

ANACHRONISMS IN SUBCHAPTER K OF THE INTERNAL REVENUE CODE: IS IT TIME TO PART WITH SECTION 736?

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Brutus: Peace! Count the clock.

Cassius: The clock hath stricken three.

Trebonius: 'Tis time to part.

—William Shakespeare, *The Tragedy of Julius Caesar*¹

On this occasion of the one-hundredth anniversary of the *Northwestern University Law Review*, the editorial board has called for a reflective view on the development of the law by its law school faculty. Appropriately, for purposes of this Essay, we have combined the divergent perspectives of two faculty members of the Tax Program at Northwestern University School of Law to scrutinize the evolution of a portion of tax law over the past fifty years. One of us, in the winter of his career, possesses a somewhat cynical view in light of his numerous years of teaching and writing in the field. The other, as a neophyte beginning his first year, brings an accompanying optimism.² From this dual perspective, we do not address the evolution of the Code³ in its entirety (a daunting task even in its description), but rather anachronisms in the same. More specifically, we focus on section 736, a provision of Subchapter K of the Code, enacted originally in 1954 to settle the tax treatment of payments by a partnership to a retiring partner or to the successor of a deceased partner in liquidation of the partner's interest. Regardless that we approach section 736 from our divergent perspectives, the

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¹ WILLIAM SHAKESPEARE, *THE TRAGEDY OF JULIUS CAESAR* act 2, sc. 1.

² The difference in backgrounds and training is highlighted by the fact that one of us began teaching fresh on the heels of the 1969 Tax Reform Act while the other enters the academy thirty-five years later in the shadow of the passage of the 2004 Jobs Act.

³ Unless otherwise indicated, all references to "the Code" and sections therein refer to the Internal Revenue Code of 1986, as amended.

conclusion is the same: time has passed section 736 by, and, rather than serve its initial purpose, section 736 survives as an anachronism preventing the coherent evolution of the Code. Section 736 thus serves as a warning of the dangers inherent in the rise of anachronisms both in Subchapter K and the Code as a whole.

An anachronism is officially defined as “1: an error in chronology; *esp*: a chronological misplacing of persons, events, objects, or customs in regard to each other. 2: a person or a thing that is chronologically out of place; *esp*: one from a former age that is incongruous in the present.”⁴ Regardless of where we encounter it—in the course of reading great literature or while surveying the Code—an anachronism should always give us pause, prompting us to ask: why is it there?⁵ To return to the literary reference that began this piece: did Shakespeare simply stumble in crafting his plot, forgetting that clocks did not exist at the time of Caesar? Or, as we strongly suspect, did he have a higher purpose, perhaps to drive home the point that time stops for no person, regardless of position?⁶

Just as we scrutinize Shakespeare’s intentions, in this Essay we speculate about the intentions of Congress (another kind of author) with its own great play of life (the Code) and that author’s decision to retain statutory provisions in the Code that appear chronologically out of place. Do these provisions continue as a mere oversight or do they persist by design? If attributable to oversight, such Code provisions would be distressing enough from a tax policy standpoint in that subsequent statutory enactments should have called into question their continued vitality. Of greater concern, however, are those anachronisms that have been revisited and amended by Congress and yet remain in place. These anachronistic provisions are more perplexing because the obvious explanation for their existence—oversight—is less plausible.

As an example of this phenomenon, this Essay will evaluate section 736 of the Code, which unlike our reference to the clock by Brutus and Cassius, we assert is an example of the more indefensible type of anachronism.⁷ Not only has section 736’s *raison d’être* been fundamentally under-

⁴ WEBSTER’S COLLEGIATE DICTIONARY 43 (11th ed. 2003).

⁵ The presence of anachronisms has caused consternation in analyzing other areas of the tax law as well. See, e.g., Calvin H. Johnson, *The Legitimacy of Basis from a Corporation’s Own Stock*, 9 AM. J. TAX POL’Y 155, 157 (1991) (“Theory and legitimacy of tax results are important because we should be committed to changing unprincipled results and rooting out anachronisms.”).

⁶ Although an apt analogy in the context of section 736, we give the benefit of the doubt to Shakespeare, much more so than to Congress, that the use of the anachronism was intentional. Used properly, anachronisms can powerfully symbolize the immediacy and timelessness of the point at hand. For Brutus, this sentiment is represented by the struggle between his aspiration to preserve the republic and his love for his friend. At this moment of decision, Shakespeare makes the struggle for Brutus immediate and relevant to the reader by using a symbol readily accessible to those in seventeenth century England—the tolling of church bells.

⁷ Section 736 has the unique distinction of having anachronistic aspects when it was enacted, because a deduction for goodwill was unavailable in any other context, and of growing more anachronistic

mined by Congress as part of the continuing evolution of the statutory framework of the Code, but Congress has specifically revisited the provision and yet failed to integrate these new Congressional directives into the antiquated text.⁸ How could a provision such as section 736, with limited utility, devastating complexity, and confusing (at best) policy implications, remain in the Internal Revenue Code? How has section 736 survived multiple calls for its repeal? A study of the evolution of section 736 provides not only the opportunity to scrutinize the tax-making machinery that determines how and why such anachronistic imperfections come to be, but also to ponder how they can be prevented in the future.⁹

To this end, Part I of this Essay will analyze the current structure and operation of section 736 and highlight the problematic aspects of the provision from a tax policy perspective. Part II will describe how and why the provisions of section 736 frustrate the development of a coherent tax policy, given the evolving structure and intent of the Code, and in particular the development of (i) the fundamental change in the treatment of goodwill for tax purposes, (ii) the fundamental change in the treatment of deferred compensation, and (iii) the expansion of efforts to root out abusive activity for partnership transactions under Subchapter K. Part III will focus on why Congress needs to turn its attention to such anachronisms, advocating the repeal of section 736 as the necessary and appropriate response. Part IV will consider how such anachronisms may be avoided in the future and advocates direct scholarly input into the legislative process as a safeguard against their future rise and continuation.

I. STRUCTURE AND OPERATION OF SECTION 736

As with most provisions in the Code, section 736 was born in 1954 of a relatively benign lineage. At the time of its enactment, there were no statu-

fifty years later as the law has changed dramatically, because (in part) goodwill in any other context is now amortizable over fifteen years.

⁸ Other anachronisms exist in Subchapter K, including, but not limited to, sections 707(c), 751(d)(3), and 751(b). Section 707(c) was effectively rendered superfluous by the enactment of sections 707(a)(2)(A) and (B) and 267(e), section 751(d)(3) by the enactment of section 724 and the repeal of section 341, and section 751(b)(2) by the amendment of section 751(a).

⁹ Thematically, the issue of anachronisms in the tax law runs in tandem with the issue of simplification. See, e.g., 2 STAFF OF J. COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (Comm. Print 2001) [hereinafter 2001 JCT STUDY]; John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1 (1993). By definition, the “technical complexity” of the Code is simplified through the removal of any Code provision. See Edward J. McCaffrey, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267. As will be illustrated, because the tax policy reasons for the enactment of section 736 have been undermined and the safeguard functions of section 736 already exist in other provisions of Subchapter K addressing the taxation of partners and partnerships, the repeal of section 736 would also further the underlying goals of simplicity. See Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 739–45 (2003).

tory provisions dealing with the income tax aspects of payments by a partnership to a retiring partner or to the successor of a deceased partner in liquidation of the partner's interest; notwithstanding a significant amount of case law in the area, no consistent answer was available to taxpayers.¹⁰ Section 736 was enacted to provide such an answer by comprehensively addressing the tax treatment of such payments.¹¹ Fifty-one years later, this decision continues to haunt the Code and torment taxpayers, practitioners, and academics alike.

A. Historical Background

When section 736 was first enacted, the tax treatment for the amount received upon the sale of the assets of a business, including goodwill, was well settled for both the buyer and the seller. Under the principles of *Williams v. McGowan*,¹² an asset-by-asset analysis of the transaction controlled for tax recognition and characterization purposes. Goodwill was held to be a capital asset, eligible for the preferential effective tax rates applicable to capital gains upon its disposition.¹³ The purchaser of the goodwill was held to have acquired a nonamortizable intangible asset.

