Partnership Taxation: A Deceased Partner's Final Year

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PARTNERSHIP TAXATION: A DECEASED PARTNER'S FINAL YEAR

Although partnerships\(^1\) have become an increasingly popular form of business organization in recent years, partnership taxation remains complex and problematic. Subchapter K\(^2\) of the Internal Revenue Code,\(^3\) which governs taxation of partners and partnerships, commingles the aggregate and entity theories\(^4\) of the nature of partnerships.\(^5\) The Code adopts the aggregate theory by taxing only the partners, and not the partnership, on income earned by a partnership business.\(^6\) Conversely, the Code treats partnerships as separate entities in at least three areas.\(^7\) A partnership must select its own taxable year,\(^8\) make all elections affecting the computation of partnership taxable income,\(^9\) and file an informational tax return reporting income for the year.\(^10\)

One significant and unresolved partnership taxation problem is the taxation of a deceased partner's final year. In a recent case of first impression, *Estate of Hesse v. Commissioner*,\(^11\) the Tax Court held that the widow of a deceased partner could not include his share of partnership income for the year.\(^12\)

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1. I.R.C. § 761(a) defines a partnership to include "a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title [subtitle], a corporation or a trust or estate." *See also* I.R.C. § 7701(a)(2); Treas. Reg. § 1.761-1(a) (1979). The Uniform Partnership Act (UPA) adopts a definition for state law purposes similar to that of the Code. Section 6(1) of the UPA states that "[a] partnership is an association of two or more persons to carry on as co-owners a business for profit."

2. Subchapter K includes I.R.C. §§ 701-761.

3. Unless otherwise noted, all references to the Code are to the Internal Revenue Code of 1954.

4. The aggregate theory of partnerships has evolved from common law. This theory views a partnership as a conduit through which partnership income and losses pass directly to the partners. The partnership consists of individual partners, each contributing capital and services to form a business venture, and is not considered a separate entity. J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP 18-19 (1st ed. 1968).

5. The entity theory of partnerships, often called the mercantile theory due to its support among businessmen, treats the partnership as a legal person with legal rights and duties. For purposes of this note, the most significant duty imposed on the partnership is the partnership's election of its own taxable year. I.R.C. § 706(b)(1). *See also* United States v. Basye, 410 U.S. 441, 448 (1973).

7. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980). McKee argues that only the entity approach should be used in the area of partnerships to prevent abuses in partnership taxation.


9. *Id.* § 703(b).

10. *Id.* § 6031.

11. 74 T.C. 1307 (1980).
losses incurred during the year of his death on their final joint income tax return. Consequently, the widow lost thousands of dollars in tax refunds because the loss deductions could not offset prior taxable income. The Tax Court believed the result was illogical and unfair, but nevertheless found that the Code required the decedent's executor to report the partnership losses on the income tax return of the decedent's estate.

This note analyzes the tax treatment of a deceased partner's final year, including the key Code provision, section 706. After surveying the history of the taxation of a deceased partner's final year, the note examines the *Hesse* case and explores three possible strategies for circumventing the *Hesse* problem under the current Code. These strategies include terminating the partnership, effecting a sale or exchange of the decedent's partnership interest, and liquidating the decedent's partnership interest with the decedent's estate or other successor in interest continuing as a partner. The note also discusses reforms which have been proposed to solve the *Hesse* dilemma, concluding that a statutory amendment is the only adequate solution to the problems created by section 706(c).

I. History of the Tax Treatment of a Deceased Partner's Final Year

Prior to enactment of the Internal Revenue Code of 1954, a partner's death often resulted in the "bunching of income" on the decedent's final individual income tax return. The Code required all partners to include partnership income or losses for partnership taxable years ending with or within the taxable year of the partners' individual tax returns. The Code also provided that a partnership's taxable year closed with respect to a partner on the termination of his interest in the partnership. A partner's death usually terminated his interest in the partnership and, therefore, a deceased partner's final income tax return had to include his share of profits or losses for that part of the partnership taxable year ending with his death. If the partner used a taxable year different from the partnership, these

12. *Id.* at 1316.
13. *Id.* The court relied on I.R.C. § 706(c).
15. See I.R.C. §§ 706(c)(1), 708.
16. See *id.* §§ 702, 706(c), 741.
17. See *id.* § 736.
19. "Bunching of income" refers to the inclusion of more than 12 months of income into a single income tax return.
21. *Id.*
22. *Id.*
rules often resulted in the bunching of income and, under the progressive tax structure, subjection to higher tax rates.24

Assume, for example, that a partnership had a taxable year ending January 31, while a partner used a calendar taxable year. If the partner died in December, his final income tax return would include not only the twelve months of income from February 1 of the previous year to January 31, but also the income accrued from February 1 until the deceased partner's death. Consequently, the decedent's final return would contain twenty-three months of partnership income.

The leading case upholding the bunching of partnership income into the decedent's final return was Guaranty Trust Co. v. Commissioner.25 In Guaranty Trust, the partner died on December 16, 1933. He had used a calendar taxable year, while the partnership used a fiscal year ending July 31. After the partner's death, the executor of the decedent's estate collected the deceased partner's share of partnership profits from August 1, 1933, until the partner's death. The decedent's executor included the amount of partnership profits earned from August 1, 1932, through July 31, 1933, on the decedent's final income tax return, but did not include profits earned from August 1, 1933, to the decedent's death. The Commissioner contended that the partnership profits from the latter period also should be included on the decedent's final return.

