 1, the partnership allocates $15,000 of ordinary income to each partner. The partnership recognizes $10,000 of capital loss from sale of the capital asset, allocated $5,000 to each of Rebecca and Paula.[54] When each partner receives half of the resulting proceeds ($60,000) on liquidation, they recognize no further gain or loss.[55] Thus, each partner recognizes, in total, $15,000 of ordinary income (attributable to the partnership's inventory) and $5,000 of capital loss (attributable to the partnership's capital asset).

Now imagine, in Example 1, instead of the partnership selling its underlying assets and liquidating, Rebecca sells her interest in the partnership to Josh for $60,000. If tax law took the "entity approach," it would treat Rebecca as if she sold an interest in a partnership that was a separate and distinct asset from any of the partnership's underlying assets.[56] Under this approach, her sale for $60,000 of an interest in the partnership that she acquired for $50,000 would result in $10,000 of capital gain from sale of her interest in the partnership.[57] Thus, Rebecca achieves more favorable tax consequences than what would have

52. *See* I.R.C. § 1001. $30,000 represents the difference between the fair market value of the inventory ($105,000) and the partnership's basis in the inventory ($75,000).

53. *See id.* § 701.

54. *See id.* § 1001. $10,000 represents the difference between the fair market value of the capital asset ($15,000) and the partnership's basis in the capital asset ($25,000).

55. When each partner contributed $50,000 to the partnership, each partner's initial basis in her partnership interest would become $50,000. *See id.* § 722. When each partner is allocated $15,000 of ordinary income, each partner's basis in her partnership interest increases by $15,000 to become $65,000. *See id.* § 705(a)(1)(A). When each partner is allocated $5,000 of capital loss, each partner's basis in her partnership interest decreases by $5,000 to become $60,000. *See id.* § 705(a)(2)(A). When each partner receives a liquidating distribution of $60,000, she recognizes no gain or loss because the amount of the distribution is no more or less than her basis in the partnership interest. *Id.* § 731(a).

56. *See supra* notes 41–42.

57. *See supra* notes 41–42.

followed if the partnership had sold the underlying assets and provided Rebecca with her share of the resulting proceeds.[58]

If tax law took the "aggregate approach," it would treat Rebecca as if she had, in essence, sold her share of each of the partnership's underlying assets.[59] Under this aggregate approach, Rebecca recognizes $15,000 of ordinary income from a sale of her interest in the inventory and $5,000 of capital loss from a sale of her interest in the capital asset, precisely (and by design) the same items that she would recognize if the partnership had, in fact, sold its underlying assets and distributed to Rebecca her share of the proceeds.[60]

Tax law, in fact, takes a third approach (the hybrid approach) that is a combination of the two approaches.[61] Under this approach, if the partnership holds any hot assets, then the selling partner will recognize ordinary income or loss equal to the gain or loss that would be allocated to the selling partner if those assets were sold for fair market value.[62] In addition, the partner will recognize gain from sale of the partnership interest in whatever amount necessary so that the total gain or loss recognized by the partner is equivalent to the difference between the consideration received by the partner in exchange for his or her partnership interest and his or her basis in the partnership interest.[63] Under this hybrid approach, in Example 1, when Rebecca sells her partnership interest, she recognizes $15,000 of ordinary income because that is the amount of income that would be allocated to her if the partnership sold its inventory for fair market value.[64] In total, she must recognize $10,000 of

58. The asset sale would have resulted in her recognizing $15,000 of ordinary income and $5,000 of capital loss. Assuming she has no capital gain from other sources, only $3,000 of the capital loss could be used against her $15,000 of ordinary income in the current year, resulting in $12,000 of ordinary income. *See* I.R.C. § 1211(b). Thus, she would be taxed on $12,000 of ordinary income as a result of the sale of underlying assets rather than the $10,000 of capital gain that would result from sale of the partnership interest under the pure entity view. Moreover, assuming the partner's holding period in the partnership interest was more than one-year, the $10,000 capital gain would be subject to tax at a lower rate than the $12,000 of ordinary income. *See id.* §§ 1222, 1(h).

59. *See supra* note 43.

60. *See supra* note 43.

61. *See supra* note 41.

62. *See supra* notes 46–51 and accompanying text. This result is subject to adjustment in some cases in which not all of the gain resulting from sale of the underlying asset would be ordinary income. *See supra* note 47.

63. *See supra* notes 46–51 and accompanying text.

64. The partnership's basis in the inventory is $75,000 and the fair market value of the inventory is $105,000. Therefore, if the partnership sold the inventory for fair market value ($105,000), the partnership would recognize gain of $30,000 ($105,000 minus $75,000). I.R.C. § 1001 (2018). Because the partners share all gains and losses equally, half of this amount ($15,000) would be allocated to each partner. *Id.* § 704.

gain, the difference between the $60,000 selling price and her $50,000 basis in the partnership interest. Thus, she must recognize a $5,000 loss from sale of her interest in the partnership (treated as capital loss), so that the $5,000 loss netted against the $15,000 of ordinary income results in $10,000 gain on net.[65]

In Example 1, the hybrid approach reaches the same end result as the aggregate approach, but the route to the result is slightly different. In order to demonstrate, consider the following example.

> **Example 2**. The facts are the same as Example 1 but instead of holding one capital asset worth $15,000 that was acquired for $25,000, the partnership holds fifty capital assets worth a total of $15,000 that were acquired for a total of $25,000. The partnership also holds inventory that it acquired for $75,000 and that has a current fair market value of $105,000. Rebecca sells her interest in the partnership to Josh for $60,000.

Strictly applying the aggregate approach to Example 2 entails valuation of each of the fifty capital assets to determine the capital gain or loss that would be allocated to Rebecca from a sale of each of those assets.[66] In addition to $15,000 of ordinary income representing Rebecca's share of the appreciation in the partnership's inventory, Rebecca would recognize each item of capital gain or loss that would be allocated to her from a sale of each of the fifty capital assets.[67] Each of those items of capital gain or loss would be treated as long-term capital gain or loss or short-term capital gain or loss based on the partnership's holding period for each of the fifty assets, and each item of capital gain or loss would carry with it any other relevant tax outcome that would result from a direct sale of the underlying asset.[68] Under the hybrid approach, the only underlying asset that needs to be valued is the inventory, leading to the determination that Rebecca recognizes $15,000 of ordinary income.[69] Rebecca recognizes capital gain or loss of whatever amount is necessary to make it so that Rebecca's total gain or loss equals the difference between the consideration she receives in exchange for her partnership interest[70] and her basis in the partnership

65. *See* Treas. Reg. § 1.751-1(g)(i)(A) (2018).

66. *See supra* note 43.

67. *See supra* note 43.

68. *See supra* note 43.

69. *See supra* note 64 and accompanying text.

70. This would include liability relief in a case in which the partnership had incurred debt. *See* I.R.C. § 752(d) (2018); Treas. Reg. § 1.752-1(h).

interest.[71] In this case, she recognizes $5,000 of capital loss (which is all treated as long-term or short-term based on her holding period in the partnership interest).[72]

II. PURPOSE OF CURRENT LAW

When taxing a selling partner, Congress could have utilized a pure entity approach—one that would have determined the partner's total gain or loss based on the difference between the consideration received by the partner and his or her basis in the partnership interest and characterized it as all capital gain or loss from the sale of an interest in the partnership.[73] Alternatively, Congress could have employed a pure aggregate approach—one that would have treated the selling partner as if the partner had sold the partner's share of each underlying asset.[74] In lieu of exclusively using one approach or the other, Congress utilized a bit of both—factoring in underlying assets is required only to the extent that the partnership holds hot assets and any residual gain or loss recognized by the partner is treated, consistently with the entity view, as capital gain or loss resulting from a sale of the partnership interest.[75]

Legislative history[76] suggests that Congress avoided the pure entity approach to prevent taxpayers from using partnerships to convert what would otherwise be ordinary income into capital gain (currently taxed at lower rates than ordinary income for non-corporate taxpayers).[77] In order to demonstrate, consider the following example.

71. *See, e.g.*, Treas. Reg. § 1.751-1(g)(i)(A) (giving example).

72. For further discussion of how the difference between the hybrid approach and the aggregate approach can affect whether capital gains or losses recognized by Rebecca are long-term capital gains or losses or short-term capital gains or losses, see *infra* Section III.C.