Assume, for example, a sole proprietorship with the following balance sheet:

	Assets			Capital	
	Adjusted Basis	Fair Market Value		Adjusted Basis	Fair Market Value
Cash:	\$10,000	\$10,000			
Fixed Assets:	20,000	23,000			
Goodwill:	0	30,000	A:	\$30,000	\$63,000
TOTAL:	\$30,000	\$63,000		\$30,000	\$63,000

Upon the arm's-length sale of the sole proprietorship by *A* for \$63,000, the money received by *A* was allocated for tax purposes \$10,000 to cash and \$23,000 to the fixed assets; the amount in excess of the fair market

¹⁰ See H.R. REP. NO. 83-1337, at 71-72 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4098; see also *infra* note 19 and accompanying text.

¹¹ *Id.*

¹² 152 F.2d 570 (2d Cir. 1945).

¹³ For most of the history of the Code (with a brief period following the Tax Reform Act of 1986 being a primary exception), net capital gains realized by a taxpayer selling a capital asset have been eligible for a preferential effective tax rate. At certain times, a portion of the net capital gain was excluded from taxable income. At other times, a lower marginal rate of tax was imposed on the total net capital gains. Under either scenario, as a general matter, the effective tax rate paid on capital gains was significantly lower than that paid on ordinary income for taxpayers in the highest marginal tax bracket.

value of the fixed assets (i.e., \$30,000) was allocated to goodwill. No gain was recognized by *A* on the cash, \$3000 of possible capital gain was recognized by *A* on the fixed assets, and \$30,000 of capital gain was recognized by *A* on the goodwill. The purchaser of the enterprise was required to capitalize his purchase price, with a tax basis of \$23,000 attributable to the fixed assets and a tax basis of \$30,000 attributable to the goodwill. The purchase price allocated to the goodwill was not amortizable.¹⁴ Accordingly, having capitalized his cost attributable to the goodwill, the purchaser received no tax benefits from the acquisition during his ownership of the proprietorship. Only upon a disposition of the business did such purchase price attributable to the goodwill come into play in determining the gain or loss realized upon the sale or exchange.

Similar analyses arose when terminating a partner's interest in a partnership. The situation inherently involved added complications, however, because the multiple ownership interests embodied in a partnership interest typically presented a number of choices to the partners in structuring the exit. For instance, the termination could be structured as an arm's-length sale of the exiting partner's partnership interest to a third party, as a sale of the exiting partner's interest to the other partner(s), or as a liquidation of the withdrawing partner's interest. If the interest was purchased, the funds came from the third party or the other partner(s). If the interest was liquidated, the funds came from the partnership. In each setting, absent tax considerations, the exiting partner would expect to receive the same amount of consideration for the relinquishment of his interest; to the extent the exiting partner received any consideration in excess of what a third party would pay in an arm's-length transaction, such excess would not be considered in exchange for partnership property.

Near identical results ensued to an exiting partner upon the sale of a similarly situated partnership interest to a third party as in the sale of a sole proprietorship to a third party. For example, assume that *A*, rather than being a sole proprietor, was a one-third partner of partnership ABC (with the same assets as the sole proprietorship, tripled in value and basis to ensure an appropriate comparison):

¹⁴ See, e.g., H.R. REP. NO. 103-213, at 696-97 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1385-86 ("The cost of goodwill acquired in connection with the assets of a going concern normally is a capital expenditure, as is the cost of acquiring accounts receivable. The cost of acquiring goodwill is recovered only when the goodwill is disposed of, while the cost of acquiring accounts receivable is taken into account only when the receivable is disposed of or becomes worthless.").

	Assets		Capital	
	Adjusted Basis	Fair Market Value	Adjusted Basis	Fair Market Value
Cash:	\$30,000	\$ 30,000	A: \$30,000	\$ 63,000
Fixed Assets:	60,000	69,000	B: 30,000	63,000
Goodwill:	<u>0</u>	<u>90,000</u>	C: <u>30,000</u>	<u>63,000</u>
TOTAL:	<u>\$90,000</u>	<u>\$189,000</u>	<u>\$90,000</u>	<u>\$189,000</u>

Assume *A* exited from the above-described partnership through a sale to a third party for \$63,000. Notwithstanding the governance of the transaction by a different statutory scheme of the Code from that applicable to the sole proprietor, i.e., Subchapter K, *A* was taxed similarly.

This result arose because, under the Code's partnership provisions, a selling partner generally derived capital gain from the sale of his partnership interest just as *A* derived capital gain from the sale of the capital assets of the sole proprietorship.¹⁵ If the partnership possessed unrealized receivables or appreciated inventory, the safeguard provision of section 751(a)¹⁶ would come into play, resulting in ordinary income to *A* equal to the amount that would have been reported by *A* had the partnership sold such inventory or collected such receivables.¹⁷ Goodwill did not constitute an unrealized receivable or an inventory item for these purposes. Thus, the consideration received by *A* for his partnership interest attributable to partnership goodwill always generated capital gain, just as it did in the sole proprietorship context. Furthermore, neither the purchaser nor the partnership was entitled under any circumstance to deduct or amortize the amount paid for the goodwill.

But while the treatment of a sale of an interest in a partnership that possessed goodwill was well settled, the tax treatment of an arm's-length "retirement" of such a partnership interest was more clouded. Although a repurchase of a retiring partner's interest was virtually identical economically to a pro rata purchase of such partner's interests by the remaining partners, because the proceeds were coming from the partnership, such payments could conceptually be considered attributable to a number of items: (i) the payment could be solely in exchange for the partner's interest

¹⁵ Treas. Reg. § 1.741-1 (as amended in 2000). See generally 1 ARTHUR B. WILLIS, JOHN S. PENNELL & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 12.01 (6th ed. 2004).

¹⁶ As a general matter, section 751(a) mandates that a seller of a partnership interest treat a portion of the gain realized on the sale as ordinary income to the extent the value of the partnership interest sold is attributable to unrealized receivables or appreciated inventory of the partnership. *Id.* ¶ 12.02.

¹⁷ *Id.*

in partnership property, generally resulting in capital gain; (ii) the payment could be solely in exchange for the partner's interest in the partnership's other assets (unrealized receivables, fees, and inventory), resulting in ordinary income; (iii) the payment could be in exchange for the partner's pro rata interest in all of the partnership's assets, resulting in part ordinary income and part capital gain; (iv) the payment could be in the nature of deferred compensation, resulting in ordinary income; (v) the payment could be "an arrangement in the nature of mutual insurance among the partners,"¹⁸ generally resulting in ordinary income treatment; or (vi) any combination thereof. The case law was in conflict regarding the tax consequences to a partner upon retirement and provided an unsatisfactory guide for the treatment of such payments to either the partnership or the retiring partner.¹⁹

B. Section 736 to the Rescue?

In the face of this uncertainty, section 736 was adopted to provide "more equitable tax treatment of distributions to retiring" or withdrawing partners.²⁰ The provision specified, and thereby clarified, the tax consequences for all parties receiving various retirement payments from the partnership, albeit at some dramatic variance from the general tax rules attributable to the purchase and sale of goodwill and unrealized receivables.

Section 736 was intended to solve the definitional and other problems that arose when a partnership made payments to a retiring partner by clarifying when such payments would be considered to be attributable to the retiring partner's interest in partnership assets (including goodwill), partnership receivables,²¹ or deferred compensation retirement benefits. It did so by apportioning the payment to the retiring partner between those amounts in the nature of ordinary income, on the one hand, and those amounts in exchange for partnership property, on the other. As discussed below, it represented a tradeoff in which the partnership would receive the

¹⁸ H.R. REP. NO. 83-1337, at 71-72 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4098.

¹⁹ Courts were split as to whether to treat such payments entirely as a purchase of the partner's partnership interest, *see, e.g.,* McKelvey v. Comm'r, 246 F.2d 609 (3rd Cir. 1957), or entirely as an allocation of operating income of the partnership, *see, e.g.,* Whitworth v. Comm'r, 204 F.2d 779 (7th Cir. 1953); Pomeroy v. Helvering, 68 F.2d 411 (D.C. Cir. 1933), and provided little guidance to taxpayers as to which result would arise under which circumstances. Few, if any, courts apportioned the payment between the two. As discussed in more detail herein, the choice would have a significant impact on the tax treatment of both the withdrawing partner and the continuing partnership. *See generally* 1 WILLIS, PENNELL & POSTLEWAITE, *supra* note 15, ¶ 15.01.

²⁰ H.R. REP. NO. 83-1337, at 71-72, *reprinted in* 1954 U.S.C.C.A.N. at 4098.