The Supreme Court held that the decedent's final return must include the entire sixteen and one-half months of partnership income. The Court noted that the partnership taxable year closed with respect to the deceased partner upon his death.26 Then, in response to the executor's argument that inclusion of more than twelve months of income offended the policy of the revenue scheme,27 the Court stated that the phrase "any taxable year" in the statute28 did not limit the amount of taxable income includible in the decedent's final return to a single twelve-month partnership accounting period. Rather, "any taxable year" also referred to the period from August 1, 1933, to the decedent's death because the partnership taxable year ended at that time for the

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26. Id. at 495.
27. Id. at 496.
28. Section 182 of the Revenue Act of 1932 stated in pertinent part:
There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. If the taxable year of a partner is different from that of the partnership, the amount so included shall be based upon the income of the partnership for any taxable year of the partnership ending within his taxable year. Revenue Act of 1932, ch. 209, § 182, 47 Stat. 222 (now I.R.C. § 706(a)) (emphasis added).
Thus, the deceased partner's executor had to include partnership profits for that short taxable year on the decedent's final return, resulting in "bunching." In 1954, Congress resolved the bunching of income problem by enacting section 706(c) of the Internal Revenue Code. That section provides that the partnership taxable year with respect to a deceased partner will not terminate prior to its regular conclusion; rather, the taxable year will continue for both the partnership and the deceased partner until the end of the partnership's taxable year. The Code only provides two exceptions to this general rule: termination of a partnership and sale or exchange of a deceased partner's interest in the partnership as of his death. If either of these events occurs, the deceased partner's taxable year closes on the date of his death.

By forcing the partnership taxable year to remain open after a partner dies, Congress insured that no more than twelve months of partnership income could be reported on the decedent's final income tax return. A partner normally must include on his yearly income tax return that amount of partnership income earned during any partnership taxable year ending within or with the partner's taxable year. If a partner dies in the middle of a partnership taxable year, his final return cannot include any portion of his partnership income for that taxable year because the partnership's taxable year has not yet terminated. The Treasury Regulations further provide that the decedent's taxable year shall close on the date of his death.

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29. According to the Court, Congress never intended that only one year's income could be taxed on a single return; taxing 16-1/2 months of income did not offend congressional intent, either express or implied. 303 U.S. at 498.

30. Prior to 1954, the only way a partner could avoid the bunching problem was to provide explicitly in the partnership agreement that the partnership's taxable year would terminate with respect to a decedent at the end of the partnership's fiscal year, rather than at the deceased partner's death. See Commissioner v. Mnookin's Estate, 184 F.2d 89 (8th Cir. 1950); Girard Trust Co. v. United States, 182 F.2d 921 (3d Cir. 1950); Henderson's Estate v. Commissioner, 155 F.2d 310 (5th Cir. 1946).

31. I.R.C. § 706(c)(2)(A)(ii) states: "(A) DISPOSITION OF ENTIRE INTEREST.—The taxable year of a partnership shall close—(i) with respect to a partner who sells or exchanges his entire interest in a partnership . . . ."


34. I.R.C. § 706(c)(1) states: "Except in the case of a termination of partnership and except as provided in paragraph (2) of this Subsection, the taxable year of a partnership shall not close as the result of the death of a partner . . . ." But see Treas. Reg. § 1.706-1(c)(3)(i) (1979), which states: "Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A)." See also Treas. Reg. § 1.706-1(c)(1) (1979).

35. I.R.C. § 706(c)(2)(A) provides in relevant part: "(A) DISPOSITION OF ENTIRE INTEREST.—The taxable year of a partnership shall close—(i) with respect to a partner who sells or exchanges his entire interest in a partnership . . . ." See also Treas. Reg. § 1.706-1(c)(2) (1979); Kean v. Manning, 128 F. Supp. 756 (D.N.J. 1955).


estate or other successor in interest must report the partnership income on the estate's income tax return "in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends." That portion of income earned by the decedent from the beginning of the partnership taxable year until the date of his death is "income in respect of a decedent" and must be reported according to the requirements prescribed by section 691.

Congress originally enacted section 706(c) as a relief measure to alleviate the bunching problem and thereby tax the decedent's distributive share of partnership income at lower rates. The statute, however, had many unintended and undesired effects. Congress apparently failed to consider the possibility of partnership losses. This oversight led to serious inequities in the operation of section 706(c) when the partnership had losses during the year of a partner's death. Under section 706(c), partnership loss deductions includible in the estate's income tax return can only offset income that the decedent has earned after his death. Because this income is usually minimal, the loss deduc-

38. Treas. Reg. § 1.706-1(c)(3)(ii) (1979) states in relevant part:
The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner. The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includable in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributive share thereof is includable in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also Grant v. Busey, 230 F.2d 290 (6th Cir. 1956); Young v. Gardner, 259 F. Supp. 528 (S.D.N.Y. 1966); Rev. Rul. 68-215, 1968-1 C.B. 312.

39. I.R.C. § 691. The "income in respect of a decedent" (I.R.D.) provision was added to the Internal Revenue Code in 1934. Its primary purpose is to neutralize the tax consequences of a decedent's death to his successor in interest. Income earned by the decedent during his lifetime, but untaxed to him, is taxed to those who receive this income as it would have been taxed to the decedent. Additionally, the successor may claim deductions allowable to the decedent during his short taxable year. "Section 691 (I.R.D.) in effect passes through to the decedent's estate or beneficiaries the tax benefit of certain deductible expenses incurred by the decedent but not properly taken into account in his final, or any earlier return." J. Freeland & R. Stephens, Fundamentals of Federal Income Taxation 303 (1972). See also Woodhall v. Commissioner, 454 F.2d 226 (9th Cir. 1972); H.R. REP. No. 1337, 83d Cong., 2d Sess. A225-26, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4090; Treas. Reg. § 1.706-1(c)(3)(v) (1979); Egerton, Planning the Buy Out of a Deceased or Retired Partner's Interest, 10 INST. EST. PLAN. 10-1, 10-7 (1976).


42. I.R.C. § 1 provides for a progressive tax rate schedule. The decedent's executor or other successor in interest has to include only twelve months of income under § 706(c), rather than the additional months of income required under prior law, see text accompanying notes 19-30 supra. Thus, the amount of reported income is less and usually will be taxed at a lower rate.