73. *See supra* note 42 and accompanying text.

74. *See supra* note 43 and accompanying text.

75. *See supra* note 41 and accompanying text.

76. *See* H.R. 8300, 83rd Cong., 100 CONG. REC. 3428 (1954) (enacted) ("Under existing law, a tax at ordinary income rates can be avoided by the members of a partnership through the devices of liquidating the partnership or selling an interest in the partnership."); S. REP. NO. 83-1622, at 4731 (1954) ("In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests or by distributions of property, certain rules have been adopted by the House and your committee which will apply to all dispositions of partnership interests."); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 235 (1999) ("[The rules related to 'hot assets'] essentially insure that the transfer of a partnership interest be viewed as a transfer of the underlying assets in order to preserve the character of gain or loss inherent in the transfer.").

77. *See* I.R.C. § 1(h) (2018).

> **Example 3**. Kate and Randall each contribute $10,000 cash to a newly formed partnership in which they are equal partners. The partnership acquires inventory for $20,000. The inventory appreciates in value to $50,000. Kate sells her interest in the partnership to Kevin for $25,000.

If the pure entity approach dictates the tax treatment of this transaction, Kate recognizes $15,000 of capital gain from a sale of her interest in the partnership.[78] The gain would be characterized as capital despite the fact that, if the partnership sold the underlying inventory, Kate would recognize $15,000 of ordinary income.[79] Thus, under a pure entity approach, selling a partnership interest could convert ordinary income into capital gain. Moreover, Kate's share of the appreciation in the inventory could forever escape taxation at ordinary income rates. This occurs because the partnership can elect to adjust its basis in underlying assets following the sale of an interest in the partnership in a way that ensures that the gain on which Kate pays tax when she sells her partnership interest is not taxed a second time when the partnership sells its assets.[80] Provided that the partnership makes such an election, if the partnership sells the inventory for $50,000 after Kevin acquires the partnership interest from Kate, the partnership allocates $15,000 of ordinary income to Randall and no gain or loss to Kevin.[81] Thus, of the $30,000 total appreciation in the inventory, Kate is subject to tax on $15,000 (but at capital gains rates rather than ordinary income rates) and Randall is subject to tax on $15,000 (at ordinary income rates).

Under the hybrid approach actually used by the tax code, Kate recognizes $15,000 of ordinary income (rather than $15,000 of capital gain) upon sale of her interest in the partnership.[82] Upon a subsequent sale by the partnership of the inventory for $50,000, the partnership would allocate $15,000 of ordinary income to Randall and no gain or loss to Kevin.[83] Thus, of the $30,000 total appreciation in the inventory, Kate will be subject to tax on $15,000 at ordinary income rates and Randall will be subject to tax on $15,000 at ordinary income rates. As a result, at least in

78. *See supra* note 42.

79. Given that the partnership holds the asset as inventory, when the partnership sells the asset, the gain allocated to Kate is treated as ordinary income. *See* I.R.C. § 702(b).

80. *See* I.R.C. §§ 743, 754.

81. *See id.*

82. *See id.* § 751(a).

83. This, once again, assumes that an election has been made under § 754 to adjust the partnership's basis in its assets. *See supra* note 80 and accompanying text.

this example, the tax code harmonizes the tax treatment of the sale of a partnership interest with the tax treatment of the sale of the partnership's underlying assets, foreclosing the possibility of converting ordinary income into capital gain through sale of a partnership interest.[84]

As just discussed, Congress spurned the pure entity approach to prevent taxpayers from converting ordinary income into capital gain.[85] This same objective could have been achieved by using a pure aggregate approach in lieu of the hybrid approach actually used. Under a pure aggregate approach, the selling partner would receive the same treatment that would follow from a sale of each underlying asset held by the partnership.[86] Congress stopped short of using the pure aggregate approach evidently because of concerns about complexity resulting from a required valuation of each of the partnership's underlying assets.[87] Under the hybrid approach actually adopted, valuation of individual assets is only necessary for any hot assets held by the partnership.[88]

III. SHORTCOMINGS OF CURRENT LAW

The sale of a partnership interest produces capital gain or loss, except to the extent that the partnership holds hot assets.[89] By requiring looking through to hot assets, the tax code aims to prevent taxpayers from converting ordinary income into capital gain by selling an interest in a partnership instead of having the partnership sell its underlying assets.[90] Current law's focus is overly narrow—it limits opportunities to convert ordinary income into capital gain. However, the same underlying

84. The current approach can also be more favorable to taxpayers than a pure entity approach if the taxpayer sells an interest in a partnership that holds "hot assets" that have depreciated in value. In that instance, the current approach results in the taxpayer recognizing some ordinary loss that would be capital loss under a pure entity approach. An ordinary loss can result in a lower effective tax rate than a capital loss because of certain limitations on the deductibility of capital losses. In particular, § 1211 limits the deductibility of capital losses to the amount of a taxpayer's capital gains (plus, in the case of a non-corporate taxpayer, $3,000). *See* I.R.C. § 1211. Section 1212 provides that any disallowed capital losses of taxpayers other than corporations generally can be carried forward to succeeding taxable years, subject to the same limitations on deductibility in those succeeding years. *See id.* § 1212. Under § 1212, corporate taxpayers, in general, can carry disallowed capital losses back three years and forward five years, subject to the same limitations on deductibility in those years. *See id.*

85. *See supra* note 76 and accompanying text.

86. *See supra* note 43.

87. *See, e.g.*, AM. LAW INST., *supra* note 39, at 22, 23–24 (discussing how the hybrid approach does not necessitate valuation of underlying assets to the same degree as the pure aggregate approach).

88. *See* I.R.C. § 751(a).

89. *Id.* §§ 741, 751(a); *see also supra* notes 47–49.

90. *See supra* note 76 and accompanying text.

rationales that justify misgivings about the potential to convert ordinary income into capital gain also justify uneasiness about any opportunities to obtain more favorable treatment by selling a partnership interest instead of having the partnership sell its underlying assets.[91] Rather than merely concerning themselves with whether any resulting gain or loss is capital or ordinary, lawmakers ought to be concerned with any situation in which the tax treatment of the sale of a partnership interest differs from the tax treatment of the sale of underlying assets. Any difference between the tax treatment of the two economically similar transactions can produce tax revenue loss, unfairness, and, in some cases, increased tax planning costs.[92]

Congress's approach is problematic because it is both unduly favorable to taxpayers and unduly unfavorable to taxpayers.[93] In other words, a partner may sometimes obtain more favorable treatment by sale of a partnership interest than what would arise if the partnership sold its underlying assets.[94] In other circumstances, sale of a partnership interest can trigger less favorable tax treatment than what would occur if the partnership sold its underlying assets.[95]

Unduly favorable and unfavorable outcomes both result from the ways in which the design of existing law does not precisely map onto the aim of harmonizing the tax treatment of the sale of a partnership interest with the tax treatment of the sale of a partnership's underlying assets. In order for the tax code to require looking through to the partnership's assets for purposes of characterizing the selling partner's gain or loss, the partnership must hold hot assets.[96] If the partnership does hold hot assets, the selling partner is treated as if he or she recognized ordinary income or loss in an amount equal to the gain or loss that would be allocated to the partner if the partnership sold its hot assets for fair market value (subject to modifications in the case of the sale of some hot assets that would produce gain that was only ordinary in part).[97] Figure 1 below represents

91. In particular, the ability to convert ordinary income into capital gain through sale of a partnership interest is problematic because it would produce tax revenue loss, disproportionately benefit sophisticated taxpayers, and, potentially, increase tax planning costs. *See supra* notes 7–11 and accompanying text. The same concerns arise as a result of any discrepancy between the tax treatment of the sale of a partnership interest and the tax treatment of the sale of underlying assets—the concern is not limited to the distinction between capital gain and ordinary income.

92. *See supra* notes 7–11 and accompanying text.

93. *See infra* Sections III.A. III.B, III.C, III.D.

94. *See infra* Sections III.A, III.B, III.C.

95. *See infra* Sections III.C, III.D.

96. *See supra* notes 47–49.

97. *See supra* notes 47–50.

current law in diagram form. [98] The top box shows the trigger for looking through to the partnership's underlying assets, and the bottom box shows the consequences that follow when looking through is required.