²¹ One example of the potentially fatal policy flaws that plagued section 736 even at its initial enactment is the variance from the general rules with respect to the treatment of payments made for a partnership interest attributable to unrealized receivables under section 751(b). Under section 751(b), the payment would be ordinary income to the retiring partner and would be capitalized into the basis of the receivables by the partnership (effectively reducing the amount of income realized upon realization of the receivables in the future). By contrast, section 736(a) granted the partnership an *immediate* deduction for the same payment.

benefit of a current deduction, but only if the retiring partner incurred ordinary income treatment in exchange. Theoretically, the inherent adversity between the partner and the partnership in this tradeoff would foster the proper characterization of payments for items of partnership property. The tradeoff, instead, created a unique opportunity for the parties to manipulate the tax treatment of such items.²²

In the enactment of section 736, Congress deliberately provided partners with substantial latitude in planning the liquidation of an interest in the partnership. The Tax Court confirmed this intention in an early decision addressing section 736. The Court wrote:

Tax law in respect of partners may often involve a delicate mechanism, for a ruling in favor of one partner may automatically produce adverse consequences to the others. Accordingly, one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent, and this is what the committee reports meant when they referred to “flexibility.” The theory was that the partners would take their prospective tax liabilities into account in bargaining with one another.²³

Section 736 advanced this flexibility by providing for two alternate and, in some cases, elective regimes for the treatment of payments in liquidation of a partnership interest. The general rule of section 736(a) was that the portion of the payments attributable to a partner’s interest in unrealized receivables, unspecified goodwill, or deferred compensation retirement benefits were treated either as guaranteed payments under section 707²⁴ or payments of a distributive share of partnership income.²⁵ Either treatment effectively generated a current deduction to the remaining partners. Section 736(b) then provided that the portion of the payments made in exchange for the partner’s interest in other partnership property, including “specified” goodwill, would be treated as payments in exchange for the withdrawing partner’s interest in partnership property; such payments would therefore be

²² As described by at least one court, the complexity alone of section 736 made it rife for mistaken application (at best) or abuse (at worst). Specifically, the court in *Foxman v. Commissioner*, 41 T.C. 535, 551 n.9 (1964), *aff’d*, 352 F.2d 466 (3d Cir. 1965), stated:

The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. . . . If there should be any lingering doubt on this matter one has only to reread section 736 in its entirety, . . . and give an honest answer to the question whether it is reasonably comprehensible to the average lawyer or even to the average tax expert who has not given special attention and extended study to the tax problems of partners. Surely, a statute has not achieved “simplicity” when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.

²³ *Id.* at 551 (citation omitted). See generally Mark P. Gergen, *The Story of Subchapter K: Mark H. Johnson’s Quest*, in *BUSINESS TAX STORIES* 207 (Steven A. Bank & Kirk J. Stark eds., 2005).

²⁴ See generally 1 WILLIS, PENNELL & POSTLEWAITE, *supra* note 15, ¶ 11 (discussing the tax treatment of guaranteed payments under section 707).

²⁵ See generally *id.* ¶ 9 (discussing the tax treatment of a distributive share of partnership income).

governed by the general rules of sections 731 and 741 (providing generally for capital gain treatment except to the extent ordinary income treatment was mandated under section 751).²⁶

Thus, payments by a partnership to a withdrawing partner in amounts exceeding the fair market value of the partner's share of the fixed assets of the partnership were excluded from treatment as payments for partnership property under section 736(b) unless they were "specified" as goodwill in the partnership agreement. The members of a partnership, therefore, possessed significant flexibility to determine whether such payments were classified as section 736(a) payments (taxable, in the nature of deferred compensation, as ordinary income to the partner and reducing the taxable income of the other partners) or as section 736(b) payments (taxable as a nondeductible payment for partnership property, resulting in a capital transaction to the withdrawing partner). To the extent the partners chose to provide in the partnership agreement that the payment was for "specified" goodwill²⁷ the payment was treated as a section 736(b) payment, otherwise the payment was a section 736(a) payment.²⁸

Congress provided this flexibility because it assumed that the interests of the continuing partners and the withdrawing partner with respect to such payments would generally be in conflict. If the payments made by the continuing partnership to the withdrawing partner were treated as either a distributive share of partnership income or guaranteed payments in the nature of deferred compensation under section 736(a), they would be taxable to the

²⁶ Sections 731 and 741 of the Code provide that the sale or redemption, respectively, of a partnership interest will generally result in capital gain to the selling or redeemed partner. As discussed above, section 751(a) mandates that a seller of a partnership interest treat a portion of the gain realized on the sale as ordinary income to the extent the value of the partnership interest sold was attributable to unrealized receivables or appreciated inventory of the partnership. See *id.* ¶ 15.

²⁷ According to the legislative history, amounts attributable to goodwill in the partnership agreement (and thus subject to these rules) were limited to the "reasonable value of the partner's share of partnership goodwill." S.REP. NO. 83-1622, at 315 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 5037. No other guidance was given as to the proper scope of the application of the treatment of goodwill. The regulations provide only that "the valuation placed upon goodwill by an arm's length agreement of the partners . . . shall be regarded as correct." Treas. Reg. § 1.736-1(b)(3) (as amended in 1995). As discussed below, the partners thus retained the ability to apportion payments in excess of the fair market value of the fixed assets of the partnership between payments for goodwill and payments in the nature of deferred compensation to maximize the total after-tax value, notwithstanding what a third party would have paid.

²⁸ This potential for manipulation was exacerbated by the fact that the decision as to whether to treat the payment as a payment for property or as a section 736(a) payment need not always be made at the initial formation of the partnership. For example, the holding in *Smith v. Commissioner*, 37 T.C. 1033, *aff'd*, 313 F.2d 16 (10th Cir. 1962), did not require that the provision with respect to payments for goodwill be included in the basic partnership agreement. Rather, a withdrawal agreement entered into at the time of a partner's withdrawal satisfied the requirement. Similarly, in *Jackson Investment Co. v. Commissioner*, 346 F.2d 187 (9th Cir. 1965), the basic partnership agreement contained no provision for liquidating payments for goodwill. At the time of withdrawal, the partners entered into an agreement that the court interpreted as providing for payments for goodwill for purposes of section 736. *Id.* at 191.

withdrawing partner at ordinary income rates and would reduce the taxable income of the other partners through the use of a current deduction or a reduction in their distributable share. If the payments made by the continuing partnership were treated as a payment for the withdrawing partner's interest in partnership property under section 736(b), the withdrawing partner would be taxable at the preferential capital gains effective tax rate, but the payments would not generate a deduction to the remaining partners. The Congressional assumption was that the continuing partners would desire the benefit of a current tax deduction while the withdrawing partner would prefer the preferential effective tax rates available for capital gains. The tension thus created between the obligor partnership and the recipient partner was thought to be an adequate means for ensuring arm's-length dealing between the two.²⁹

This flexibility gave rise to dramatically different tax consequences in identical settings.³⁰ In the above-discussed example involving our hypothetical partnership,³¹ the balance sheet appeared as follows:

	Assets		Capital	
	Adjusted Basis	Fair Market Value	Adjusted Basis	Fair Market Value
Cash:	\$30,000	\$ 30,000	A: \$30,000	\$ 63,000
Fixed Assets:	60,000	69,000	B: 30,000	63,000
Goodwill:	<u>0</u>	<u>90,000</u>	C: <u>30,000</u>	<u>63,000</u>
TOTAL:	<u>\$90,000</u>	<u>\$189,000</u>	<u>\$90,000</u>	<u>\$189,000</u>

Upon a liquidation of *B*'s interest in the partnership for \$63,000 of cash, the tax consequences of the distribution were governed by section 736. Thus, depending upon the specification of goodwill in the partnership agreement by the partners, *different* tax consequences arose.

If the partnership agreement specified that the \$30,000 payment in excess of the fair market value of the partner's share of the fixed assets of the partnership was in exchange for goodwill, then the \$30,000 of gain attribut-

²⁹ One would think that such tension holds true in other, nonpartnership transactions involving a purchase and a sale of a business between unrelated parties. See Treas. Reg. § 1.1060-1(c)(4) (as amended in 2004); Treas. Reg. § 1.751-1(g) exs. 3 & 4 (as amended in 2004). However, these provisions do not allow for the unique tax treatment, and potential for manipulation, available in section 736.