43. See note 63 infra for an example of the adverse consequences of I.R.C. § 706(c).

44. The regulations speak only in terms of partnership profits. Treas. Reg. § 1.706-1(c)(3)(ii) (1979). See note 56 infra. Congress probably failed to consider partnership losses because such losses were far less prevalent in 1954 than they are today, largely because of the recent explosion in the number of tax shelter limited partnerships that regularly sustain significant tax losses.
tions are forfeited, and the decedent's estate or successor in interest may pay substantial extra taxes on the decedent's final personal return.\textsuperscript{45}

II. \textit{ESTATE OF HESSE: AN ILLOGICAL AND UNFAIR RESULT}

\textit{Estate of Hesse v. Commissioner}\textsuperscript{46} illustrates the inequity of applying section 706(c) when a partnership incurs losses during a deceased partner's final year. In \textit{Hesse}, the decedent, Stanley Hesse, died on July 16, 1970, when he was a general partner in the brokerage firm of H. Hentz and Company. This company, a limited partnership, dealt in commodities and securities. During 1970, the partnership incurred substantial losses resulting from inaccurate reporting of securities sales. Both Mr. Hesse and the partnership used a calendar year as their taxable year. The partnership maintained its records using the cash basis method of accounting. In December of 1970, the books of the partnership revealed that the decedent's share of losses sustained by the partnership during that year totaled $391,587.18.

In 1967 and 1968, Mr. and Mrs. Hesse had filed joint income tax returns. In 1970, Mrs. Hesse filed a final joint income tax return, in which she included her income for the taxable year ending December 31, 1970, and the income from her husband's taxable period ending July 16, 1970.\textsuperscript{47} On this return, Mrs. Hesse deducted $391,587.18, which represented the decedent's share of losses incurred by the partnership during his final year. The Commissioner of Internal Revenue (the Commissioner), however, said that the deduction belonged on the fiduciary income tax return of the decedent's estate.

The basic issue facing the Tax Court was whether the deduction belonged on the estate's income tax return rather than on the Hesses' final joint return. Mrs. Hesse argued that she should include her husband's losses on their final joint return because, under the terms of the partnership agreement,\textsuperscript{48} his partnership interest terminated upon his

\textsuperscript{45} Berning, \textit{supra} note 24, at 781.

\textsuperscript{46} 74 T.C. 1307 (1980).

\textsuperscript{47} Section 6013(a)(2) allows a joint income tax return to include income from different taxable years of a husband and wife if such taxable years begin on the same day but end on different days as the result of one spouse's death. Section 6013, however, provides two exceptions to permitting such a joint return. If the surviving spouse remarries during the taxable year, the executor of the decedent's estate must file the decedent's final income tax return separately. Likewise, the surviving spouse may not file a joint return containing different taxable years if either spouse's taxable year is a fractional part of a year under § 443(a)(1), which permits changes of annual accounting periods.

\textsuperscript{48} The partnership agreement provided in relevant part:

In the event of the death or withdrawal of a partner, his interest in the Firm shall cease as of the end of the month in which the death shall occur or the effective date of withdrawal, and his participation in the profits or losses, if any, shall be computed in accordance with the standard accounting practice of the Firm. \ldots A deceased or withdrawn partner shall have no interest in the working assets of the Firm and his claim against the Firm shall be limited to the amount of his capital and his interest in such profits, if any, as of the date of death or withdrawal, less his share in such losses, if any.
death. She argued alternatively that the decedent's partnership interest became worthless before he died, thereby making his entire investment deductible on the final joint return.\(^\text{49}\)

The Commissioner claimed that section 706(c)(2)(A)(ii),\(^\text{50}\) which provides that the taxable year of a partnership shall not close with respect to a partner who dies prior to the end of the partnership taxable year, applied to the decedent's situation. He argued that because the partnership's taxable year did not close until December 31, 1970, while the decedent's taxable year terminated on July 16, 1970, the decedent's final joint return could not include losses that the partnership did not sustain until December 31, 1970.\(^\text{51}\) Thus, the decedent's executor should have included the decedent's share of partnership losses on the estate's income tax return.\(^\text{52}\)

The tax consequences of each party's position were radically different. If Mrs. Hesse were able to deduct the loss on their final joint return, she could carry back the deduction to previous years as a net operating loss.\(^\text{53}\) This carryback would permit the taxpayer to receive a refund of nearly $250,000 from taxes already paid during 1967 and 1968.\(^\text{54}\) If, however, the deduction were includible on the estate's income tax return, then the deduction would only offset the minimal amount of income recognized on the estate's tax return and no refunds would result.\(^\text{55}\)

The *Hesse* Court found that the statute supported the Commis-

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\(^{49}\) Mrs. Hesse's alternative argument will not be examined in depth in this note. The taxpayer, however, plans to appeal this case to the Second Circuit Court of Appeals and will rely heavily on this argument. Telephone interview with O. John Rogge, counsel for plaintiff (October 1980).

\(^{50}\) The partnership did not sustain a loss until the end of its taxable year because partnership profits and losses are calculated at year-end to reflect depreciation, sales, and purchases of the entire year. See generally *Abbin*, supra note 18.

\(^{51}\) The reader should note the important distinction between the decedent's estate's *income tax* return and the decedent's *estate tax* return. This note focuses on the income tax return of the decedent's estate and the tax consequences associated with it.


\(^{53}\) A net operating loss carryback under \(\$172(b)\) would result only if the loss deduction of $391,587.18 exceeded taxable income for 1970. For example, if Mr. Hesse had taxable income of $400,000 in 1970, the entire loss would be deducted against income, leaving no net operating loss to be carried back to 1967 and 1968.

\(^{54}\) Net operating losses cannot be carried back to previous returns of the estate. Losses may, however, be carried forward under I.R.C. \(\$642(h)\), but only to the beneficiaries of the es-
sioner and ruled that the partnership losses had to be reported on the estate's income tax return.\textsuperscript{56} Although the court recognized that the losses would have been deductible on the joint income tax return if Mr. Hesse's partnership interest had terminated at his death,\textsuperscript{57} the court ruled that the partnership agreement\textsuperscript{58} only provided for liquidation, which was insufficient to close the partnership taxable year as to Mr. Hesse.\textsuperscript{59} Because the partnership taxable year remained open as to Mr. Hesse after his death, the court held that the statute mandated deduction of the losses on the estate's income tax return.\textsuperscript{60}

The court did not ignore the problems faced by the taxpayer. The court noted that Congress originally intended section 706(c) to be a relief measure that would eliminate the bunching of income,\textsuperscript{61} but that the section actually created several other problems.\textsuperscript{62} The most egregious of these problems, illustrated by \textit{Hesse}, was the mismatching of income and losses when a partnership sustained significant losses during the deceased partner's final year. The court admitted that the problem would not have occurred under the pre-1954 Code\textsuperscript{63} and that another section virtually had eliminated the bunching problem,\textsuperscript{64} but concluded that section 706(c) required the partnership losses to be re-

\textsuperscript{56} According to the court, the statute, the regulations and the legislative history of section 706(c) make it clear that this is the manner in which Congress determined that a decedent's distributive share of partnership income shall be reported. And although the regulations speak only of the decedent's share of partnership profits, it follows logically that partnership losses must be treated in an identical manner.