Figure 1:
Design of Current Law

Trigger: If the partnership holds any hot assets

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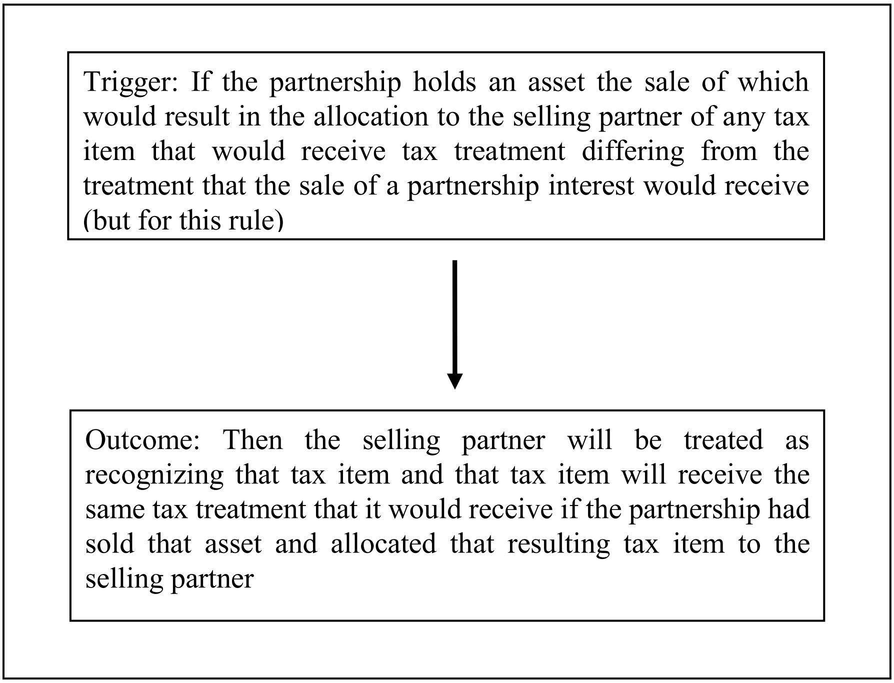
Outcome: Then the amount of gain or loss that would be allocated to the selling partner with respect to the transferred interest if the partnership sold those assets for fair market value shall be treated as ordinary income or loss (subject to modification in the case of some specified types of hot assets the sale of which would generate gain that was only ordinary in part)

Ensuring that the tax treatment of a sale of a partnership interest more precisely corresponds to the tax treatment of the sale of the partnership's underlying assets requires that lawmakers modify both the trigger for looking through to underlying assets and the consequences of looking through to underlying assets. Figure 2 below illustrates, in diagram form, the design of a more precise set of rules.

98. *See* I.R.C. § 751 (2018); Treas. Reg. § 1.751-1(a)(2) (2018).

Figure 2:
Design that Would Equate Tax Treatment of Sale of Partnership Interest with Sale of Underlying Assets



As Figure 2 illustrates, the tax consequences of the sale of an underlying asset would need to be considered anytime such sale would result in tax treatment that differed from the tax treatment of the sale of the partnership interest absent any look-through. There are instances in which this trigger would apply even if an underlying asset was not a hot asset.[99] In such instances, the existing regime produces results that are either unduly favorable (if the tax consequences of the sale of the underlying asset would be less favorable than the tax consequences of the sale of a partnership interest) or unduly unfavorable (if the reverse is true).[100] For example, when a non-U.S. partner sells an interest in a partnership that conducts a trade or business in the United States, it is possible for the partnership to hold assets that are not hot assets even though their sale would result in the non-U.S. partner bearing a more significant tax burden than what would result if the non-U.S. partner sold

99. *See infra* Sections III.A, III.B, III.C.
100. *See infra* Sections III.A, III.B, III.C.

an interest in the partnership.[101] When this is true, not looking through to the underlying assets produces unduly favorable results which were only partially addressed by the 2017 Tax Act.[102] Unduly favorable or unduly unfavorable results can also arise because a partnership might hold a capital asset (which is not a hot asset) with a holding period that differs from the partner's holding period in his or her partnership interest.[103] When holding periods differ, sale of the underlying capital asset can produce short-term capital gain or loss while sale of the partnership interest results in long-term capital gain or loss; or vice versa.[104] However, because the underlying capital asset is not a hot asset, when the partner sells his or her partnership interest, current law does not require looking through to the underlying assets, and, thus, current law permits a divergence between the tax treatment of the sale of a partnership interest and the tax treatment of the sale of underlying assets.[105]

In addition to requiring look-through to assets other than hot assets, a more precise set of rules would dictate that the outcome of looking through to a partnership's underlying assets is to impose upon the selling partner identical tax treatment to what would result from a sale of the underlying assets. The tax code, instead, simply provides that the partner will recognize any ordinary income or loss that would be allocated to the partner upon sale of underlying hot assets.[106] This method sometimes results in unduly favorable treatment because characterizing the gain or loss as ordinary does not necessarily carry with it whatever negative tax consequences would follow from a direct sale of the underlying asset.[107] As one example, even though the sale of an underlying asset might produce loss that is subject to a new restriction on the deductibility of trade or business losses enacted in December 2017,[108] sale of a partnership interest might produce loss that is not subject to that same restriction.

This Part will proceed by discussing, in turn, various examples of ways in which the existing provisions might produce unduly favorable results or unduly unfavorable results. It concludes by noting that the design of current law is prone to error as Congress, inevitably, overlooks the need

101. *See infra* Section III.A.

102. *See infra* Section III.A.

103. *See infra* Section III.C.

104. *See infra* Section III.C.

105. *See infra* Section III.C.

106. *See* I.R.C. § 751(a) (2018).

107. *See infra* Section III.B.

108. *See* I.R.C. § 461(l). For further discussion, see *infra* Section III.B.

to update the provisions governing sale of a partnership interest to take into account changes made to other, unrelated provisions.[109]

A. Unduly Favorable Results: Sale of an Interest in a Partnership by a Non-U.S. Person

The sale by a non-U.S. person of an interest in a partnership that conducts a trade or business in the United States can lead to tax results that are more favorable than what would follow if the partnership sold its underlying assets.[110] In this instance, the unduly favorable results arise because the category of hot assets is not broad enough to include all assets the sale of which would lead to less favorable tax treatment than the sale of the partnership interest itself.[111]

As part of the 2017 Tax Act, Congress adopted a provision that partially eliminated the potential tax savings resulting from sale of a partnership interest in this particular context.[112] However, Congress's solution failed to fully eliminate the possibility that the sale of a partnership interest could produce more beneficial tax treatment than the sale of underlying assets even in the specific context that it addressed.[113]

Understanding this example requires a brief primer on the taxation of non-U.S. persons holding interests in a partnership. A non-U.S. person is generally subject to U.S. tax only on U.S.-source income of certain types and income effectively connected with a U.S. trade or business.[114] If a non-U.S. person[115] holds an interest in a partnership that conducts a trade or business in the United States and that partnership sells assets that generate income that is effectively connected with that trade or business, then the resulting income allocated to the non-U.S. partner will be treated as effectively connected to a U.S. trade or business and subject to U.S. tax.[116]

In 2017, the Tax Court confronted the question of what would occur when a non-U.S. person, instead, sold an interest in a partnership that conducted a trade or business in the United States.[117] In that case, *Grecian*

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109. *See infra* Section III.E.

110. *See infra* text accompanying notes 117–139.

111. *See infra* text accompanying notes 117–139.

112. H.R. REP NO. 115-466, at 88–90 (2017) (Conf. Rep.).

113. *See infra* text accompanying notes 133–139.

114. I.R.C. §§ 881, 882 (2018).

115. *See supra* note 16 (defining "Non-U.S. Person").