³⁰ From a tax policy standpoint, such a result implicated the maxims of horizontal and vertical equity, i.e., similar settings should be taxed similarly and there should be an appropriate differentiation among unequals. See Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993) (discussing in general the definitional debate between horizontal and vertical equity and whether horizontal equity has any independent consequence).

³¹ See *supra* notes 15-17 and accompanying text.

able to goodwill resulted in capital gain to *B* and no deduction to the partnership. If, instead, the partnership agreement was silent as to the allocation of such payment, then the \$30,000 resulted in ordinary income to *B*,³² with the partnership in turn receiving an ordinary deduction (or reduction in distributable share) of \$30,000.³³

Thus, results arose in the partnership retirement context—ordinary income to the seller and an immediate deduction to the purchaser—that were not available in any other situation involving the sale or acquisition of the assets of a going concern, including goodwill. This exceptional treatment alone should have called into question the foundation for the enactment of section 736 and the tax policy legitimacy of its operation.

C. Calls for the Amendment or Repeal of Section 736

In adopting section 736, Congress believed that the inherent adversity in the parties' interests would offset the policy defect underlying the provision—namely, the potential for the parties to work together to take advantage of the tax benefits afforded by section 736. This assumption, however, failed to take into account two possibilities for manipulation.

First, the remaining partners in the partnership could pay the withdrawing partner a portion of the benefit attributable to the deduction available under section 736(a) for payments attributable to unspecified goodwill. The withdrawing partner could consent to ordinary income characterization in exchange for this payment. To the extent the present value of the deductions attributable to goodwill were greater to the continuing partners than the cost of ordinary income treatment to the withdrawing partner, such an agreement would benefit both the continuing partners and the withdrawing partner. This potential for manipulation increases as taxpayers, including partners in service partnerships, grow more sophisticated about the economic treatment of payments to retiring or withdrawing partners.³⁴

Second, the retiring partner could be in a lower marginal tax bracket upon retirement than while an active partner in the partnership (a not uncommon situation for service professionals retiring from active participation in their service partnership).³⁵ The section 736(a) payment could be

³² Under section 736(a), the payment for the goodwill would be considered either a guaranteed payment under section 707 or a distributive share of partnership income under section 702. With respect to the latter, it is possible that a portion of the payment could be capital gain to the extent the partnership realized capital gain in the year of payment. For purposes of this Essay, however, it is assumed that the payment is attributable entirely to ordinary income.

³³ As an indication of the out-of-sync nature of section 736 and its elective treatment, as previously discussed, an exiting partner in a sales context under section 741 received only capital gain treatment with respect to the value of the partnership interest attributable to goodwill.

³⁴ See *infra* note 58.

³⁵ See, e.g., Edward J. McCaffrey, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 863–865 (2005) (describing the pattern of increasing and then decreasing marginal tax rates over the life of a taxpayer).

paid over time to take advantage of the withdrawing partner's reduced tax bracket (which in many cases could be similar to the preferential effective capital gains rate), further mitigating the negative impact of ordinary income treatment. Meanwhile, the partnership would obtain the benefit of the current deduction for the payments as made, presumably at the higher ordinary income rates for the partners who remained active in the partnership.

The combination of these strategies could potentially mitigate the adversity between the parties entirely. Rational actors would negotiate to maximize the *total* (rather than each individual's) present value of after-tax proceeds and divide it among themselves accordingly. The only loser would be the fisc.³⁶

In 1984, the American Law Institute ("ALI") addressed section 736 in its *Federal Income Tax Project on Subchapter K*. The ALI determined that, given its deviation from established tax policy principles, section 736(a)(2) should be amended to prevent a deduction for goodwill. As it stood, section 736(a)(2) represented "a considerable variation from the rules generally applicable to such payments."³⁷ The ALI, however, failed to call for the outright repeal of the section, proposing instead that section 736 be modified to reduce the opportunities for manipulation of tax payments to retiring partners.³⁸ While these opportunities would be eliminated for capital-intensive partnerships, they would remain for service-intensive partnerships. The ALI justified this continuation for service partnerships because of the perceived difficulties in determining the amount of goodwill in such settings.³⁹

³⁶ See *infra* note 44.

³⁷ ALI, FEDERAL INCOME TAX PROJECT SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 62 (1984) [hereinafter ALI STUDY]. In a footnote, the ALI also noted that this would be its position even if goodwill were amortizable for United States federal income tax purposes. *Id.* at 63 n.8. An immediate deduction for the acquisition of goodwill would be excessive from a tax policy standpoint if the standard treatment in all other cases was its amortization over a fixed period of time.

³⁸ *Id.* at 56–65. Qualified retirement plans implemented pursuant to a preexisting written plan would remain available to partners and, although they would provide some similar results, they would have to comply with the significant requirements and limitations imposed by the retirement plan rules of the Code.

³⁹ Specifically, the ALI wrote:

[I]t is frequently difficult to determine the goodwill of a partnership in which capital is not a material income-producing factor. . . . Moreover, in many instances, the goodwill of a partnership in which capital is not a material income-producing factor cannot be effectively transferred. A rule requiring capitalization of payments for goodwill in such partnerships would produce substantial litigation and uncertainty with doubtful revenue benefits. For these reasons it seems appropriate to exclude payments to general partners in partnerships in which capital is not a material income-producing factor from a general rule requiring capitalization of payments for goodwill.

Id. at 63. Of particular concern from a policy standpoint was the ALI's assertion that goodwill in the service-intensive partnership context was difficult to value. If true, these difficulties existed in other circumstances including those involving the acquisition of a service-intensive sole proprietorship. Nevertheless, such difficulties are typically irrelevant for tax purposes.

Thereafter, academic commentators advocated more dramatic action by Congress than that recommended by the ALI.⁴⁰ They argued that the ALI's recommendation eliminated only part of the problem with section 736 (the deductibility of goodwill) and only with respect to certain partnerships (those for which capital was a material income-producing factor). The commentators were unanimous in their assertion that section 736 in its entirety had outlived its usefulness, since whatever safeguards it imposed already could be found in Subchapter K,⁴¹ making section 736 excessive and unsound from a tax policy perspective.

D. Congressional Amendment of Section 736 in 1993

Notwithstanding the unique tax treatment in the partnership context of unspecified goodwill and critical commentary regarding its tax policy defects, section 736 persisted in the Code undisturbed for thirty-nine years. In 1993, Congress revisited section 736 in connection with its consideration of a number of other legislative enactments that fundamentally altered the assumptions underlying section 736. Although these enactments served to exacerbate the tax policy defects of section 736, and should have led to its repeal, section 736 lived on.

For the first time in the history of the Code, Congress permitted the amortization of intangible assets, including goodwill, through the enactment of section 197.⁴² Given that Congress was adopting a regime for the treatment of goodwill at the same time it was reconsidering section 736, at a minimum one would have thought Congress would have taken into account that section 736 already addressed partnership goodwill in certain contexts. In fact, if the nonamortization of goodwill was the impetus that dictated a different treatment for such payments when section 736 was enacted in 1954, the change to allow the ability to amortize goodwill in 1993 should have dictated, at a minimum, conformity between the provisions.⁴³

⁴⁰ See Walter D. Schwidetzky, *Hyperlexis and the Loophole*, 49 OKLA. L. REV. 403 (1996); John A. Lynch, Jr., *Taxation of the Disposition of Partnership Interests: Time to Repeal I.R.C. Section 736*, 65 NEB. L. REV. 450, 484 (1986). See generally Philip F. Postlewaite, 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, 613–14 (1986) (advocating a repeal of section 736).

⁴¹ For example, the treatment of payments attributable to the partner's interest in unrealized receivables would be subject to the general safeguard rules of section 751. Further, as discussed *infra* Part III, the deferred compensation function of section 736 and the tax treatment of partnership goodwill have been substantially replaced by other regimes.

⁴² Section 197 provided for amortization of intangible assets over fifteen years. Amortization under section 197 was made available in the partnership context as well. If an election were filed under section 754, goodwill could be amortized over fifteen years by an incoming partner in the case of a sale of a partnership interest or by the partnership in the case of a liquidation of a partnership interest involving specified goodwill. See generally 1 WILLIS, PENNELL & POSTLEWAITE, *supra* note 15, ¶¶ 12, 13.