\textsuperscript{57} See note 35 supra.

\textsuperscript{58} See note 48 supra.

\textsuperscript{59} See I.R.C. § 706(c)(2)(A)(ii).

\textsuperscript{60} See note 56 supra.

\textsuperscript{61} 74 T.C. at 1312-13.

\textsuperscript{62} The court stated: Instead of benefiting most successors in interest to decedent partners, section 706(c)(2)(A)(ii) now serves to penalize them. Because the decedent's final return does not include his distributive share of partnership profits for the year, if he had little other income, the benefit of any deductions and exemptions incurred by the decedent during his final year will be lost. \textit{See} Sec. 691(a)(1). In addition, the advantage of income splitting by filing a joint return with his spouse will be precluded . . . .

\textsuperscript{63} Under the pre-1954 Code, the partnership taxable year would have terminated with respect to Mr. Hesse on his death. The partnership losses, therefore, would have been includable on Mr. and Mrs. Hesse's final joint return. \textit{See} notes 19-30 and accompanying text supra.

\textsuperscript{64} Prior to 1954, the Internal Revenue Code did not contain a provision requiring a partnership to use the same taxable year as its general partners. This omission permitted bunching to occur. The 1954 Code, however, virtually eliminated this problem by enacting I.R.C. § 706(b)(1), which states: "The taxable year of a partnership shall be determined as though the partnership were a taxpayer. A partnership may not change to, or adopt, a taxable year other than that of all its principal partners unless it establishes, to the satisfaction of the Secretary, a business purpose therefor." \textit{See} W. McKee, W. Nelson & R. Whitmire, \textit{Federal Taxation of Partnerships and Partners}, ¶ 11.02(3), 11-6 (1977). A principal partner is defined in I.R.C. § 706(b)(3) as "a partner having an interest of 5 percent or more in partnership profits or capital."
ported on the estate's income tax return. Recognizing that the application of section 706(c) denied Mrs. Hesse thousands of dollars in tax refunds simply because her husband died in the middle of the partnership taxable year, the court characterized the result of its own decision as "illogical and unfair" and urged Congress to correct the problem "before this unfortunate result is repeated."

Not only is the Hesse mismatching problem serious, but it is also quite prevalent. Investors have formed limited partnerships with increasing frequency because of the growth of tax shelter arrangements. These limited partnerships regularly sustain tax losses that are then allocated to and deducted by the partners according to the partnership agreement. The Hesse holding will affect every participant in a tax shelter partnership who dies during the partnership's taxable year. Moreover, the Hesse holding might create serious problems in both family partnerships and two-person partnerships, because often the partners do not even view themselves as a partnership and thus have not taken preventive measures to avoid the Hesse result.

III. STRATEGIES FOR CIRCUMVENTING HESSE UNDER THE CURRENT CODE

Various options exist within the present Code to circumvent the problems generated by section 706(c). These options include termination of the partnership, sale or exchange of the decedent's partnership interest, or liquidation of the deceased partner's interest. Each of these options requires close scrutiny, however, because an attempt to avoid the Hesse mismatching problem may generate undesirable side-effects.

A. Termination of the Partnership

Section 706(c)(1) of the Internal Revenue Code provides that termination of the partnership closes the partnership's taxable year. Section 708(b)(1) defines termination as occurring either when no partner continues any aspect of the business venture of the partnership or when a sale or exchange of fifty percent or more of the total interest in the partnership occurs within a twelve-month period. While a sale

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65. If Mr. Hesse had lived until the end of the taxable year, he would have been able to use the partnership losses to obtain the refunds.
66. 74 T.C. at 1316.
67. Id.
68. Treas. Reg. § 1.706-1(c)(3)(i) (1979) reveals that when a termination occurs, the taxable year of the partnership closes as of the date of termination for all partners, including a deceased partner. See also Lee, Partnership Taxation in the Estate Situation, 114 TR. & EST. 154, 156 (1975).
69. Rev. Rul. 81-38, 1981-5 I.R.B. 14, states that transfer of a 50% partnership interest to a wholly owned corporation in a transaction governed by I.R.C. § 351 is an exchange within the meaning of § 708(b)(1)(B), thus terminating the partnership.
70. I.R.C. § 708(b)(1). A discrepancy exists between the Treasury Regulations and the congressional history of § 708(b)(1). Treas. Reg. § 1.708-1(b)(1)(ii) (1979) provides that in order to effectuate a termination of the partnership, the sale or exchange of the 50% interest may be made
or exchange\textsuperscript{71} of a fifty percent interest terminates the partnership, liquidation of a fifty percent interest will not terminate the partnership because liquidation is not considered a sale or exchange within the meaning of the statute.\textsuperscript{72}

If termination of the partnership occurs, the partnership taxable year closes with respect to \textit{all} partners. Each partner includes his share of partnership profits or losses on his income tax return for the year in which the partnership ends.\textsuperscript{73} The executor may then include the deceased partner's share of partnership income on the decedent's final personal return, rather than on the fiduciary return.

Terminating the partnership upon the death of any partner would prevent the \textit{Hesse} mismatching problem. Termination, however, has several disadvantages. For tax purposes, termination is not easy to accomplish. Either the deceased partner must own a fifty percent interest in the partnership which his estate or other successor in interest sells or exchanges on the date of his death, or the partners must agree to sell fifty percent of their partnership interests to third parties as of the deceased partner's death.\textsuperscript{74}

The collateral effects of termination, moreover, outweigh any tax advantages. Terminating a partnership that has a large number of partners and starting anew each time a partner dies would be costly and inefficient.\textsuperscript{75} Thus, while termination of a partnership is an effec-
tive way to close a decedent's partnership taxable year and avoid the problems generated by section 706(c), it also has serious potential drawbacks and is difficult to effectuate.

