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Survey of Federal Income Taxation of Changes in Partnership Interest

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Sanchez — Taxation of Changes in Partnership Interest

NAME AND ADDRESS	DATE

SURVEY OF FEDERAL INCOME TAXATION OF CHANGES IN PARTNERSHIP INTEREST

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Gilbert Stephens Sanchez

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IMPORTANT REFERENCES ABBREVIATED

Acq.	Acquiesced.
Aff'd.	Affirmed.
A.L.R.	Americal Law Reports Annotated.
Am. St. Rep.	American State Reporter.
B.T.A.	Board of Tax Appeals.
C.C.A.	Circuit Coart of Appeals.
CCH	Commerce Clearing House.
Cir.	Circuit.
Comm'r.	Commissioner of Internal Revenue.
Ct. Cl.	United States Court of Claims.
Cum. Bull.	Official Cummulative Bulletin of Treasury Department Rulings.
Dec.	Decision.
F. or Fed.	Federal Reporter.
G.C.M.	General Councel's Memorandum.
I.T.	Income Tax Unit Rulings.
Int. Rev.	Internal Revenue.
Mem.	Memorandum.
P-H	Prentice-Hall.
Reg.	Regulations of Treasury Department.
Rep.	Reporter.
Rev'd.	Reversed.
Sec.	Section of Income Tax Statutes, Uniform Partnership Act, or Treasury Department Regulations.

Supp.	Supplement.
T.C.	Tax Court.
Treas.	Treasury.
U.S.	United States Reporter of Supreme Court.
U.L.A.	Uniform Laws Annotated.
U.P.A.	Uniform Partnership Act.

CHAPTER I

THE PROBLEM

Statement of the Problem

The portion of the Internal Revenue Code outlining the general method for the income taxation of partners and partnerships is contained in Supplement F. The entire supplement contains only nine short and brief sections. The attempts of the Courts and the Commissioner of Internal Revenue to apply these sketchy provisions have resulted in grave confusion with respect to the income tax consequences of a great many partnership transactions.

Most of the problems now unsolved result from a conflict between the two basic concepts in respect to the nature of the partnership. If the partnership were an entity, its members might generally deal with it as they would with an outsider, subject to the limitations necessary to prevent tax avoidance. If it were a mere aggregate of the individuals of which it was composed, then any transaction between partner and partnership would be in substance merely a transaction between that partner individually and that partner plus all remaining partners, qua partners. This conflict of entity theory and aggregate theory threads through almost every major income tax problem involving partnerships.

It is the purpose of this study to present and discuss tax questions peculiar to changes in partnership interest

CHAPTER I

INTRODUCTION

Statement of the Problem

The complexity of the present [illegible] in setting forth the general method for the income taxation of partners and partnerships is recognized [illegible]. The entire partnership element contains only nine short sections [illegible]. Attempts of the Courts and the Commissioner of Internal Revenue to apply these sections [illegible] have resulted in grave confusion with respect to the proper tax treatment of a great many partnership transactions.

Most of the problems now existing result from a conflict between the two basic approaches to [illegible] the nature of the partnership. If the partnership [illegible] its members might [illegible] an outsider, subject to [illegible] tax avoidance. [illegible] duals of which it was composed, [illegible] partner and partnership would [illegible] action between that partner [illegible] plus all remaining partners, [illegible] entity theory and aggregate [illegible] every major [illegible] partnership.

It is the purpose of [illegible] tax questions pertaining to [illegible]

under the provisions of the Federal Income Tax Law. Consideration will be given not only to the partner disposing of a partnership interest, but also to the tax consequences of the buying partner as well as the partnership itself wherever necessary. This study has been undertaken with a view to discovering and analyzing some of the income tax problems arising from the major unresolved conflicts in interpreting the Internal Revenue Code by the Courts and the Commissioner of Internal Revenue, and an attempt is made to reveal the general trend now being followed.