⁴³ By way of comparison, although it took eleven years, Congress did begin conforming certain other provisions of the Code with section 197. In 2004, Congress amended sections 195 and 709 relating to the amortization of organizational and start-up expenses to require that such expenses be amor-

Congress did recognize, however, that the previously assumed adversity of interests between the retiring partner and the continuing partnership was not materializing as originally intended.⁴⁴ In response, Congress adopted the ALI's recommendation regarding section 736 and restricted the flexibility provided in section 736 by enacting section 736(b)(3). This amendment narrowed the available flexibility with regard to the specification of goodwill by allowing for the election only for withdrawing general partners⁴⁵ in partnerships in which capital was not a material income-producing factor (i.e., service partnerships). The sole explanation for retaining the elective regime for service-type partnerships was, "It is recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law."⁴⁶ Thus, the

tized over fifteen years, rather than five years, as had previously been the case. The rationale for the change was that such expenditures effectively were acquisitions of an intangible asset and thus should receive the same treatment as acquisitions of other intangible assets subject to section 197. Once again, however, Congress failed to discuss, let alone address, the same problem inherent in section 736.

⁴⁴ According to the Committee Report:

The special treatment of goodwill was apparently predicated on the assumption that the adverse positions of the taxpayers will result in a stated price equal to the true value of the goodwill. That assumption is false. If the value of the preferential rate (if any) and the income deflection are not equal, the stated goodwill and total retirement payments will likely be set so as to maximize the combined tax savings for both retiring and continuing partners.

H.R. REP. NO. 103-111, at 782 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 1013. Identical language can be found in STAFF OF J. COMM. ON TAXATION, 103RD CONG., TECHNICAL EXPLANATION OF THE TAX SIMPLIFICATION ACT OF 1993, at 169 (H.R.13) (1993) [hereinafter BLUEBOOK].

⁴⁵ Even this congressional effort at reform is unraveling with the advent of a new generation of forms in which a noncorporate enterprise may operate. The limited liability company and its progeny create uncertainty as to whether its members can be classified as general partners for purposes of section 736. See Sheldon I. Banoff, *Tax Distinctions Between Limited and General Partners: An Operational Approach*, 35 TAX L. REV. 1 (1979); Steven G. Frost, "Square Peg, Meet Round Hole": *Classifying LLC Members as "General Partners" or "Limited Partners" for Federal Tax Purposes*, 73 TAXES 676 (1995); Sheldon I. Banoff et al., *Defining 'General Partner' and 'Limited Partner' for Federal Tax Purposes*, TAX NOTES TODAY, Feb. 22, 1996, 96 TNT 37-82 (LEXIS). For purposes of section 736, is there a "general partner" if one of these entities is involved? See, e.g., Steven G. Frost & Sheldon I. Banoff, *Square Peg, Meet Black Hole: Uncertain Tax Consequences of Third Generation LLEs*, 100 J. TAX'N 326 (2004).

In 2001, the Joint Committee proposed changing all references to "general partners" (including that in section 736) to reflect this fact. See 2 2001 JCT STUDY, *supra* note 9, at 278 ("Nevertheless, a number of provisions of the tax law refer to either 'general partners' or 'limited partners.' These references generally predate the widespread use of limited liability companies, and are based on the distinction made under State law with respect to general and limited partners of partnerships. The distinction is difficult to interpret when applied to owners of a limited liability company, who, though treated as partners for Federal income tax purposes, are not subject to the State-law rules relating to partners and partnerships, and are neither general partners nor limited partners under State law.").

⁴⁶ H.R. REP. NO. 103-111, at 782 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 1013. Identical language can be found in the *Bluebook*. BLUEBOOK, *supra* note 44, at 169. Interestingly, the ALI's rationale in proposing an exemption from the repeal of section 736 for service partnerships was the *difficulty* that such partnerships would face in valuing goodwill. See *supra* note 39. Yet, Congress seemed unconcerned about requiring partnerships to value their goodwill for purposes of section 197.

assumption underlying the continuation of section 736 for service partnerships was that the inherent incentive for manipulating such payments was not present.

Surprisingly, this congressional rationale was so unfounded that one wonders from where it came.⁴⁷ By definition, the parties *have* to value goodwill if it exists. Both sides acting rationally and at arm's length in arriving at an exit price will always take goodwill into account, just like any other valuable asset of the partnership, no matter how difficult its valuation. Further, beyond the need to calculate goodwill for purposes of structuring the transaction, the operation and structure of section 736 contemplates the valuation of goodwill to determine whether it would be specified or unspecified. If, as asserted by Congress, goodwill did not exist in such settings, there would be no reason to grant the parties the option to specify goodwill in those settings. Rather, all payments in excess of the fair market value of the fixed assets of the partnership would necessarily be in the nature of deferred compensation, which would be treated as ordinary income in normal circumstances.

II. FUNDAMENTAL SHIFTS IN THE TAX LAW UNDERLYING SECTION 736

As discussed above, section 736 was based on a number of underlying assumptions. These assumptions included: (i) that the adversity of interests between the partners would regulate the treatment of goodwill, (ii) that payments for the purchase of goodwill were nondeductible capital expenses, and (iii) that the partners would utilize section 736 to structure deferred compensation to a retiring partner. In 1993, Congress recognized that one of the fundamental underpinnings of section 736—that the adverse interests of the parties would safeguard against abuse—was fatally flawed. This led to a reassessment and contraction of the contours of section 736. Nevertheless, in reconsidering the flawed underlying assumption of section 736, Congress ignored other fundamental shifts in the tax law that had occurred since its enactment which further undermined the remaining assumptions of section 736. This failure effectively converted section 736 from a questionable policy choice into a pernicious anachronism.

A significant conceptual underpinning of section 736 was fundamentally altered by the 1993 enactment of section 197. Under the original section 736 regime, payment to a withdrawing partner in exchange for *specified* goodwill resulted in no current tax benefit to the remaining part-

⁴⁷ Of course, one possible explanation could be that Congress merely granted a preference item to general partners of service partnerships under a public choice theory of legislation, i.e., that special interest groups (service partnerships) appealed to the self-interest of members of Congress to retain favorable tax treatment for their partnerships. See, e.g., Daniel Shavero, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1 (1990); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988).

ners.⁴⁸ Payment for *unspecified* goodwill, however, generated an immediate deduction for what, in any other context, was a nonamortizable, capital expenditure. Section 197 changed the assumed treatment of the former, with Congress adopting a regime intended to comprehensively⁴⁹ address the issue of purchase price attributable to intangible assets (including goodwill) by permitting amortization over fifteen years. Importantly, this change applied to all settings, not only to goodwill in the partnership context.

A dichotomy was therefore created. While all other taxpayers confronted the “unified” regime of fifteen-year amortization for acquisitions of goodwill under section 197, section 736 continued to allow partners in service partnerships to claim a current deduction for the purchase of goodwill from a withdrawing general partner. Disturbingly, this disparity arose precisely at the same time Congress was specifically amending and revisiting section 736. Yet Congress demonstrated no concern about the unique treatment accorded goodwill in the partnership context.⁵⁰

The lack of coordination between these two seemingly contradictory provisions leads to interpretative complexities as well—for example, what is the definition of “goodwill” for purposes of these sections? Goodwill for purposes of section 197 refers to goodwill calculated under the residual method of section 1060.⁵¹ Thus, goodwill for these purposes reflects only that value of a business in excess of the fair market value of all other assets, tangible and intangible (including patents, trademarks, customer lists, covenants not to compete, and going concern value).

In contrast, neither the statute nor the regulations under section 736 define goodwill. Historically, many intangible assets, items such as customer lists, insurance agency listings, formulas, know-how, going concern value, office records, client files, the right to use the firm name, and many others, have been included in the term “goodwill” as used in section 736.⁵² Congress, however, did not provide any indication as to whether the term as

⁴⁸ H.R. REP. NO. 83-1337, at 71–72 (1954), *reprinted in* U.S.C.C.A.N. 4017, 4098 (“The amounts paid for the capital interest of the withdrawing partner are treated in the same manner as a distribution. *The remaining partners, of course, are allowed no deductions for such payments.* Essentially, these payments represent a purchase by the remaining partners of the withdrawing partner’s capital interest in the partnership.” (emphasis added)).

⁴⁹ “No other depreciation or amortization deduction is allowed with respect to a section 197 intangible that is acquired by a taxpayer.” H.R. REP. NO. 103-213, at 673 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1362.

⁵⁰ Interestingly, even a partnership may qualify for amortization of goodwill under section 197. If goodwill is specified, the partnership’s payment is not deductible under section 736. Nevertheless, if the partnership makes a section 754 election and the anti-churning rules do not apply, it may amortize the goodwill payments over a fifteen-year period under section 197(f)(9)(E). *See* 1 WILLIS, PENNELL & POSTLEWAITE, *supra* note 15, ¶ 13.05.

