La Rue v. Commissioner, 90 T. C. 465 (1988)

A partner's basis in a partnership interest cannot include liabilities until they meet the all-events test, and a transfer of partnership assets and liabilities to a third party constitutes a sale or exchange resulting in capital loss.

Summary

Goodbody & Co. , a stock brokerage firm, faced financial collapse due to "back office" liabilities. To prevent its failure, Goodbody transferred its business to Merrill Lynch, which assumed all assets and liabilities. The court held that liabilities must meet the all-events test to be included in the partners' bases. The transfer resulted in a sale or exchange of the partners' interests, leading to a capital loss. The court rejected the partners' claims of worthlessness or abandonment, affirming that the transaction was a sale or exchange under tax law.

Facts

Goodbody & Co. , a stock brokerage firm, experienced significant "back office" liabilities due to record-keeping issues. These liabilities led to capital withdrawals and violations of New York Stock Exchange rules. To avert collapse, Goodbody transferred its entire business, including all assets and liabilities, to Merrill Lynch on December 11, 1970. Merrill Lynch agreed to hold Goodbody harmless from these liabilities. The New York Stock Exchange (NYSE) indemnified Merrill Lynch for any net worth deficit up to $20 million. The partners received no direct distribution from the transfer but continued as employees of a Merrill Lynch subsidiary.

Procedural History

The IRS determined deficiencies in the partners' tax returns for various years, leading to consolidated cases in the U. S. Tax Court. The partners conceded adjustments related to the deduction of "back office" liabilities but argued that these liabilities should be included in their partnership interest bases. The court needed to determine the tax consequences of the transfer to Merrill Lynch, including the partners' bases and the character of any resulting loss.

Issue(s)

1. Whether reserves for "back office" liabilities can be included in the bases of the partners' partnership interests.
2. Whether the transfer of Goodbody's business to Merrill Lynch resulted in relief from partnership liabilities, causing constructive distributions and reducing the partners' bases in their partnership interests.
3. Whether the transaction constituted a sale or exchange of the partners' partnership interests, resulting in a capital loss, or if the partners should be allowed an ordinary loss deduction for worthlessness or abandonment.

Holding

1. No, because the reserves did not meet the all-events test, as the amount of liability was not determinable with reasonable accuracy in 1970.
2. Yes, because Merrill Lynch's assumption of liabilities resulted in a decrease in partnership liabilities, causing constructive distributions that reduced the partners' bases.
3. Yes, because the transfer of Goodbody's business to Merrill Lynch constituted a sale or exchange of the partners' interests, resulting in a capital loss, as Merrill Lynch's assumption of liabilities was considered consideration.

Court's Reasoning

The court applied the all-events test to determine when liabilities could be included in the partners' bases, ruling that the "back office" liabilities were not fixed or determinable in amount until securities were bought or sold. The court found that Merrill Lynch's assumption of liabilities constituted consideration, making the transaction a sale or exchange under tax law. The court rejected the partners' claims of worthlessness or abandonment, citing that the assumption of liabilities by a third party constituted an amount realized, which is consideration for tax purposes. The court also noted that the transaction terminated the partners' interests in Goodbody, as they no longer had an ownership interest in the business or assets. The court's decision was influenced by the plain language of the financing agreement and the economic reality of the transaction, which transferred Goodbody's entire going business to Merrill Lynch.

Practical Implications

This decision clarifies that liabilities must meet the all-events test before they can be included in a partner's basis, affecting how similar cases should be analyzed. It also establishes that a transfer of partnership assets and liabilities to a third party constitutes a sale or exchange, resulting in a capital loss, which impacts how such transactions should be reported for tax purposes. The ruling has implications for partnerships facing financial distress and considering similar transfers to avoid collapse. It also affects legal practice in determining the tax consequences of partnership transfers, emphasizing the need to consider the economic substance of the transaction. Later cases have applied this ruling in determining the tax treatment of partnership transfers involving liabilities.

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