B. Sale or Exchange Upon Death

The Code provides that the sale or exchange of a partner's entire interest in a partnership closes the partnership's taxable year for that partner as of the date of sale. The decedent's estate or other successor may sell the decedent's interest to one or more of the existing partners or to a person who is not a member of the partnership. If the interest is sold to existing partners, the method is often called a "cross purchase" arrangement. If the existing partners do not wish to include additional partners, they normally provide in the partnership agreement that any sale or exchange must be to an existing partner. The sale or exchange of a partnership interest, however, does not include the transfer of such interest at death "as a result of inheritance or any testamentary disposition."

To avoid the problems inherent in section 706(c), the sale or exchange must take place on the date of the deceased partner's death. If the sale takes place at that time, the partnership's taxable year closes with respect to the deceased partner, and his distributive share of partnership income is includible on his final individual or joint income tax return. The Code does not treat the share of income accrued as of the decedent's death as income in respect of a decedent. The Code instead treats that income as having been earned during the decedent's last taxable year and therefore properly includible on his final return.

Under section 741, a valid sale or exchange usually results in capi-portion of the tax credit that corresponds to the unused portion of the property's useful life. Assume, for example, that a partnership holds investment tax credit property with a useful life of seven years. After four years, a partner dies, and the partnership is terminated and subsequently reorganized. The Code will require the partnership to recapture three years of investment tax credit. For an excellent discussion of the recapture of investment tax credit in the partnership context, see Patton, *The Investment Credit and Its Recapture in Partnership Transactions*, 5 TAX. OF INDIVIDUALS 53 (1981).

80. If the sale takes place at any time subsequent to the decedent's death, the sale will not solve the Hesse problem because the decedent will not have earned the income during his final taxable year. Thus, the estate or other successor in interest must report this income on the estate's income tax return.

The amount of all items of gross income in respect of a decedent's estate which are not properly includible in respect of the taxable period in which falls the date of his death or a prior period . . . shall be included in the gross income, for the taxable year when received of the decedent's estate or other successor in interest.
Cross purchases afford other advantages in addition to capital gains. If such an arrangement is effective on the death of a partner, for example, it solves the mismatching problems posed by the Hesse case. The Code provides that the sale or exchange of a partner's entire interest closes the partnership taxable year with respect to that partner on the date of sale. Thus, no mismatching of income and loss deductions results. The decedent's spouse includes all allowable deductions and the decedent's share of partnership income or losses on their final joint income tax return.

Moreover, the partner who purchases the decedent's partnership interest receives, under sections 742 and 1012 of the Code, an increase in the adjusted basis of his partnership interest equal to the cost of acquiring the deceased partner's interest. An increase in the acquiring partner's adjusted basis permits him to recognize a smaller gain for tax purposes upon the subsequent sale of his partnership interest.

A cross purchase arrangement, however, has two primary disadvantages. First, the partner who purchases the deceased partner's interest cannot receive a current deduction for any part of the purchase price. Consequently, the purchasing partner must fund the buy-out with after-tax dollars. Second, if the deceased partner holds more than a fifty percent share of partnership capital and profits, a sale or exchange of his partnership interest terminates the partnership. As noted above, termination is undesirable to the partnership because it is costly and inefficient.

Thus, a cross purchase arrangement is generally more favorable to

84. The only exceptions to capital gains treatment are payments for inventory items that have appreciated substantially in value and "unrealized receivables." The Code taxes these payments to the transferor as ordinary income. See I.R.C. §§ 751(c), (d).

85. I.R.C. § 741 provides:

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

Capital gains are desirable because they receive more favorable tax treatment under the Code than does ordinary income. Only 40% of the gain earned from the sale or exchange of a capital asset held for more than one year is included in income. I.R.C. § 1202(a). See I.R.C. §§ 1221-1223 for a definition of what constitutes a capital gain.


88. An increase in the acquiring partner's adjusted basis also allows the acquiring partner higher depreciation deductions if a § 754 step-up is elected. Jordan, Estate Planning for Partnerships, 115 TR. & EST. 588, 641 (1976). See generally Black, Partnership Buy-Sell Agreements, 36 N.Y.U. INST. FED. TAX. 51 (1978).

89. This policy directly contrasts the tax treatment of liquidations which allows a deduction for part of the purchase price. See text accompanying notes 94-125 infra.

90. Egerton, supra note 39, at 10-25; Abbin, supra note 18, at 104. Liquidation of the decedent's interest, on the other hand, is funded with before-tax dollars. See text accompanying notes 110-13 infra.


92. See note 75 and accompanying text supra.
the deceased partner, who receives capital gains treatment on most of his partnership interest, than to the other partners, who must buy the decedent's partnership interest with after-tax dollars. The cross purchase, however, satisfactorily solves the Hesse mismatching problem.

C. Liquidation of a Decedent's Partnership Interest

The Code defines liquidation as the termination of a partner's interest in partnership capital and profits through payments to the partner or his successor in interest by the partnership. This concept is distinct from the sale or exchange of a deceased partner's interest in two ways. First, in a liquidation the partnership acquires the decedent's partnership interest, while in a sale or exchange the individual partners acquire the deceased partner's interest. Second, in a liquidation the decedent's partnership interest is dissolved, while in a sale or exchange his interest is merely reallocated.

Liquidation of a deceased partner's interest involves paying the value of the deceased partner's interest to his estate or other successor in interest. Section 736 of the Code governs these payments, dividing the payments into two categories, 736(a) payments, or second tier payments, and 736(b) payments, or first tier payments. The partnership makes first tier payments for a deceased partner's interest in partnership property. The Code normally gives these payments capital gains treatment. Second tier payments are all payments that cannot be

93. Unrealized receivables and substantially appreciated inventory items receive ordinary income treatment. See note 85 supra.