Delimitation of the Problem

Since the scope of current partnership tax problems dealing with conflicting theories of taxation is so extensive and varied, it has become necessary to limit this study to the tax consequences of transfers in partnership interest. The conflicting concepts of taxation of gains or losses resulting from changes in partnership interest are also varied and extensive, and only the major issues will be considered in this study. These major issues include (1) basis of property, (2) holding period, (3) nature of gain or loss, (4) requisites to constitute a change in partnership interest, and (5) the taxability of partnership income in the year when a change in partnership interest is made.

A further limitation was attempted to transfers of a partnership interest resulting from a sale by a partner

under the provisions of the [illegible] Code. Consi-
deration will be given not only to the continuing partner of a partnership interest, but also to the consequences to the buying partner as well as to the partnership itself whenever necessary. This study is also undertaken with a view to discovering an equitable basis of the "[illegible]" problems arising from the major controversial [illegible] in the courts and the Internal Revenue Code by the [illegible] and the [illegible] of Internal Revenue, and in so far as [illegible] the general trend now being followed.

Delimitation of the Problem

Since the scope of this study is [illegible] for problems dealing with conflicts [illegible] of [illegible], [illegible] and [illegible], it was [illegible] to [illegible] this study to the tax consequences of [illegible] in partnership interests. The conflicting concepts of [illegible] resulting from changes in partnership interest are [illegible] and extensive, and only the major issues [illegible] considered. In this study, [illegible] major [illegible] (1) [illegible] of property, (2) holding period, (3) [illegible] of [illegible], (4) [illegible] to partners [illegible], and (5) the [illegible] of [illegible] in the year when a change in partnership interest is made.

A further limitation of the study [illegible] partnership interests [illegible]

although, in some instances, it was necessary to discuss changes of partnership interest resulting from the death of a partner because of the similarity in tax consequences.

Importance of the Problem

In the face of all the unresolved conflicts in interpreting the Internal Revenue Code by the Courts and the Commissioner, substantial uncertainties prevail as to the tax results of even the simplest transactions involving changes of partnership interests. The continued uncertainty of these tax results in the face of ever increasing tax rates is a substantial deterrent to any taxpayer contemplating entry into a partnership. In addition, to the extent that the conflict is unresolved, the taxpayer is at a definite disadvantage in negotiating such questions with the Bureau, because of the presumption of correctness attaching to the latter's determinations. An understanding of these conflicts is necessary in order to best evaluate any or all partnership taxation literature that is being published today. It will also aid businessmen and accountants to use better judgment in solving present business problems, for they will be able to view the problem from past as well as current trends.

The need for statutory clarification by Congress is long overdue and is becoming increasingly urgent with the rise in popularity of the partnership as an organizational vehicle for conducting business. Continued delay will

although, in some instances, [illegible] changes of partnership [illegible] a sufficient amount of [illegible] for tax purposes.

Importance of the Problem

In the field of [illegible] probing the Internal Revenue Code [illegible] ministry, [illegible] interpretation, [illegible] results of [illegible] of partnership interests. The [illegible] these tax results in the form of [illegible] tax savings is a substantial incentive to any [illegible] entry into a partnership. In addition, the present time the conflict is unresolved, [illegible] disadvantage [illegible] because of the uncertainty of [illegible] lation [illegible]. The [illegible] is necessary [illegible] partner-ship [illegible] will also [illegible] ment to [illegible] able to [illegible].

The need for [illegible] long [illegible] rise in [illegible] which [illegible]

penalize an increasing number of hapless taxpayers who attempt to adopt a simple method of doing business, only to find themselves immediately saddled with formidable tax problems which often may be satisfactorily solved only by litigation.

SOURCES OF DATA

Current literature and texts on partnership taxation have been carefully studied with the intention of presenting the different points of view which are not fully agreed upon pertaining to concepts of taxation of changes in partnership interest resulting from a sale by a partner. The present status of the law has also been examined with respect to each such problem, by a review of court decisions, published Bureau of Internal Revenue rulings and informal Bureau practices in situations where such practices differ from the published rulings. In addition, published suggestions for the solution of these problems have been analyzed and such corrective suggestions have been offered as seem advisable.

It is hoped that the readers of this thesis are induced to delve into all the interesting and important partnership literature and court decisions that are being published currently.