116. I.R.C. §§ 875, 702(b).

117. Grecian Magnesite Mining, Indus. & Shipping Co. v. Comm'r, 149 T.C. 63, 67 (2017).

Magnesite Mining, Industrial & Shipping Co. v. Commissioner,[118] a non-U.S. corporation owned an interest in a partnership that engaged in the business of extracting, producing, and distributing magnesite that it mined in the United States.[119] The non-U.S. corporation recognized gain from a sale of its interest in the partnership when the partnership redeemed the interest it held.[120] The Tax Court concluded that the gain from the sale[121] was not effectively connected to a U.S. trade or business.[122] Section 741 of the Code provides that, except for gain attributable to hot assets (which the gain was not), gain from sale of an interest in a partnership shall be treated as gain from sale of a *capital asset*.[123] The Internal Revenue Service argued that § 741 does not specify *which* capital asset—stated differently, the statute could mean that the gain would be treated as gain from a sale of the capital assets[124] that were the underlying assets held by the partnership (so that the resulting gain would be effectively connected income).[125] The Tax Court disagreed, concluding that the "capital asset" to which § 741 refers is the partnership interest itself, and capital gain resulting from sale of the partnership interest was not effectively connected to a U.S. trade or business.[126] In so holding, the Tax Court rejected the position taken by the IRS in a prior revenue ruling from 1991.[127]

As part of the 2017 Tax Act, Congress adopted a legislative fix that attempts to address the possibility of the sale of a partnership interest by a non-U.S. person producing unduly favorable results, but the fix only works in some cases.[128] In particular, new § 864(c)(8) provides that gain or loss recognized by a non-U.S. person on sale of an interest in a partnership that is engaged in a trade or business in the United States shall be treated as effectively connected to that trade or business to the extent that the gain does not exceed the amount of effectively connected income

118. 149 T.C. 63 (2017).

119. *Id.* at 65.

120. *Id.*

121. This was true except for gain attributable to U.S. real estate held by the partnership which was subject to tax under rules specifically applicable to U.S. real estate. *See* I.R.C. § 897(g).

122. *Grecian Magnesite Mining*, 149 T.C. at 83.

123. *Id.* at 72.

124. For ease of exposition, this Part uses the term "capital asset" to refer to assets that are, more precisely, § 1231 property.

125. *Grecian Magnesite Mining*, 149 T.C. at 78.

126. *Id.* at 82.

127. *See* Rev. Rul. 91-32, 1991-1 C.B. 107; *Grecian Magnesite Mining*, 149 T.C. at 84.

128. H.R. REP NO. 115-466, at 88–90 (2017) (Conf. Rep.).

that would have been allocated to the partner if the partnership had sold all of its assets for fair market value.[129]

Sometimes, the newly adopted provision will ensure that the tax treatment of the sale of a partnership interest is aligned with the tax treatment of the sale of underlying assets, but opportunities for mismatch remain. In order to demonstrate, consider the following examples.

> **Example 4**. Two non-U.S. individuals own interests in a partnership that conducts a trade or business in the United States. Upon formation, each individual contributes $50 to the partnership, and they agree to share equally in all gains and losses. The partnership acquires one capital asset (the ECI Asset) for $25 that it uses in its trade or business, and the partnership acquires another capital asset (the Non-ECI Asset) for $75 not used in its trade or business. The ECI Asset appreciates in value to $125, and the Non-ECI Asset appreciates in value to $105.

In this example, if the partnership sold both assets for fair market value and liquidated, each partner would recognize effectively connected income of $50 as a result of the sale of the ECI Asset and no effectively connected income as a result of the sale of the Non-ECI Asset.[130]

In Example 4, if, instead, a partner were to sell his or her interest in the partnership for $115, prior to the enactment of new legislation in December 2017, the partner would recognize $65 of gain that was not effectively connected income, based on the Tax Court's holding in *Grecian Magnesite Mining*.[131] Thus, the partner would have received more favorable treatment by selling his or her interest in the partnership than by having the partnership sell its underlying assets.

In the context of Example 4, newly enacted § 864(c)(8) addresses this discrepancy. It provides that the $65 gain that would be recognized by the partner upon sale of his or her interest in the partnership is treated as effectively connected income to the extent that it does not exceed the $50 of effectively connected income that would have been allocated to the selling partner if the partnership had sold all of its assets for fair market value.[132] Thus, the selling partner recognizes $50 of effectively connected income and $15 of gain that is not effectively connected income—a result

129. I.R.C. § 864(c)(8) (2018).

130. These examples assume the Non-ECI Asset is not U.S. real estate.

131. *See Grecian Magnesite Mining*, 149 T.C. 63; *supra* text accompanying notes 117–127.

132. I.R.C. § 864(c)(8).

that corresponds to the outcome of a sale by the partnership of its underlying assets.

In order to demonstrate discrepancies between the sale of underlying assets and the sale of a partnership interest that persist even after the adoption of new § 864(c)(8), consider the following example.

> **Example 5**. Two non-U.S. individuals own interests in a partnership that conducts a trade or business in the United States. Upon formation, each individual contributes $50 to the partnership, and they agree to share equally in all gains and losses. The partnership acquires one capital asset (the ECI Asset) for $25 that it uses in its trade or business, and the partnership acquires another capital asset (the Non-ECI Asset) for $75 not used in its trade or business. The ECI asset appreciates in value to $125, *but the Non-ECI Asset declines in value to $45*.

If the partnership in Example 5 were to sell both assets for fair market value and liquidate, each partner would recognize effectively connected income of $50 as a result of the sale of the ECI Asset.[133] Each partner would also recognize a loss of $15 as a result of the sale of the Non-ECI Asset; however, this loss would not be effectively connected to a U.S. trade or business, and, thus, could not be deducted against the $50 of effectively connected income recognized by each partner.[134]

If instead a partner in Example 5 were to sell his or her interest in the partnership for $85, prior to the enactment of new legislation in December 2017, the partner would recognize $35 of gain that was not effectively connected income, based on the Tax Court's holding in *Grecian Magnesite Mining*.[135] Thus, the partner would have received more favorable treatment by selling his or her interest in the partnership than the treatment that would have arisen from a sale of the partnership's underlying assets.[136]

In the context of Example 5, newly enacted § 864(c)(8) only partially addresses this discrepancy. In particular, it provides that the $35 gain that would be recognized by the partner on sale of his or her interest in the partnership is treated as effectively connected income to the extent that it does not exceed the $50 of effectively connected income that would have

133. *Id.* §§ 875, 702(b).

134. *Id.* § 882(c)(1)(A).

135. *See Grecian Magnesite Mining*, 149 T.C. 63; *supra* text accompanying notes 117–127.

136. *See supra* text accompanying notes 134–135.

been allocated to the selling partner if the partnership had sold all of its assets for fair market value.[137] Thus, the selling partner recognizes $35 of effectively connected income, $15 less than the effectively connected income that would be recognized by the partner upon sale by the partnership of its underlying assets.[138] In effect, sale of the partnership interest allows the partner to deduct the partner's share of the loss that has accrued in the Non-ECI Asset against the partner's share of the gain that has accumulated in the ECI Asset, a result that could not be achieved by a sale of underlying assets.[139]

Notably, sophisticated taxpayers can engage in tax structuring so that they achieve the results of Example 5 even when they do not fall upon facts similar to Example 5 merely by happenstance. If a partnership holds a capital asset the sale of which would generate ECI, a partner who held a capital asset that had declined in value but that was not used in the partnership's business (a Non-ECI Asset) might very well contribute that asset to the partnership to create facts that mirrored Example 5 and subsequently sell an interest in the partnership to a third party. Absent successful recharacterization by the IRS as a direct sale of the Non-ECI Asset by the partner to the third party (which might occur if the asset contribution and sale of the partnership interest occurred close in time),[140] a partner could, through use of this technique of stuffing built-in loss assets into the partnership, manufacture the facts of Example 5.[141] Thus,

137. I.R.C. § 864(c)(8).

138. *See id.* § 882(c)(1)(A); *supra* text accompanying note 134.

139. In this respect, the approach of the new statutory provision is less robust than I.R.C. § 751(a). Under § 751(a), if a partnership holds appreciated inventory and capital assets that have declined in value, the partner will recognize the full amount of the ordinary income that would have been allocated to the partner upon sale of the inventory and a capital loss, rather than capping the ordinary income recognized at the total amount of gain recognized from sale of the partnership interest. *See supra* text accompanying notes 64–65. For additional discussion of this difference between § 751(a) and § 864(c)(8), see KPMG, TAX REFORM – KPMG REPORT ON NEW TAX LAW 78 (2018), https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf [https://perma.cc/5NE9-56ED] ("Accordingly, where the partnership holds both appreciated effectively connected assets, and depreciated non-effectively connected assets, it appears that not all of the foreign partner's effectively connected gain, as determined on a look-through basis, would be recognized under the provision."). It is possible that Treasury might adopt regulations to address the remaining discrepancies, but, if so, the regulations would contain rules that diverged from the current statutory text.