94. I.R.C. § 761(d).

95. See notes 76-93 and accompanying text supra.


97. In a sale or exchange, the number of partnership interests does not decrease. The partnership shares are merely shifted. For example, assume that four partners comprise a partnership. One partner then dies and another partner purchases his interest. The partnership still consists of four partnership shares—two partners own one-quarter interests in the partnership and a third partner holds two one-quarter shares. In a liquidation, however, the actual number of partnership interests decreases. In the above example, if one partner dies, the partnerships liquidates his interest, thereby leaving three remaining partners who each hold a one-third interest in the partnership.

98. Black, supra note 88, at 57.

99. But see I.R.C. § 736(b)(2), which states that payments made in exchange for a partner's interest in unrealized receivables of the partnership, as defined by § 751(c), and payments for good will of the partnership, if good will is not specifically provided for in the partnership agreement itself, are not to be considered partnership property includible under § 736(b)(1). These payments therefore fall under § 736(a) and receive ordinary income treatment. See also Abbin, supra note 18, at 104. For the legislative history of § 751 as it relates to unrealized receivables, see H.R. REP. No. 1337, 83d Cong., 2d Sess. A225-26, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4090, 4097.

Unrealized receivables include more than just goods delivered but not yet paid for and services rendered. Section 751(c) includes as unrealized receivables many varieties of recapture property governed by I.R.C. §§ 1245, 1250, and 617. This provision makes unrealized receivables fairly substantial in amount. For example, a landlord owns a residential building which he depreciates using an accelerated method of depreciation. If he sells the building at a gain, he must
classified as first tier payments, and the Code treats these payments as ordinary income rather than as capital gains.

The Code subdivides second tier payments into those considered a distributive share of a decedent's interest in partnership income and those considered guaranteed payments. If the amount of a second tier payment is determined with regard to the income of the partnership, it is a distributive share payment. The deceased partner's estate or other successor in interest receives these distributive share payments. The recipient of this distributive share is regarded as a partner for purposes of these payments. The surviving partners must exclude the distributive share payments in calculating their own shares of partnership income. The estate or other successor in interest also may receive guaranteed payments. Second tier payments are guaranteed payments if their amount is determined without regard to the income of the partnership. The partnership may deduct such payments as ordinary and necessary business expenses. The estate must report all section 736(a) payments as income in respect of a decedent as defined by section 691 on the estate's income tax return.

The Code allows the partnership to make a portion of the payment for the deceased partner's interest with before-tax dollars, because second tier guaranteed payments are usually deductible to the partnership. This differs from sale or exchange of a deceased partner's interest, in which the purchase of the decedent's interest is not deductible. Thus, liquidation is attractive to the partnership.

The second advantage of liquidation is that the partners can control, at least partially, the tax treatment of the liquidation through the good will provision of section 736(b)(2)(B). If the partners desire to recapture the excess depreciation over straight line as ordinary income. Assume, however, that the landlord sells his interest in the partnership, sale of the building becomes partnership property. If the landlord sells his interest in the partnership, sale of the building becomes partnership property, thereby receiving capital gains treatment under § 736(b)(1). The Code, however, says that the recaptured portion of the building's depreciation will be treated as an unrealized receivable under § 736(b)(2), so that the income is treated as ordinary income. Hence, the purpose of § 751 is largely to eliminate any tax difference in the treatment of partnership assets and an individual's assets. See Treas. Reg. § 1.751-1(c)(4)(i), (ii) (1979); Barrie, supra note 96, at 763.

100. See I.R.C. § 736(a).
101. I.R.C. § 736(a)(1). These payments are governed by I.R.C. § 707(a).
102. I.R.C. § 736(a)(2). Guaranteed payments are governed by § 707(c) of the Code.
103. I.R.C. § 736(a)(1).
104. Only part of the distributive share is taxable to the estate or other successor in interest as ordinary income. Part of the payment may be considered tax-free income. See Gorman, supra note 77, at 547-48.
111. 6 J. MERTENS, supra note 23, § 35.71, ch. 35, 232-33. See generally Commissioner v.
PARTNERSHIP TAXATION

confer a benefit on the partnership, they would allocate nothing to good will in the partnership agreement. Thus, a greater portion of the payment by the partnership to the deceased partner’s successor would fall under section 736(a) as a guaranteed payment, which would be deductible by the partnership.\textsuperscript{112} If, however, the partners want to give a tax benefit to the decedent’s estate or other successor in interest, they would allocate a high value to good will within the partnership agreement, thereby designating a larger portion of the liquidating payment as a first tier payment that is eligible for capital gains treatment to the successor,\textsuperscript{113} but allowing the partnership no deduction for its payments.

The final advantage of liquidation is that even if the deceased partner whose interest is being liquidated owns fifty percent or more of partnership capital and profits, liquidation of his interest will not terminate the partnership.\textsuperscript{114} Under section 708(b)(1)(B), a partnership terminates if sale or exchange of at least a fifty percent partnership interest occurs within twelve months. The Code does not, however, treat liquidation as a sale or exchange for purposes of section 708(b)(1)(B).\textsuperscript{115} Thus, the partnership will not terminate, even if a partner holding a fifty percent interest liquidates his partnership interest.

Liquidation, however, has two distinct disadvantages. First, a higher percentage of the payments made to a decedent’s estate or other successor in interest for the deceased partner’s interest will receive ordinary income treatment in a liquidation than in a cross purchase arrangement.\textsuperscript{116} In a cross purchase, with the exceptions of unrealized receivables and substantially appreciated inventory items,\textsuperscript{117} the entire sale of the decedent’s partnership interest receives capital gains treatment. In a liquidation, however, only payments made in exchange for the decedent’s interest in partnership property\textsuperscript{118} and payments for good will, set forth in the partnership agreement,\textsuperscript{119} receive capital gains treatment.

Second, a liquidation alone will not solve the problems raised in \textit{Hesse}. Section 706(c)(2)(A)(ii) states that the partnership’s taxable year closes when the partnership liquidates a partner’s interest. This section, however, states an exception to the rule, providing that the partnership’s taxable year with respect to a partner who dies during the

\textsuperscript{112} Miller v. United States, 181 Ct. Cl. 331 (1967); Henkel, \textit{supra} note 40, at 1585.