⁵¹ *See, e.g.*, H.R. REP. NO. 103-213, at 689 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1378; Treas. Reg. § 1.197-2(f)(4)(ii) (as amended in 2002).

⁵² *See* 1 WILLIS, PENNELL & POSTLEWAITE, *supra* note 15, ¶ 15.03[2] (citing *Rudd v. Comm’r*, 79 T.C. 225 (1982)).

used in sections 197 and 736 should be reconciled. Since Congress failed to address the issue, the result is that goodwill could have a different meaning for purposes of section 197 and section 736. This result is clearly incompatible with sound tax policy and the intent to have section 197 serve as a comprehensive regime for the treatment of goodwill. The resulting rise of the anachronism appears attributable directly to Congress's failure to view broadly the impact of its new tax legislation.

Another fundamental shift in the tax law that further challenged the conceptual underpinnings and policy rationale for section 736 was the rise of unified regimes for tax-favored retirement accounts. Under section 736, the ordinary income characterization for payments to retiring partners, combined with a current deduction to the partnership provided for in section 736, was grounded in part on the assumption that the payment upon the partner's retirement was a form of deferred compensation for services previously rendered.⁵³ Through the rise of a regime of tax-favored retirement accounts, however, a partnership could set aside funds *prior* to a partner's retirement to compensate such partner upon the partner's retirement from the partnership for services previously rendered. Congress provided for such tax-favored accounts for partnerships in 1962, creating the so-called HR 10 accounts or Keogh accounts. At that time, however, the requirements for partners to establish these accounts, and the benefits that could be derived, were substantially less favorable for "employee-owners" in a partnership than those available for "shareholder-employees" in a corporation. Thus, section 736 often provided a useful alternative to the Keogh account regime for retiring partners.

Congress remedied this imbalance by enacting the Tax Equity and Fiscal Responsibility Act of 1982, which, *inter alia*, provided for a unified tax-favored retirement account system for both partnerships and corporations that incorporated elements of both preexisting regimes. As a result, partners were eligible to participate in a retirement program on a similar basis as shareholder-employees in a corporation. To avail themselves of the beneficial treatment of this regime, however, Congress obligated partners to comply with the significant procedural safeguard requirements of section 401 and of section 416.

Once the disparity in treatment between qualified retirement plans for corporations and partnerships was removed, the need for the "flexibility" to

⁵³ The legislative history for section 736 specifically anticipated a retirement payout function. It stated:

Where a retiring partner receives a lump sum or fixed payments determined without regard to the income of the partnership, the portion of such payments attributable to the capital interest of the retiring partner is to be treated as the purchase of a capital interest by the remaining partners. The balance, however, will be treated like a salary paid by the partnership. . . . Thus, to the extent that payments to a retiring partner or deceased partner's successor are not in exchange for a capital interest, they are treated as deductions to the remaining partners and as income to the withdrawing partner or his successor irrespective of over how long a period they may be paid.

S. REP. NO. 83-1622, at 296 (1954), *reprinted in* 1954 U.S.C.A.N. 4621, 4731.

use section 736(a) payments as a means of paying deferred compensation was reduced significantly. The use of deferred compensation retirement planning in the context of employee-partners shifted from focusing on payments by the partnership at the time of retirement to establishing a qualified retirement plan with defined annual contributions, funded by the partner, the partnership, or both, at the inception of the partnership. However, section 736 remained, permitting partnerships an alternative method of structuring deferred compensation for retiring partners without complying with the requirements of the otherwise “unified” retirement account regime.

The fundamental shift from negotiated withdrawal upon retirement to pre-planned retirement compensation strategies was completed in 2004 with the enactment of section 409A. Section 409A constructed a unified regime detailing the specifics as to when and how a deferred compensation program would be respected for federal income tax purposes. Among other requirements, section 409A specified that no deferral would qualify unless the deferral election was for a fixed period of time and that the fixed deferral period generally could not be accelerated. To ensure compliance with this regime, Congress imposed significant penalties on any deferred compensation not qualifying under these rules.

The legislative history of section 409A is silent (most likely due to oversight) on the interaction of its requirements (for example, fixed deferral periods with limited rights to acceleration) with section 736. Thus, subsequent to the enactment of section 409A, it was unclear whether section 736 remained available as a statutory option to partners retiring from service partnerships to structure payments in the nature of deferred compensation. The Internal Revenue Service (“IRS”) and other commentators immediately recognized this uncertainty; as a result, the IRS adopted a temporary interim solution to address the conflict between the statutory regimes and requested comments for a permanent solution.⁵⁴ This need for such ad hoc provisions

⁵⁴ The IRS stated in Notice 2005-1 that, until otherwise provided in applicable Regulations, it would not apply section 409A to payments made under section 736. This conflict has also been the subject of numerous commentaries. See, e.g., Roger C. Siske, *Attorney Asks Whether 409A Regs Will Affect Payments to Partners*, TAX NOTES TODAY, Mar. 25, 2005, 2005 TNT 59-21 (LEXIS); Kent A. Mason, *Attorney Seeks Guidance Under New Deferred Compensation Rules*, TAX NOTES TODAY, Nov. 19, 2004, 2004 TNT 224-30 (LEXIS). In response to the IRS request for comments, the Tax Section of the American Bar Association confirmed that, in the opinion of its members, section 736 no longer serves as a vehicle to structure deferred compensation, stating:

Obviously, in the case of a terminated partner, the partner frequently is receiving a share of income that he or she did not directly help to generate. However, it does not follow that the payments are deferred compensation. In many cases, they are for unrealized receivables or goodwill and are subject to Section 736(a) (even though unrealized receivables or goodwill are really just types of property) *solely by virtue of Section 736(b)(2)(A)*. . . . Treating payments for goodwill as deferred compensation is inappropriate because goodwill is an asset of the partnership as a whole, reflecting its value as a going concern, which can and does exist even when all of the partners were fully compensated for their services on an annual basis. Payments for goodwill are, in substance, payments for property *regardless of how they might be treated under Section 736(b)*.

reflects the fact that, once again, Congress failed to enact a truly “unified” statutory regime by failing to take into account the inconsistent provisions of section 736 in an “unrelated” area of the Code.

A third fundamental shift in the evolution of the tax law that further undercut the foundation for section 736 was the rise of “anti-abuse” or “purposive” provisions for partnership transactions in Subchapter K. The original anti-abuse provision was Treasury Regulation section 1.701-2.⁵⁵ Under the regulation, actions taken by a partnership and its partners, although technically compliant with Subchapter K, can be disallowed if they are inconsistent with the intent of Subchapter K. An important exception to this rule appears at Treasury Regulation section 1.701-2(a)(3), which provides that specific rules in Subchapter K effectively trump the anti-abuse regulation.⁵⁶ The combination of these rules leads to the following question: does the use of a partnership to make section 736(a) payments to a withdrawing partner for his share of partnership goodwill or as payment of deferred compensation violate the intent of Subchapter K in light of sections 197, 401, 416, and 409A or, does section 736 meet the “specific rule” exception to the anti-abuse provision?⁵⁷

The abusive potential for the use of section 736(a) was part of the reason for its amendment in 1993, which limited its use to partnerships for which capital is not a material income-producing factor. Given the failure to repeal section 736, however, service partnerships remain able to utilize its provisions to circumvent other provisions of the Code. For example, an individual wishing to purchase another’s professional practice for cash and deduct part of the cost of acquisition could attempt to utilize section 736. A direct acquisition of the practice would not permit a current deduction for the cost attributable to the goodwill. However, an indirect acquisition through the formation of a partnership with the use of section 736(a) payments for goodwill upon the “retirement” of the “seller” from the partnership after a period of “service” would generate additional tax benefits.⁵⁸ Congress, through the amendment of section 736, attempted to foreclose

Kenneth W. Gideon, *ABA Tax Section Members Comment on Application of Section 409A to Partnership Transactions*, TAX NOTES TODAY, May 24, 2005, 2005 TNT 99-28 (LEXIS) (emphasis added).

⁵⁵ For a discussion of the appropriate use and scope of anti-abuse regulations, see Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004).

⁵⁶ Treas. Reg. § 1.701-2(a)(3) (as amended in 1995).