140. *See, e.g.*, Comm'r v. Court Holding Co., 324 U.S. 331, 334 (1945) (characterizing the sale by a shareholder of an asset following its distribution by a corporation as, instead, a sale of the asset by the corporation).

141. The current regime could also lead to situations in which sale of a partnership interest led to less favorable treatment if the partnership held assets the sale of which would generate ECI that had declined in value and assets the sale of which would not generate ECI that had appreciated in value. In these situations, current law produces unduly unfavorable results in the case of a sale of the

Congress's incomplete fix to the tax treatment of the sale of a partnership interest by a non-U.S. person fails to address significant ways in which the sale of a partnership interest can produce unduly favorable results for taxpayers.

B. Unduly Favorable Results: Trade or Business Losses

As discussed in Section III.A, sale by a non-U.S. person of an interest in a partnership could produce unduly favorable results prior to the adoption of a partial legislative fix, and, given the incomplete nature of the fix, such a transaction can continue to produce unduly favorable results in some cases.[142] In addition to failing to fully address the potential for unduly favorable results in that particular context, Congress created the potential for a new set of transactions to produce unduly favorable results.[143] The 2017 Tax Act instituted a new restriction on the deductibility of losses incurred in a trade or business contained in § 461(l).[144] Newly enacted legislation, however, is silent on how this provision will be applied in the context of a sale of an interest in a partnership. Lawmakers' failure to address the application of this provision in the context of a sale of a partnership interest leaves open the possibility that, in some situations, a sale of a partnership interest could circumvent the new restrictions.

Section 461(l) provides that deductions attributable to any trade or business of a taxpayer other than a C-corporation can be used only against income or gain attributable to a trade or business of the taxpayer and up to $250,000 of other income (for a single taxpayer) in any given year.[145] Excess trade or business losses can be carried over to other years.[146] Section 461(l)(4) provides that, in the case of a partnership, this restriction will be applied at the partner level and the partner will take into account his or her allocable share of tax items from trades or businesses attributable to the partnership.[147] The 2017 Tax Act, however, is silent on how this provision will be applied in the context of a sale of an interest in a partnership.

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partnership interest. However, as mentioned above, sophisticated taxpayers would tend to structure transactions in those situations as asset sales. *See supra* text accompanying notes 27–28.

142. *See supra* Section III.A.

143. *See infra* text accompanying notes 149–155.

144. H.R. REP NO. 115-466, at 19–20 (2017) (Conf. Rep.).

145. I.R.C. § 461(l) (2018).

146. *Id.* In those years, the losses are, apparently, not subject to the same restriction.

147. *Id.* § 461(l)(4).

The failure of the legislation to address the application of the new provision in the context of the sale of an interest in a partnership creates the potential for taxpayers to escape the provision's full effects by selling an interest in a partnership.[148] A partnership may hold depreciated hot assets the sale of which might produce losses from a trade or business. In those cases, § 751(a) provides that the selling partner recognizes loss from "sale or exchange of property other than a capital asset" in an amount equal to the amount of loss that would be allocated to the partner if the partnership sold those underlying assets.[149] Section 751(a), however, stops short of explicitly providing that the loss from a non-capital asset so recognized will be treated as a loss from the sale of the particular underlying asset. That said, to the extent that § 751(a) comes into play, the transaction likely should be analyzed through the lens of the aggregate view so that gain or loss recognized under § 751(a) should be treated in the same manner as gain or loss from the sale of the underlying asset.[150] However, because the statutory language does not explicitly provide for such treatment, there is room for taxpayers to take the position that a loss from sale of a non-capital asset resulting from § 751(a) is not necessarily a trade or business loss so that it is not subject to the restriction of § 461(l). If taxpayers take that position successfully, they do so because of one cause of § 751(a)'s unduly favorable approach. In particular, § 751(a) merely provides that gain or loss from sale of a hot asset is ordinary, which does not necessarily carry with it all of the negative consequences that would follow from a direct sale of the underlying asset.[151]

Mismatch between the treatment of the sale of an interest in a partnership and the sale of underlying assets may be even more likely in a case in which the partnership holds an asset used in a trade or business that is not a hot asset. Imagine, for instance, a partnership operates a manufacturing business and owns equipment with a value less than the asset's basis. If the partnership were to sell the equipment, the resulting loss would likely be treated as loss from a trade or business subject to the restriction in § 461(l).[152] If a partner were to sell his or her interest in the

148. *See infra* text accompanying notes 149–155.

149. I.R.C. § 751(a).

150. As others have noted, to the extent that § 751(a) applies, the tax code adopts an aggregate approach to the sale of a partnership interest. *See* MCKEE, NELSON & WHITMIRE, *supra* note 41, at ¶ 1.02. Arguably, when applying a provision that is based on the "aggregate approach," one ought to treat the resulting gain or loss as arising from the particular underlying asset of the partnership that gives rise to the gain or loss.

151. I.R.C. § 751(a).

152. *Id.* § 461(l).

partnership, given that the equipment is not a hot asset, the partner would recognize capital loss from sale of his or her interest in the partnership. This loss likely would not be subject to the restriction contained in § 461(l).[153] It would be subject to restrictions applicable to the deductibility of capital losses.[154] However, for some taxpayers with capital gains but no trade or business income from other sources, the restrictions on the deductibility of capital losses are effectively less onerous than the restrictions on the deductibility of trade or business losses because such taxpayers may be able to deduct capital losses currently but not trade or business losses.[155] For these taxpayers, treatment of the loss as a capital loss can result in a more favorable outcome than treatment as a trade or business loss.

C. Unduly Favorable Results and Unduly Unfavorable Results: Capital Gains and Losses and Holding Period

As another example of both unduly favorable treatment and unduly unfavorable treatment, sale of a partnership interest could produce *long-term* capital gain (or loss) that would, instead, be treated as *short-term* capital gain (or loss) if the partnership sold its underlying assets.[156] In other cases, sale of a partnership interest could produce *short-term* capital gain (or loss) that would, instead, be treated as *long-term* capital gain (or loss) if the partnership sold its underlying assets.[157] In order to demonstrate the first possibility, consider the following example.

> **Example 6**. Mindy and Danny form a partnership on January 1, 2016 in which they are equal partners. They each contribute $50 to the partnership. The partnership acquires a capital asset (Asset 1) for $100. On January 1, 2019, the partnership sells Asset 1 for $300, producing $200 of long-term capital gain that is allocated $100 to each partner. The partnership uses the resulting $300 of proceeds to acquire another capital asset (Asset 2). On March 31, 2019, Asset 2 is worth $450.

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153. The taxpayer's argument would parallel the argument made, successfully, by the taxpayer in *Grecian Magnesite Mining*. 149 T.C. 63, 72 (2017); *see also supra* text accompanying notes 117–127.

154. *See* I.R.C. § 1211.

155. In particular, § 1211 limits the deductibility of capital losses to the amount of a taxpayer's capital gains (plus, in the case of a non-corporate taxpayer, $3000). *See supra* note 84 and accompanying text.

156. *See infra* text accompanying notes 158–162.

157. *See infra* text accompanying notes 164–170.

On March 31, 2019, if the partnership sells Asset 2 and liquidates, the partnership would recognize $150 of short-term capital gain (allocated $75 to each partner).[158] Upon receipt of $225 cash on liquidation, each partner would recognize no further gain or loss.[159] Thus, a sale of Asset 2 would produce $75 of short-term capital gain for each partner. On March 31, 2019, if, instead, either partner were to sell his or her partnership interest for $225, the sale would produce $75 of long-term capital gain.[160] Thus, a sale of an interest in the partnership would produce potentially more favorable treatment because capital gain that would be short term as a result of a sale of underlying assets is, instead, classified as long term.[161] In such a situation, the results of the rules governing the tax treatment of the sale of a partnership interest are unduly favorable.

In a situation similar to Example 6 but in which Asset 2 declined in value, a sale of the partnership interest would produce long-term capital loss while a sale of Asset 2 would produce short-term capital loss. For some taxpayers, long-term capital loss receives less favorable treatment than short-term capital loss. For example, if the taxpayer has recognized long-term capital gain and short-term capital gain from other sources, then

158. The $150 of gain is the difference between the partnership's $300 basis in Asset 2 and the $450 fair market value of Asset 2. The resulting gain is short-term capital gain because the partnership held Asset 2 for not more than one year. *See* I.R.C. § 1222(1) (defining short-term capital gain as gain from the sale of a capital asset held for not more than one year).