\textsuperscript{113} I.R.C. § 736(b)(2)(B). The good will allocation must be reasonable.

\textsuperscript{114} I.R.C. § 751(c), (d). See also note 84 supra.

\textsuperscript{115} I.R.C. § 736(b)(2)(B).
taxable year continues until its normal conclusion even if the decedent’s partnership interest is liquidated. Thus, a liquidation normally will not solve the Hesse problem of mismatching income and deductions.

One alternative exists that will eliminate the Hesse dilemma and provide for a liquidation as well. If the deceased partner was married, he could have designated his spouse as the successor in interest to his partnership share. Under the Code, the spouse then becomes a partner and remains a partner until the decedent’s interest is fully liquidated. Thus, when the liquidation finally occurs, the interest liquidated is that of the surviving spouse-partner. Because section 706(c)(2)(A)(ii) provides that the taxable year of the partnership terminates as to the surviving spouse on the date of liquidation, the spouse can include the distributive share of partnership profits or losses on the final joint return, thereby matching income and deductions.

Designating a successor in interest to solve the problems raised by Hesse only will be effective if the deceased partner was married and designated his spouse as successor in interest; otherwise, the same problem of mismatching income and loss deductions prevails. The Code permits only a husband and wife to file a joint return. Thus, no other successor would be able to include the decedent’s final share of partnership income on the successor’s return. The decedent’s partnership share would still have to be reported on his estate’s income tax return and the Hesse mismatching problem would remain unresolved. Consequently, while a liquidation is an attractive means in which to effectuate the distribution of a decedent’s partnership interest, it only will be a viable alternative to the Hesse case if the partnership agreement designates the decedent’s spouse as successor in interest.

IV. REFORM PROPOSALS

All proposed strategies to circumvent the Hesse mismatching
problem within the current statutory framework possess disadvantages that severely restrict their usefulness. Consequently, an amendment to section 706 is necessary to overcome the *Hesse* dilemma. This note analyzes two proposed amendments, one prepared by the American Law Institute and the other proposed for the first time in this note.

**A. American Law Institute Proposal**

The American Law Institute (ALI) recently proposed amending section 706(c).

The proposal includes two sections, Proposal H1 and Proposal H2. The general rule, set forth in H1, is that the partnership's taxable year terminates as to a deceased partner on the date of his death. The decedent's distributive share of profits or losses is calculated as of that date. Because the partnership's taxable year closes as to the decedent upon his death, he has earned his distributive share of partnership income during his short taxable year. The decedent's executor or other successor would then be able to report this income on the decedent's final personal income tax return rather than on his estate's income tax return. Thus, the ALI proposal solves the mismatching problems faced in the *Hesse* case.

The principal drawback of this general rule is that partnerships often cannot determine a deceased partner's share of profits and losses during the middle of a taxable year. Many partnerships that sustain losses during the taxable year do not actually incur those losses until the last few weeks or even the last days of the taxable year. Thus, to require a partnership to calculate a partner's interest during the middle of the year could result in a substantial underestimation or overestimation of the partner's actual interest. To deal with this problem, the proposed ALI regulations provide a feasible way to determine the value of the decedent's partnership interest without the necessity of closing the partnership books mid-year. The regulations suggest that the books remain open until year-end. At that time, the deceased partner's interest is estimated as a pro rata share of his partnership interest had he re-

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126. In 1959, the *Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Code: Hearings Before the House Comm. on Ways & Means*, 86th Cong., 1st Sess. 135 (1959), proposed another amendment to § 706(c). The reason the Advisory Group gave for the proposal is that § 706(c) "overlooks the fact that where 'bunching' is not a serious problem this may deny the opportunity to offset this income against deductions and exemptions available in the year of death. It may also deny the benefits of income-splitting with respect to this partnership income."

The Advisory Group proposed that § 706(c) be amended so that the partnership taxable year closes with respect to a deceased partner at the date of his death unless his estate or other successor in interest chooses to have the decedent's taxable year remain open until the end of that taxable year. The Group also proposed several minor changes to the § 706 provisions. Congress, however, chose not to amend § 706(c) in accordance with the Advisory Group's recommendations. *See also Anderson & Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K, 15 Tax L. Rev. 285, 309-10 (1960).*


128. *Id.* at 23.
mained a partner through year-end. Therefore, the decedent’s partnership interest will take account of profits and losses incurred at the end of the partnership's taxable year.

Proposal H2 deals with the situation in which the deceased partner's final tax return contains bunching of income. If application of H1 would result in the inclusion of more than twelve months of income or losses from the partnership in the decedent's final return, Proposal H2 provides that the partnership taxable year of the decedent will not close upon his death. Rather, it will terminate either when the deceased partner's interest is sold, exchanged, or liquidated or, alternatively, at the close of the partnership's taxable year.

Although Proposal H2 avoids the problem of bunching, it fails to solve the loss carryback problems illustrated in Hesse. If the partnership's taxable year remains open under Proposal H2, then a decedent's final income tax return cannot contain his distributive share of partnership income or losses incurred during the short taxable year of his death. Consequently, mismatching of income and deductions will still occur. If, on the other hand, the decedent's estate or other successor in interest sells, exchanges, or liquidates the decedent's partnership interest, Proposal H2 provides that the partnership taxable year closes on the date of sale or liquidation. This rule does not alter existing law, and therefore creates no additional ways to circumvent the Hesse problem of denial of loss carrybacks.