⁵⁷ Arguably, a transaction structured to comply with an express statutory election would appear immune from the anti-abuse rules. Nevertheless, the Regulations contemplate that certain failures to elect basis adjustments under section 754 can be abusive notwithstanding the generally elective feature of the statute. See Treas. Reg. § 1.701-2, exs. 8 & 9 (as amended in 1995).

⁵⁸ According to the *Bluebook*, it is precisely this abuse that the 1993 amendment was intended to prevent, and yet by its terms, the amendment seemed to permit general partners in service partnerships to continue to utilize this type of transaction. See BLUEBOOK, *supra* note 44, at 169 (“Under present law, a prospective buyer of a business may structure the transaction so as to currently deduct such an amount by first entering into a partnership with the seller and then liquidating the seller’s partnership interest.”).

such possibilities. But while partnerships in which capital is a material income-producing factor can no longer engage in such abusive techniques, they appear to remain available for service partnerships. Under a literal reading of section 736, the use of the indirect acquisition would generate an immediate deduction for the payments. While such a result appears consistent with the terms of section 736,⁵⁹ such an effort would appear to be the precise type of abuse for which the anti-abuse regulations were promulgated.

On three separate occasions over the life of section 736, Congress and the Treasury Department have concluded that improvements to the proper and efficient operation of the overall tax law (by either statute or regulation) were necessary. Notwithstanding these efforts, both Congress and the Treasury Department failed to extend such efforts to all areas of the tax law, specifically Subchapter K, resulting in dramatic variances from their mandates by the continued existence of section 736. As a result, the anachronism of section 736, in large part, has remained intact.

III. THE OVERDUE REPEAL OF SECTION 736

Having analyzed section 736 and concluded that it is an anachronism, the issue confronted is: What should be done to cure this tax policy defect? As evidenced by the continued existence of section 736, anachronistic provisions tend to maintain a life of their own. Given its limited scope, however, should Congress focus its efforts on the repeal of such a relatively obscure provision? After all, numerous provisions of the Code have outlived their usefulness,⁶⁰ provided improper subsidies,⁶¹ or skewed distributional neutrality⁶² and yet are not the focal point of this Essay.

Section 736 is more than a minor annoyance or preference item. Rather, it is an example of the pernicious impact anachronistic provisions such as section 736 have on the Code. Accordingly, its repeal is essential.

What differentiates section 736 from other candidates for repeal is the combination of (i) congressional recognition that the original intent of the

⁵⁹ Other potential arguments against this type of transaction include that the enterprise did not constitute a partnership for purposes of section 7701 because there was no intent to share income, gain, loss, or deductions of the business or that there was a deemed sale of the withdrawing partner's partnership interest under section 707. Although these may be viable bases upon which to disallow such transactions from qualifying for section 736, they do not address the fundamental underlying conflict between section 736 and the partnership anti-abuse regulation.

⁶⁰ See, e.g., Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307 (1999).

⁶¹ See, e.g., Kamron Keele, *A Plea for the Repeal of Section 107: No More Tax-Free Mansions for Dubious "Ministers of the Gospel"*, 56 TAX LAW. 73 (2002).

⁶² See, e.g., Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004).

statute was flawed,⁶³ (ii) fundamental shifts in the tax law that undermined the tax policy rationale for the provision, (iii) the conflict in coverage and governance between the provision and those subsequent enactments, and (iv) the inherent interpretative tension between the legislative branch and the executive and judicial branches that arise as a result. Section 736 thus highlights the larger problem of the failure of Congress to enact nominally fundamental tax reform into truly coherent legislative schemes.

Section 736 remains an exception to the provisions of section 197 (comprehensive treatment of intangible assets, including goodwill), section 401 and section 416 (comprehensive treatment for qualified deferred retirement savings plans), and section 409A (comprehensive treatment for nonqualified deferred compensation plans). These conflicts raise difficult tax policy issues regarding the interpretation and implementation of these statutory provisions. Have the later-in-time “comprehensive” regimes “impliedly” repealed section 736 by undermining its rationale? Or does the presumption against legislative surplus prevent this conclusion, especially since Congress revisited this provision and explicitly readopted it?⁶⁴ The mere fact that these questions are raised and debated confirms the need for a solution. To this end, the presence of section 736 in the Code places it squarely within the center of the larger debate regarding the proper interpre-

⁶³ At the time of the 1993 amendments, the Joint Committee stated, “It is recognized, however, that general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law.” BLUEBOOK, *supra* note 44, at 169. By 2001, however, in trying to explain why general partners are entitled to the “special rule” of section 736, the Joint Committee stated as follows:

An additional special rule provides that a payment for unrealized receivables or goodwill may nevertheless qualify for favorable exchange treatment, if two requirements are met. The first requirement is that capital is not a material income-producing factor for the partnership, and the second requirement is that the partner was a general partner. *Both of these requirements are intended to ensure that the retiring or deceased partner performed personal services for a service partnership.*

See 2 2001 JCT STUDY, *supra* note 9, at 281–82 (emphasis added). Interestingly, the study contains no mention that general partners do not value goodwill. Was this because the Joint Committee assumed that partners that perform personal services for the partnership also inherently do not value goodwill? Or rather, is it possible that even the committee responsible for developing tax policy for Congress fell victim to the pernicious anachronism?

⁶⁴ There has been a significant debate over the appropriateness of applying the “reenactment” doctrine in the context of the tax laws. *See, e.g.,* Paul L. Caron, *Tax Myopia, or Mamas Don’t Let Your Babies Grow up to Be Tax Lawyers*, 13 VA. TAX REV. 517 (1994). To this end, does the IRS have the authority in administering the tax law to limit the term “goodwill” in the section 736 context to its definition under section 197 when Congress failed to do so at the time it enacted (or reenacted) both provisions? Does the Treasury Department have the authority to enact regulations prohibiting the use of section 736 by service partnerships to avoid the provisions of section 409A given the fact that section 409A came later in time, even if it did not legislatively repeal section 736? Given the narrow scope of section 736, would this allow the Treasury Department to effectively repeal the duly enacted legislation? These tax policy dilemmas confirm that the mere presence of the anachronism is pernicious not only to the Code but to the administration of the tax laws as well, further supporting the need for the repeal of section 736.

tation and application of the Code as a whole;⁶⁵ indeed, its anachronistic aspects render the traditional tools for interpretation nearly impossible to apply.⁶⁶

In addition, the executive branch is forced to struggle with the anachronism of section 736 in the administration of the tax laws. The mere presence of the anachronism forces the Treasury Department and the IRS to administer potentially conflicting legislative frameworks,⁶⁷ adding to the complexity of the tax laws and calling into question not only the proper interpretation of the regimes enacted by Congress, but also the authority of the executive branch to do so.⁶⁸

These pernicious results arise solely because of the anachronistic characteristics of section 736, i.e., it is the *mere existence* of section 736 as a statutory provision in the Code, located out of time and context with subsequently enacted regimes, which raises the issue. Thus, as long as section 736 remains in the Code, the coherent evolution of the Code and tax policy cannot occur. Unlike the tolling chimes, which for Brutus signaled the point of no return, section 736 serves no useful purpose in an evolving world of unified regimes for goodwill, retirement accounts, and deferred compensation. Rather, section 736 stands alone, having outlived its “usefulness” and remaining an impediment to the development of coherent, unified regimes of statutory clarity with regulatory “purposive” backstops. It is time for Congress to part with section 736!

IV. IMPROVEMENTS IN THE TAX-MAKING PROCESS

Given the pernicious impact that anachronisms such as section 736 have on the evolution of the Code, the study of section 736 necessarily leads to a critical question regarding the evolution of the tax law: how can

⁶⁵ See, e.g., Cunningham & Repetti, *supra* note 55, at 2 (“During the last decade, a substantial debate has developed over the approaches courts use to interpret statutes. . . . The debate about the appropriate method for interpreting statutes underlies a crisis in the administration of tax law.”).

⁶⁶ For example, what is the “evolutive” nature of a provision that on its face and in its policy does not fit within the present framework of the Code? See, e.g., Michael Livingston, *Practical Reason, “Purposivism,” and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677, 720 (1996).

⁶⁷ For example, the IRS, in enforcing the anti-abuse provisions of Treasury Regulation section 1.701-2, may be required to choose between permitting a service partnership with a retiring general partner to effectively avoid the application of section 197 through the use of section 736 or alternatively to determine that the partnership has impermissibly avoided section 197 in violation of the anti-abuse Regulation. This effective delegation of an essential policy choice to the executive branch, i.e., whether payments for partnership goodwill should be allowed to be expensed in the context of a withdrawing or retiring partner, itself raises fundamental concerns regarding the presence of such a provision in the Code.