159. When each partner contributed $50 to the partnership, each partner's initial basis in his or her partnership interest became $50. I.R.C. § 722. When each partner is allocated $100 of long-term capital gain from sale of Asset 1, each partner's basis in his or her partnership interest increases by $100 to become $150. *Id.* § 705(a)(1)(A). When each partner is allocated $75 of short-term capital gain on sale of Asset 2, each partner's basis in his or her partnership interest increases by $75 to become $225. *Id.* § 705(a)(2)(A). When each partner receives a liquidating distribution of $225, he or she recognizes no gain or loss because the amount of the distribution is no more or less than his or her basis in the partnership interest. *Id.* § 731(a).

160. When a partner contributes cash to the partnership, the partner's holding period of the partnership interest received in exchange starts anew upon receipt of the partnership interest. *See* Treas. Reg. § 1.1223-1(a) (2018). Because the partners contribute cash on January 1, 2016, and make no further cash contributions, each partner would have a holding period in his or her partnership interest of 3 years and 3 months by March 31, 2019. Thus, the gain from sale of his or her partnership interest would be long-term capital gain. *See* I.R.C. § 1222(3) (defining long-term capital gain as gain from the sale of a capital asset held for more than one year).

161. Classifying capital gain as long term is more favorable than classifying it as short term because, unless the taxpayer has recognized other short-term capital losses and long-term capital gains from other sources, short-term capital gain will be taxed at regular ordinary income rates while long-term capital gain will be taxed at lower rates applicable to net capital gain. *See* I.R.C. § 1(h) (providing for a lower tax rate on "net capital gain"); *id.* § 1222(11) (defining "net capital gain").

recognizing long-term capital loss leads to a less favorable outcome than recognizing short-term capital loss.[162]

As Example 6 shows, in some cases, sale of a partnership interest will produce *long-term* capital gain (or loss) even though sale of an underlying asset would produce *short-term* capital gain (or loss). In other cases, sale of a partnership interest could produce *short-term* capital gain (or loss) that would, instead, be treated as *long-term* capital gain (or loss) if the partnership sold its underlying assets.[163] In order to demonstrate, consider the following example.

> **Example 7**. Mindy and Danny form a partnership on January 1, 2016 in which they are equal partners. They each contribute $50 to the partnership. The partnership acquires a capital asset for $100. On January 1, 2019, at a time when the capital asset is still worth $100 so that Mindy's and Danny's partnership interests are each worth $50, each partner contributes an additional $50. The partnership acquires inventory for $100. On March 31, 2019, the capital asset is worth $300, and the inventory is worth $150.

On March 31, 2019, if the partnership sold each of its underlying assets and liquidated, the partnership would recognize $200 of long-term capital gain from sale of the capital asset (allocated $100 to each partner),[164] and the partnership would recognize $50 of ordinary income (allocated $25 to each partner) from sale of the inventory.[165] Each partner would recognize no further gain or loss when they receive $225 cash on liquidation.[166]

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162. To demonstrate, assume a taxpayer has recognized $10,000 of long-term capital gain and $8,000 of short-term capital gain from other transactions. If that taxpayer recognizes $8,000 of capital loss, the resulting tax consequences will vary depending on whether the capital loss is long term or short term. If it is short term, it effectively can be used to offset the taxpayer's $8,000 of short-term capital gain, and the taxpayer's $10,000 of long-term capital gain will be taxed at favorable low rates. If it is long term, the taxpayer must offset it against the taxpayer's long- term capital gain, so that the taxpayer would be left with $2,000 of net capital gain taxed at favorable low rates and $8,000 of short-term capital gain taxed at higher ordinary income rates. *See* I.R.C. § 1(h); *id.* § 1222.

163. *See infra* text accompanying notes 164–168.

164. The difference between the partnership's $100 basis in the capital asset and its $300 fair market value is $200. The gain is long-term capital gain because the partnership held the capital asset for more than one year. *See* I.R.C. § 1222(3).

165. The difference between the partnership's $100 basis in the inventory and the inventory's $150 fair market value is $50.

166. When each partner contributed $50 to the partnership, each partner's initial basis in his or her partnership interest became $50. I.R.C. § 722. When each partner is allocated $100 of long-term capital gain from sale of the capital asset, each partner's basis in his or her partnership interest increases by $100 to become $150. *Id.* § 705(a)(1)(A). When each partner contributes an additional $50 to the partnership, each partner's basis in his or her partnership interest increases by $50 to

Thus, a sale of underlying assets would produce $100 of long-term capital gain and $25 of ordinary income for each partner. On March 31, 2019, if, instead, either partner were to sell his or her partnership interest for $225, the sale would produce $25 of ordinary income,[167] $50 of long-term capital gain, and $50 of short-term capital gain.[168] Thus, a sale of an interest in the partnership would produce less favorable treatment in that some capital gain that would be long term as a result of a sale of underlying assets is, instead, classified as short term.[169]

In a situation similar to Example 7 but in which the underlying assets declined in value, a sale of the partnership interest produces more short-term capital loss while a sale of the underlying assets produces more long-term capital loss, and, for some taxpayers, short-term capital loss receives more favorable tax treatment than long-term capital loss.[170] In such a situation, the current rules governing the tax treatment of the sale of a partnership interest produce unduly favorable results for some taxpayers.

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become $200. *Id.* § 722. When each partner is allocated $25 of ordinary income on sale of the inventory, each partner's basis in his or her partnership interest increases by $25 to become $225. *Id.* § 705(a)(2)(A). When each partner receives a liquidating distribution of $225, he or she recognizes no gain or loss because the amount of the distribution is no more or less than his or her basis in the partnership interest. *Id.* § 731(a).

167. The inventory would be an "inventory item" that would cause each partner to recognize $25 of ordinary income under I.R.C. § 751(a).

168. When a partner contributes cash to the partnership, the partner's holding period in the partnership interest received in exchange starts anew upon receipt of the partnership interest. *See* Treas. Reg. § 1.1223-1(a) (2018). When an existing partner contributes cash to a partnership, the partner's holding period in the partnership interest received in exchange for cash will start anew. Thus, after their additional $50 cash contribution in January 2019, Mindy and Danny would hold interests in the partnership one-half of which had a holding period of two years (where one-half is the $50 value of the partnership interest before the contribution divided by the $100 value after the contribution) and one-half of which had a holding period of zero years (where one-half is the $50 cash contributed divided by the $100 value of the partnership interest after the contribution). *See id.* § 1.1223-3(b)(1). As a result, by the time of the sale in March 2019, each partner's holding period is one-half short term (three months) and one-half long term (two years and three months). Thus, the $100 capital gain recognized by each individual would be one-half short term and one-half long term. *See id.* § 1.1223-3(c)(1), (f) ex.5.

169. Classifying capital gain as short-term is potentially less favorable than classifying it as long-term because, unless the taxpayer has recognized short-term capital losses and long-term capital gains from other sources, short-term capital gain will be taxed at regular ordinary income rates while long-term capital gain will be taxed at lower rates applicable to net capital gain. *See* I.R.C. §§ 1(h), 1222.

170. In particular, if the taxpayer has recognized long-term capital gain and short-term capital gain from other sources, then recognizing short-term capital loss leads to a more favorable outcome than recognizing long-term capital loss. For further discussion, see *supra* note 162.

The observations made in this Section III.C are summarized in the table below.

	Short-Term Holding Period in Partnership Interest; Long-Term Holding Period in Partnership's Assets	**Long-Term Holding Period in Partnership Interest; Short-Term Holding Period in Partnership's Assets**
Assets Have Built-in Gains	Sale of underlying asset potentially more favorable	Sale of partnership interest potentially more favorable
Assets Have Built-in Losses	Sale of partnership interest potentially more favorable	Sale of underlying asset potentially more favorable

D. Unduly Unfavorable Results: Change of Purpose in Holding Real Estate

If a partnership holds land that has appreciated in value and that it intends to develop, subdivide, and sell in numerous sales of separate real estate parcels, a partner who exits the partnership prematurely, before any real estate development has occurred, may, in some cases, receive less favorable treatment than what would have occurred if the partnership had sold the underlying land before any real estate development occurred.[171]

In order to demonstrate, consider the following example.