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NATURE AND HISTORY OF THE PARTNERSHIP

With the first feeble stirrings of the capitalistic system, the individual entrepreneur soon found that the pooling of his resources with those of others similarly engaged often made for a more vigorous and successful enterprise. The most informal and therefore one of the simplest methods of accomplishing this pooling was by an agreement between the parties. A relationship was thereupon created which the law came to classify as a partnership.

Partnerships have grown with the growth of trade and multiplied with the extension of trade. The partnership is a creation of necessity, not of logic. Whether or not this is the reason for it, there can be no doubt that the law has had difficulty in fitting the partnership into neat general categories.

The difficulties with the partnership commence with attempts to define it. As defined by Chancellor Kent,

> A partnership is a contract of two or more competent persons, to place their money, effects, labor, and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss in certain proportions. . . .

Chancellor Kent's classic definition has often been quoted with approval, and the United States Supreme Court[1] has

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1 Goldsmith v. Eichold Bros., 94 Ala. 116, 10 So. 80, 33 Am. St. Rep. 97 (1891); Blackerby v. Oder, 201 Ky. 403, 257 S.W. 43 (1923).

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[illegible] pooling [illegible]

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defined the term in similar words which, except on a close inspection, appear to carry the same meaning. Yet other courts have been critical of all suggested definitions and have pronounced the task of evolving a precise definition an impossibility.[2] However, all the attempts at definition have a distinct similarity, and perhaps the difficulty in this case is overemphasized by any suggestion that it is unique. The Uniform Partnership Act defines a partnership[3] as "an association of two or more persons to carry on as co-owners a business for profit". Good use of this definition can be made by one who recognizes that this simple definition is not supposed to provide the key to the solution of all problems but merely to serve as a sort of introduction to the sections which follow.

A gradual evolution has occurred in the law of partnerships and their characteristics. Originally, partnerships were regarded as a sort of tenancy in common, with the added feature of an agency relationship between the partners. This view found expression in cases holding that there must be a joint ownership of funds.[4] At the same time it was recognized

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2 Keiswetter v. Rubenstein, 209 N.W. 154 (1926); Snow Hill Bkng. & T. Co. v. D. J. Odom Drug Co., 125 S.E. 394 (1924).

3 Uniform Partnership Act, Section 6.

4 See, for example, Robbins v. McKnight, 5 N.J. Eq. 642, 45 Am. Dec. 406 (1847).

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that joint ownership, even though coupled with joint use, did not necessarily result in a partnership, real or ostensible.[5] The emphasis on joint ownership inevitably began to be lessened by the increasing complexity of the industrial and commercial life of the country. For example, large partnerships in which several but not all of the partners were the active managers led to frequent situations in which one partner would have a larger share in the profits than in the firm's assets, and a non-working partner would have a smaller share in the profits than in the firm's assets. Indeed, in modern business practice it is not unknown for a partner to become such without making a contribution of capital and without acquiring a right to share in the assets upon dissolution.

The provisions of the Uniform Partnership Act can be best used as illustrative of the rules now generally accepted.[6] This Act did not establish the partnership as a distinct legal person.[7] It did, however, adopt many of the provisions which make impossible a categorical classification of the partnership as an entity or not an entity. For

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5 Childers v. Neeley, 47 W.Va. 70, 24 S.E. 828, (1899); U.P.A. Sec. 7(2); Arnold v. Debooy, 161 Minn. 255 (1924).

6 The U.P.A. has been adopted in 32 jurisdictions.

7 Williams v. McGowan, 152 F.2d 570, 572 (C.C.A. 2d 1945); Comm'r. v. Whitney, 169 F.2d 562 (C.C.A. 2d 1948).

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example, the Act provides that the assignment of his interest by any partner does not dissolve the partnership,[8] and the remaining partners, and the assignee if admitted, continue to exercise all the rights and powers theretofore possessed. When a partner dies, the partnership is "dissolved" but not "terminated",[9] the remaining partners continue to have the power to bind each other,[10] and the Act contemplates that the remaining partners will normally reconstitute themselves into a new partnership and provides that the rights of creditors carry over to the new partnership.[11]

Moreover, the Act insulates the partner from ownership in fee of an undivided interest in specific assets. The relevent provisions of the Act provide that: a partner cannot, by sale of his own interest, convey an interest in specific assets; his assignee acquires no right to possession but merely an interest in the profits from continued operation.[12]

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8 U.P.A. Sec. 27. The Commissioners' note recognizes this is a change from the common law to reflect commercial conditions (7 U.L.A. 160). Sec. 31 of the English Partnership Act is to the same effect.