Finally, Proposal H2 states that if a cross purchase arrangement is operative at the date of the deceased partner's death, the partnership taxable year closes with respect to him on the day after his death. The ALI included this provision to avoid the bunching problem that would result if the buy-out were effective at the date of death. The provision

129. Id. at 24.
130. This problem has rarely arisen since 1954, when Congress added § 706(b)(1), which requires a partnership to use the same taxable year as all of its principal partners. Bunching of income, however, can still occur under the Code because § 706(b)(1) allows a partnership to adopt a taxable year which is different from that of its principal partners if there are significant business reasons for doing so. Thus, a partnership can adopt a fiscal year for tax purposes when its partners use a calendar year, thereby creating the potential for bunching. See Rev. Proc. 72-51, 1972-2 C.B. 832, which generally allows a partnership to adopt a taxable year different from that of its principal partners if the partners are not then able to defer realization of income for more than three months. See also Treas. Reg. 1.706-1(a)(2)(b)(ii) (1979).
131. The taxable year of a partnership will not close for a deceased partner as of the date of his death if such closing would result in the inclusion of more than 12 months of items from that partnership in the decedent's final return. In that event, the taxable year of the partnership will close for the deceased partner's interest as of the first to occur of the following—
(a) the closing of the taxable year of the partnership;
(b) the date the deceased partner's entire interest (held by his estate or other successor) is sold, exchanged or liquidated.
If the entire interest of the deceased partner is sold, exchanged or liquidated under an agreement operative on the death of the partner, then, solely for purposes of determining which taxpayer will report partnership items, the partnership year will be considered to close on the day following the death of the partner.

fails, however, to resolve the Hesse dilemma because the decedent is not treated as incurring his share of partnership income or loss during his short taxable year. Thus, the decedent's estate must include his share of partnership income or loss on the estate's income tax return.

Moreover, both Proposals H1 and H2 are mandatory. A taxpayer must follow the section which applies. While Proposal H1 solves the Hesse mismatching problem, a taxpayer may not elect H1 if his income tax return would contain more than twelve months of income. In that situation, the taxpayer must apply Proposal H2, which solves the bunching problem but does not solve the Hesse mismatching situation. Because the proposals are mandatory, a taxpayer only can solve either the Hesse problem or bunching, and the taxpayer cannot choose which problem to solve. Thus, the American Law Institute Proposal is not a viable reform solution.

B. Statutory Amendment to Section 706(c)

The following proposed amendment to section 706(c) solves the Hesse mismatching problem without altering the current Code's solution to the bunching problem. Moreover, the amendment allows the estate planner freedom to choose the best method for receiving the decedent's partnership interest upon death.

SECTION 706. TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

(d) TAX RETURN IN WHICH PARTNERSHIP INCOME IS INCLUDIBLE.—In reporting the taxable income of a deceased partner for the final taxable year, the partner's estate or other successor in interest shall have the option of reporting the decedent's distributive share of partnership income or loss either on the final income tax return of the decedent or on the fiduciary income tax return of the estate.

Congress originally adopted section 706(c) as a relief measure for a deceased partner's estate or other successor in interest to avoid bunching of income which would result in higher tax brackets and corresponding higher rates. This proposed amendment conforms to congressional intent by allowing the decedent's estate or successor to match income and deductions, thereby alleviating the Hesse mismatching problem. Furthermore, because the existing subsections of section 706 would remain unchanged, they would continue to solve the bunching problem.

Under the amendment, when a partner dies, the partnership taxable year remains open for both the deceased partner and the partnership itself until the year's normal conclusion. When the taxable year closes, the partnership calculates the decedent's partnership interest as

133. See text accompanying notes 41 & 42 supra.
of year-end. The partnership will pay the decedent's estate or successor a pro rata portion of the decedent's interest according to the number of days during the taxable year that the decedent was a partner. The estate or successor will then have the option of reporting this partnership distributive share on either the decedent's final income tax return or on the estate's income tax return. Most often, the successor will wish to report the decedent's income and losses on his final return, especially if the decedent's spouse files a joint income tax return. The final joint return is usually preferable because it combines the benefit of income-splitting with the matching of decedent's partnership income and deductions he received during his last taxable year.

The estate or successor, however, may prefer to report the decedent's partnership income on the estate income tax return if the final joint return contains a large amount of income from other sources. By reporting the decedent's partnership distributive share on the estate's income tax return, the estate or other successor could allow the income to be taxed at lower rates than if the entire amount of income was included on the decedent's final return.

This amendment also solves the bunching problem because it does not alter the existing provisions of section 706. Section 706 alleviates bunching by keeping the partnership's taxable year open after a partner dies until its normal conclusion, thereby preventing the decedent from being treated as earning any partnership income during the short taxable year of his death.

This proposed amendment allows the decedent's estate or other successor in interest to choose the best means of receiving the decedent's distributive share of partnership income without worrying about the Hesse mismatching problem. A liquidation, which would not be the correct choice if the deceased partner could not name his widow as successor in interest, would be placed on equal footing with a sale or exchange. While a sale or exchange closes the partnership's taxable year for the deceased partner, liquidation does not. Leaving the partnership's taxable year open after the decedent's death, however, would no longer be a problem because the decedent's executor still could include the decedent's partnership income on the decedent's final personal income tax return. This solves the Hesse mismatching problem without the necessity of closing the partnership's taxable year upon the decedent's death. Thus, a deceased partner's estate can weigh liquidation and sale or exchange for their tax consequences without considering the Hesse problem because the latter is solved by a separate provision.

Finally, the amendment would not carry with it the problems asso-

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134. The ALI proposal suggested this pro rata method.
135. The estate or other successor in interest must still choose whether to use a sale or exchange or a termination to obtain the decedent's partnership income.
associated with partnership termination because the partnership does not terminate under this amendment. Rather, the partnership remains open for all partners until the end of the year in which the decedent has died at which point it terminates with respect to the decedent\textsuperscript{136} and continues for all of the other partners.

V. Conclusion

_Estate of Hesse v. Commissioner_ requires that a deceased partner's estate or other successor report the decedent's distributive share of partnership income attributable to the year of his death on the estate's income tax return rather than on the decedent's final joint income tax return. Such a requirement, mandated by section 706, produces a mismatching of income and deductions, potentially resulting in substantial and illogical inequities.

Eliminating these potential inequities requires an amendment to section 706. The amendment suggested in this note allows the decedent's estate to choose whether it would be more beneficial to include the decedent's partnership distributive share on his final income tax return or on his estate's income tax return. Additionally, the amendment alleviates the problem of _Hesse_ and does not produce other adverse consequences. The remaining partners and the decedent's estate or other successor in interest are given the option of liquidating or selling the deceased partner's interest in the partnership. Consequently, the proposed amendment would solve a serious problem facing partnerships and ensure that the unfortunate result in _Hesse_ is not repeated.

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\textsuperscript{136} I.R.C. § 706(c)(2)(A)(ii).