> **Example 8**. Three individuals, Ilana, Abbi, and Matt, decide to form a partnership to acquire undeveloped land with the intention of subdividing the land, installing streets and making other improvements, and selling individual lots. Before they have undertaken any substantial steps towards their goal, a business dispute arises, and Matt decides to sell his interest in the partnership to an unrelated third party, Trey. At the time of the sale, the land has appreciated in value.

In Example 8, there is a significant likelihood that Matt's gain would be characterized as ordinary income as a result of characterizing the land

171. In a similar fact pattern but in which the land declined in value, the results would be unduly favorable for most taxpayers in that sale of the partnership interest is likely to produce ordinary loss, while sale of the underlying asset is likely to produce capital loss.

as a hot asset, although the results of the current regime are not entirely clear.[172] This is true even though a direct sale of the land under similar facts would likely produce capital gain.[173] Demonstrating this potential mismatch between the sale of the partnership interest and a sale of the underlying asset requires an examination of the principles that can be drawn from existing case law.

1. Direct Sale of Real Estate

Imagine an example slightly different from Example 8.

> **Example 8A**. Three individuals, Ilana, Abbi, and Matt, decide to form a partnership to acquire undeveloped land with the intention of subdividing the land, installing streets and making other improvements, and selling individual lots. Before they have undertaken any substantial steps towards their goal, a business dispute arises, and Matt no longer wants to participate in the partnership. The land has appreciated in value. The partnership distributes to Matt, in-kind, a pro rata interest in each asset, which he sells to Trey who then contributes the assets to the partnership in which Ilana, Abbi, and Trey are now partners.

In Example 8A,[174] relying on existing case law, Matt could likely treat the resulting gain as capital gain.[175]

When a taxpayer sells appreciated real estate, the resulting gain will be classified as ordinary income if the real estate is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," as described by § 1221(a)(1).[176] Real estate fitting this description is often referred to as "dealer property."[177] If, instead, the

172. The results are not entirely clear because the determination of whether sale of real estate produces ordinary income or capital gain is based on the facts and circumstances of each case, and cases with similar fact patterns sometimes result in different outcomes across cases within a jurisdiction or across jurisdictions. *See, e.g.*, United States v. Winthrop, 417 F.2d 905, 906 (5th Cir. 1969) ("Finding ourselves engulfed in a fog of decisions with gossamer like distinctions, and a quagmire of unworkable, unreliable, and often irrelevant tests, we take the route of ad hoc exploration to find ordinary income.").

173. Again, this outcome is not entirely certain.

174. This analysis assumes that Example 8A is not recast as a sale of the interest in the partnership by Matt.

175. *See infra* note 184 and accompanying text.

176. I.R.C. § 1221(a)(1) (2018).

177. *See, e.g.*, GERALD J. ROBINSON, FEDERAL INCOME TAXATION OF REAL ESTATE ¶ 17.13 (2019) ("[P]roperty sold at a gain produces ordinary income when the property is deemed held

taxpayer holds the real estate for investment purposes, the resulting gain will be capital gain.[178]

Whether or not real estate is "dealer property" is determined based on all relevant facts and circumstances bearing on whether the taxpayer held the property with the intent described in § 1221(a)(1).[179] Courts will examine facts that include, but are not limited to: (1) the frequency and substantiality of sales (where a greater volume of sales increases the odds of characterization as dealer property), (2) the extent of improvements made to the property by the taxpayer (where, again, more extensive improvements increase the odds of characterization as dealer property), and (3) efforts by the taxpayer to advertise the property for sale (where more extensive advertising heightens the likelihood of characterization as dealer property).[180]

Sometimes a taxpayer acquires property with the original purpose of selling the property to customers in the ordinary course of the taxpayer's trade or business but the taxpayer's purpose changes prior to the sale of the property.[181] In some cases, such a taxpayer will attempt to characterize any resulting gain as capital gain, but the court will hold that the original purpose governs so that the sale produces ordinary income.[182] There are cases in which a taxpayer successfully asserts change of purpose.[183]

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primarily for sale to customers in the ordinary course of the taxpayer's trade or business, so-called dealer property.")

178. I.R.C. § 1221(a).

179. *See, e.g.*, Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir. 1976) (examining various factors including frequency and substantiality of sales, extent of improvements to the property, and solicitation and advertising efforts); United States v. Winthrop, 417 F.2d 905, 911 (5th Cir. 1969) ("In analyzing a case of this sort no rubrics of decision or rubbings from the philosopher's stone separate the sellers garlanded with capital gains from those beflowered in the garden of ordinary income. Each case and its facts must be compared with the mandate of the statute.").

180. *See, e.g.*, *Biedenharn Realty Co.*, 526 F.2d 409; *Winthrop*, 417 F.2d 905.

181. *See infra* text accompanying notes 182–184.

182. In one case, for example, the taxpayer purchased undeveloped land with the intent of developing and reselling it. Prior to undertaking development activities (which were delayed due to difficulty obtaining financing), taxpayer received an offer to purchase the undeveloped land, and taxpayer accepted the offer. The court held that the gain on sale was ordinary income. *See* Evwalt Dev. Corp. v. Comm'r, 22 T.C.M. (CCH) 220 (1963). In *Grant v. Comm'r*, 22 T.C.M. (CCH) 771 (1963), *aff'd*, 333 F.3d 603 (4th Cir. 1964), land was purchased with the intent of developing and selling the land. However, before development could be undertaken, Chrysler announced that it intended to construct a plant near the land, and the taxpayer was approached by a company that wanted to buy the land for use in laying a railroad track to access the plant. Therefore, the taxpayer sold the land in bulk. Gain on the sale was held to be ordinary income.

183. In *Maddux Constr. Co. v. Comm'r*, 54 T.C. 1278 (1970), for example, the taxpayer, an entity engaged in the business of residential development and construction of homes, originally purchased land with the intention of subdividing it for residential purposes. However, soon after acquisition, it became apparent that the land would be better suited for commercial purposes. After coming to this

A taxpayer's odds of success are greater when some unusual factor, beyond the control of the taxpayer, precipitated the change of purpose—such as unexpected financial difficulties or another intervening cause.[184]

We can now turn to Ilana, Abbi, and Matt from Example 8A. Because the sale is precipitated by an unusual event (a business dispute) and because the sale takes place before the parties have carried out their plans to subdivide and improve the real estate and sell off separate parcels in numerous sales, Matt can likely characterize the resulting gain as capital gain.[185] Doing so would be consistent with existing precedent in which the taxpayer's change of purpose was instigated by an unusual event that prompted premature sale of the real estate and the taxpayer successfully claimed capital gain treatment.[186]

2. *Sale of a Partnership Interest*

By contrast, if the facts are exactly the same as Example 8, so that Ilana, Abbi, and Matt hold interests in a partnership that holds the undeveloped land and Matt sells his interest in the partnership following a business dispute, existing case law suggests that his gain would be treated as ordinary income.[187] For example, in *Martin v. United States*,[188] a partnership purchased land for the purpose of subdividing it into lots and selling the lots to customers.[189] One partner decided to retire, took no

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realization, the taxpayer made limited improvements to the property, made limited efforts to sell the property, and continued to hold the property for two years before it was eventually sold. The court held that gain on the sale was capital gain, despite the taxpayer's original purpose in acquiring the property.

184. *See, e.g.*, Scottwood Dev. Co. v. Comm'r, 26 T.C.M 855 (1967) (holding that gain on sale was capital gain when the taxpayer developed homes with the intent of selling homes, but, because of unfavorable market conditions, rented the homes for a period of time instead before eventual sale); Hale v. Comm'r, 24 T.C.M. 1497 (1965) (holding that gain on sale was capital gain where properties were initially acquired for residential development, development did not proceed because of difficulties financing development and changes in zoning restriction, and undeveloped properties were sold following unsolicited offers). Even when an unusual factor beyond the taxpayer's control prompts the change of purpose, the taxpayer's attempt to claim capital gain is not always successful, however. *See, e.g.*, *Evwalt Dev.*, 22 T.C.M. (CCH) 220 (taxpayer's attempt to claim capital gain treatment failed despite the fact that undeveloped land was sold after taxpayer was unable to obtain financing to develop the land as planned).

185. Instead, a court might characterize the gain as ordinary income based on the rationale that the partnership's purpose (rather than Matt's) should govern and the purpose of the partnership arguably did not change. *See Evwalt Dev.*, 22 T.C.M. (CCH) 220.

186. *See supra* note 184 and accompanying text.