⁶⁸ See, e.g., John F. Coverdale, *Text as Limit: A Plea for a Decent Respect for the Tax Code*, 71 TUL. L. REV. 1501 (1997); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995); Mary L. Heen, *Plain Meaning, the Tax Code and Doctrinal Incoherence*, 48 HASTINGS L.J. 771 (1997); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623 (1986).

such aberrations be avoided in the future? One approach to the problem is patience and a belief in the system; sooner or later, Congress effectuates needed improvements in the tax law. The various institutional forces that bear on the formulation of tax policy ultimately detect such imperfections and cure them on their own.⁶⁹

The problem with this approach, as highlighted by this Essay, is that it may be like “waiting for Godot”; just like Godot, the necessary amendment may never arrive. This is particularly true in Subchapter K, given its detail, complexity, and oft-unintended interactions with other provisions and regimes of the Code. Section 736 recently celebrated its fifty-first birthday. While the tax community waits for the tax-making machinery to discover and remedy this policy flaw in Subchapter K, the anachronism continues, wreaking havoc on the Code and the administration of the tax law.

The continuing presence of section 736 suggests a more fundamental problem: *Congress itself may be the problem*. More specifically, the continued resilience of section 736 reflects the lurching piecemeal approach Congress undertakes to adopt “fundamental” changes in the statutory regime. So long as Congress considers the provisions of payments to retiring partners as “unrelated” to the enactment of “unified” regimes (whether for tax-favored retirement accounts, deferred compensation schemes, the amortization of goodwill, or otherwise), the regimes will never truly be unified or fundamental.⁷⁰

A second approach requires a broader view of the tax-making process in which there is a recognition that the institutional machinery does not operate in a vacuum. Instead, societal forces, ranging from lobbyists to impacted taxpayers to bar associations to academics, each with valuable viewpoints on needed adjustments to the Code, the efficiency of proposed regulations, and the wisdom and legitimacy of other administrative actions, exert their influence at the margins.

Importantly, input from the academy plays a significant role in the evolution of the tax law. An excellent example of this process was the recent charge by Congress for a report from the Joint Committee on Taxation suggesting improvements to the tax law. In response, the Joint Committee in 2005 issued a comprehensive report.⁷¹ Among its recommendations was the

⁶⁹ The harmonization of sections 195 and 709 with section 197 is an example of this process, although it took eleven years for Congress to turn its attention to these provisions. *See supra* note 43.

⁷⁰ For an overview of the debate between fundamental and incremental tax reform, see Christopher H. Hanna, *Incremental and Fundamental Tax Reform: Introduction*, 56 SMU L. REV. 3 (2003), and the articles and topics in the SMU tax symposium cited therein.

⁷¹ STAFF OF J. COMM. ON TAXATION, 111TH CONG., *OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES* (Comm. Print 2005) [hereinafter *OPTIONS TO IMPROVE*]. The text of the report was in excess of 430 pages and offered over 65 proposals through which to improve the income, gift, and estate tax law.

repeal of section 707(c).⁷² In its discussion of the reasons for the proposed repeal of section 707(c), the Joint Committee referenced the writings of commentators upon which it relied in formulating the proposal.⁷³ While this example documents the importance of the contribution of commentators, particularly to the extent that such advocacy is detached from the economic interests of others, it appears that lengthy delays are endemic to this approach. In fact, some of the commentaries upon which the Joint Committee relied were almost twenty years old.

A more appropriate safeguard against the continuation of an anachronistic provision may be for commentators to *aggressively* enter the tax-making process. Too frequently, academics content themselves with the publication of their insights in academic and professional journals, assuming erroneously that they will be read by all interested parties and, if found worthy, will see their way into legislation or regulation. The experience of section 707(c) demonstrates, however, that the tax-making machinery does not necessarily internalize the lessons to be gleaned from academic commentary. A more effective approach may be for scholarly commentators to directly submit their work to the Joint Committee, the Treasury Department, the IRS, the House Ways and Means Committee, and the Senate Finance Committee. This could be accompanied by publication of the same through the tax press and, perhaps at times, the lay press, making public both the substance of the commentary and the fact that it is in the hands of those responsible for the development and implementation of the tax laws.

By highlighting the systemic and policy concerns of anachronisms, scholarly commentators help bring attention to the external costs of those statutory and regulatory provisions that might otherwise have gone unnoticed by the taxpaying public, which indirectly bears such costs. By both submitting scholarly input directly to the tax-making machinery and disseminating it in the press, academics would compel members of the institutions comprising the tax-making machinery to either adopt the positions expressed therein, provide a reasoned explanation for not doing so, or ignore the input altogether. If the third approach is chosen, such members would potentially have to explain to others (if queried) why such costs were ignored, in disregard of the advice of “neutral” members of the academic

⁷² *Id.* at 170–73. See *supra* note 8 for the Authors’ suggestion that section 707(c) is also an anachronism in Subchapter K.

⁷³ “Several commentators have questioned the continued viability of a concept of guaranteed payments separate from the concept of payments treated as made to a partner in a nonpartner capacity.” OPTIONS TO IMPROVE, *supra* note 71, at 172 (citing Philip F. Postlewaite & David L. Cameron, *Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984*, 40 TAX LAW. 649 (1987)). Later, the report states, “Several commentators have advocated an approach like that of the proposal, stating that the ‘better approach would be to eliminate Section 707(c) totally and provide that any payment to a partner, not determined with regard to partnership income, constitutes a Section 707(a) payment.’” *Id.* at 172 n.401 (citing Philip F. Postlewaite & John S. Pennel, *JCT’s Partnership Tax Proposals—‘Houston, We Have a Problem,’* 76 TAX NOTES 527, 538 (1997)).

community. In this manner, the systemic and policy costs of maintaining anachronisms in the Code could be internalized into the tax-making machinery—costs that are currently lost in the process.⁷⁴ Commentators, particularly academics, need to enter the fray, rather than sit on the sidelines.⁷⁵

Such aggressive dissemination of scholarly commentary would have provided precisely the perspective that Congress appears to have lacked in permitting section 736 to survive, i.e., the historical and policy perspective of the interaction of “unified” statutory regimes with seemingly unrelated and outdated provisions of the Code. Notwithstanding the problems section 736 was initially intended to resolve, neither the legislative history nor the *Bluebook* indicate that Congress even considered the significant tax policy defects arising from the anachronistic aspects of section 736 at the time of its original enactment, the time of its revision in 1993, or since. A more aggressive dissemination of the critical scholarly commentary regarding section 736, which existed both at the time of its reconsideration in 1993 and which has developed since, could have directly injected this perspective into the legislative process, forcing Congress to take account of such commentary (one way or another). This process could well have produced positive results or, at a minimum, placed the responsibility for the current anachronistic state of section 736 squarely in the hands of Congress. There is no reason to believe that these lessons could not apply with equal force to other anachronisms in Subchapter K and beyond, shortening the life span of anachronistic provisions or, even more ambitiously, preventing their rise in the first place.

Accordingly, be it resolved that this discourse will soon find itself on the desks of the most influential tax policymakers in the nation’s capital. Time will tell whether the effort bears fruit.

⁷⁴ See, e.g., Shaviro, *supra* note 47, at 100 (“[I]ntellectual and academic elites can powerfully influence political agendas, although perhaps not quite so powerfully as the members of these elites would prefer.”). Needless to say, numerous other proposals for ameliorating this problem could be considered, including: similar to section 8022(3)(B), a standing branch of the Joint Committee could be established and charged with producing a report annually on anachronisms and any needed changes in the tax law, or, given the dramatic impact of the ALI study on Subchapter K, a permanent committee of leading practitioners and academics could be established under the auspices of the ALI that would similarly produce such annual recommendations.

⁷⁵ During the nearly thirty years in which one of us has been publishing on the topic of the law of taxation, regretfully he never sent his work product to any of the committees directly involved in the formulation of tax legislation. While a cottage industry has arisen as of late in the dissemination of an academic’s work product to other academics in hopes of bolstering their institution’s standing in the annual rankings by *US News & World Report*, it is a rather safe prediction that most academics and commentators have also avoided a more hands-on approach to the evolution of the tax law.