187. *See, e.g.*, Freeland v. Comm'r, 393 F.2d 573 (9th Cir. 1968); Martin v. United States, 330 F. Supp. 681 (M.D. Ga. 1971).

188. 330 F. Supp. 681 (M.D. Ga. 1971).

189. *Id.* at 682–83.

further part in the business of the venture, and sold his interest in the partnership.[190] The court held that the gain on the sale of the partnership interest was ordinary income because the taxpayer's individual change of purpose did not change the character of the investment—in other words, in the partnership's hands the real estate remained "dealer property" and, as a result, a hot asset so that the selling partner's gain was treated as ordinary income.[191]

To sum up, if a partnership holds appreciated land that it intends to develop and sell through numerous separate transactions, a partner who has a change of heart prompted by an unusual event (such as financial difficulties or a business dispute) and who opts to exit the deal before the plans come to fruition *may* receive less favorable treatment by selling his or her partnership interest than what would arise from a sale of the underlying assets under similar circumstances.[192] In such a situation, the current rules produce unduly unfavorable results.

E. Risk of Error

As discussed above in Sections III.A through III.D, despite good reasons for equating the tax treatment of the sale of a partnership interest with the treatment of the sale of underlying assets, differences persist.[193] In some cases, the differences result in the sale of a partnership interest receiving unduly favorable treatment, and, in other cases, the differences result in the sale of a partnership interest receiving unduly unfavorable treatment.[194] Furthermore, because the tax code does not automatically require looking through to the underlying assets of a partnership in all cases, there is a risk that changes to tax provisions outside of the partnership tax rules could be circumvented by sophisticated taxpayers. Any time Congress adopts a provision that leads to any item of gain or loss being treated differently than gain or loss that would arise from sale of a partnership interest, Congress might unintentionally fail to make corresponding changes to the provisions governing the tax treatment of a sale of a partnership interest.[195] When this occurs, selling a partnership

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190. *Id.*

191. *Id.* at 684.

192. The results are not entirely certain, however. *See supra* note 172.

193. It would be possible to address each of the illustrations provided in this Article with narrow fixes that specifically addressed each of these particular examples of ways in which sale of a partnership interest produced different tax treatment than sale of an underlying asset. However, one virtue of the more general approach proposed by this Article is that it mitigates the risk of discrepancies arising later as a result of future changes to tax law.

194. *See supra* Sections III.A, III.B, III.C, III.D.

195. For discussion of a specific example, see *supra* Section III.B.

interest may provide taxpayers with a way to sidestep the new rules. This is true, for example, of the new restriction on deductibility of losses arising in a trade or business discussed above in Section III.B.

IV. PROPOSAL FOR REFORM

The current tax treatment of a partner's sale of his or her interest in a partnership is problematic because it is both unduly favorable to taxpayers and unduly unfavorable to taxpayers, compared to an approach that more accurately equates the tax treatment of the sale of a partnership interest with the tax treatment of the sale of underlying assets.[196]

In lieu of the existing approach, Congress should require looking through to the underlying assets of the partnership in all cases. Congress should provide that, when a partner sells his or her interest in a partnership, the partner will recognize any tax item that would be allocated to the partner with respect to the interest that is sold if the partnership sold all of its assets for fair market value. In addition, the selling partner will recognize any tax item that would be recognized by the partner if the partnership distributed to the selling partner his or her share (with respect to the interest that is sold) of the proceeds in redemption of the interest that is sold.[197] In each of the examples discussed above in Part III, this proposal would have the result of equating the tax treatment of the sale of a partnership interest with the tax treatment of the sale of underlying assets.

Some might object to this proposal because they view it as making the determination of the selling partner's tax consequences more complex.[198] It would entail some additional complexity; however, the incremental amount of complexity (compared to current law) may be overstated.[199] Potential additional complexity stems from two sources. First, this approach would require the partnership to determine the value of each of

196. *See supra* Part III.

197. If the partner's basis in his or her partnership is not same as the partner's share of the partnership's basis in its assets, this approach would produce some residual gain or loss from sale of a partnership interest recognized as a result of the deemed redemption of the partner's interest. In that way, it is not purely an aggregate approach, but it would, nonetheless, harmonize the tax treatment of exiting by sale of a partnership interest with the tax treatment of exiting by sale of a partnership's assets followed by redemption of the partner's interest. Moreover, discrepancies between a partner's basis in his or her partnership interest and the partner's share of the partnership's basis in its assets could be eliminated by mandating adjustments to a partnership's basis in its assets in cases in which such adjustments are currently elective.

198. *See* AM. LAW INST., *supra* note 39, at 22–36; *supra* text accompanying note 87.

199. *See infra* notes 200–202 and accompanying text.

its underlying assets at the time of the sale of the partnership interest.[200] While this would be costly, it does not represent a large departure from what is currently required. Under current law, valuation of any hot asset is already required to properly apply the existing tax provisions.[201] Moreover, for non-tax business reasons, in many cases, the selling and purchasing partner may determine asset values regardless of the requirements imposed by tax law in order to properly value the partnership interest that is sold.[202]

Second, additional complexity arises because the selling partner must now determine the character of any tax item that would be allocated to the partner from the sale of each underlying asset of the partnership. Under current law, the partner only needs to determine which assets are hot assets and then ascertain the consequences under § 751 that follow from the partnership holding those assets. The partner need not determine what tax consequences would follow from the sale of any asset that is not a hot asset. Under the proposed reform, the partner would be required to determine the resulting tax consequences that would follow from a sale of each underlying asset, not just hot assets.[203] As a practical matter, however, in the course of evaluating different possible ways of exiting the partnership, many selling partners might already make such a

200. *See* AM. LAW INST., *supra* note 39, at 23–24.

201. *See id.*; Postelwaite, *supra* note 40, at 575 (discussing the ALI's observations about the extent to which valuation is required even without looking through to all assets). One might argue that "inventory items" and "unrealized receivables" are materially easier to value than other assets given that they are items that are sold with frequency. While this might be true of "unrealized receivables" in the traditional sense of rights to payment for goods or services, given the expansion of "unrealized receivables" to include a host of other items the sale of which produces ordinary income or loss, this rationale has become less convincing. In addition, § 1(h)(5)(B) requires the valuation of underlying assets that are collectibles. Furthermore, valuation of all underlying assets may be required by tax law for other purposes. For instance, in order to determine whether the partnership's assets have a "substantial built-in loss" so that basis adjustments would be required by § 743(d), valuation will be required any time that it is possible that such a substantial built-in loss might exist. Also, if a substantial built-in loss exists or if a partnership has made a § 754 election, valuation of underlying assets will be necessitated by § 743 and § 755.

202. *See* Postelwaite, *supra* note 40, at 575 ("[W]hen a prospective purchaser seeks to purchase a partnership interest, or when the partnership decides to 'buy' (redeem) one of its partner's interests, a detailed evaluation of each asset's fair market value is required to determine a fair purchase (redemption) price. Behaving in any other manner would be economically imprudent.") In some cases, this might not be true because the parties might value the overall business without valuing each individual asset by, for instance, looking at comparable businesses or making projections regarding future earnings in order to determine a discounted cash flow valuation for the business. ASWATH DAMODARAN, INVESTMENT VALUATION: TOOLS AND TECHNIQUES FOR DETERMINING THE VALUE OF ANY ASSET (3d ed. 2012).

203. For example, the partner would have to determine the partnership's holding period for each of its capital assets in order to determine whether the resulting capital gain or loss is long-term or short-term.

determination. Furthermore, if the change is deemed to be unduly onerous in the case of a partner selling an interest in a small partnership, for instance, the reform could be accompanied by a *de minimis* rule that did not require full look-through to underlying assets in such cases.

CONCLUSION

The sale of a partnership interest produces capital gain or loss except to the extent that a partnership holds hot assets.[204] If a partnership holds hot assets, Congress requires that some of the selling partner's gain or loss will be ordinary in order to prevent taxpayers from converting ordinary income into capital gain.[205] However, the focus of the existing provisions is too narrow—rather than merely preventing taxpayers from converting ordinary income into capital gain, lawmakers ought to ensure that the sale of a partnership interest produces the same tax consequences that follow from the sale of underlying assets in all cases.[206] The reforms proposed by this Article would accomplish that objective.

204. *See supra* Part I.

205. *See supra* Parts I, II.

206. *See supra* Parts III, IV.