9 U.P.A. Sec. 30 and 31. The Act (Sec. 29) defines "dissolution" as being only "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business".

10 U.P.A. Sec. 33 and 35.

11 _Ibid_. Sec. 41.

12 _Ibid_. Sec. 25 and 27.

example, the Act provides that the [illegible] of his interest by any partner does not [illegible] the partnership,[8] and the remaining partners [illegible] to exercise all the [illegible] When a partner dies, the partnership is dissolved, but not terminated;[9] the [illegible] continue to have the power to wind up [illegible] affairs,[10] and [illegible] the remaining partners will [illegible] themselves into a new partnership and [illegible] that the [illegible] of creditors [illegible][11]

Moreover, the Act indicates the partner's [illegible] in favor of an undivided interest in [illegible]. The relevant provisions of the [illegible] that a partner cannot, by sale of his own interest, convey [illegible] specific assets, [illegible] merely an interest in [illegible] the profits [illegible][12]

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8 U.P.A. sec. 27. (The Uniform Partnership Act [illegible] this is a change from the common law [illegible] conditions (7 U.L.A. 1961 [illegible] ship act [illegible] same effect.

9 U.P.A. sec. 30 and 31. The latter, sec. 29, defines "dissolution" as being only "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinct from the winding up of the business".

10 U.P.A. sec. 33 and 35.

11 Ibid. [illegible]

12 Ibid. Sec. 25 and 27.

The specific assets of the partnership are beyond the reach of attachment or execution for his personal debts,[13] and are not subject to the dower, curtesy, or community claims of the partner's spouse.[14] The partner's right in the specific assets ceases on his death.[15] The partner's interest in the partnership is defined as "his share of the profits and surplus, and the same is personal property".[16]

If one approaches any of a variety of questions, such as the right of an assignee of a partner's interest to insist on either a share in management of the partnership assets or an immediate distribution to him of an aliquot portion of them, from the premise that the partnership is not an entity, it is evident from the provisions of the Uniform Partnership Act mentioned above that one will get the wrong answer. But it is equally true that there are some questions, such as the continuation of a partnership upon death or retirement of a partner, to which one will get the wrong answer if approached from the premise that the partnership is an entity. The truth is that the statement that the

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13 Ibid. Sec. 25.

14 Loc. cit.

15 Loc. cit.

16 U.P.A. Sec. 26. This provision is of particular interest where the partnership assets include or consist of real property.

The creditor does not [illegible]

or attachment [illegible]

not subject to the [illegible]

the partner's [illegible]

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11 [illegible]

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death [illegible]

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13. [illegible]

14. [illegible]

15. [illegible]

16. [illegible]

partnership is an entity or is not an entity is not a statement of a premise at all but of a conclusion. In the case of a corporation, the law does not say that a corporation is an entity and leave us to infer the significance of that status. The law confers certain characteristics on corporations which so liken them to beings, that lawyers have come to categorize them as entities. That, however, is merely a shorthand method of stating a conclusion, the premise for which lies in a particularized catalogue of characteristics.[17]

BASIC PATTERN FOR TAXATION OF PARTNERSHIPS

If the income tax law governing partners and partnerships is approached with the foregoing thought in mind, some false starts may be avoided. The statements by Mr. Sternhagen for the Board of Tax Appeals, in Edward B. Archbald

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17 Louisiana, with its civil law background, accepts the partnership as a person or entity with less hesitation than its sister states. See Brinson v. Monroe Auto and Supply Co., 180 La. 1064, 185 So. 558, 96 A.L.R. 1206 (1934); Henderson v. Comm'r., 155 F.2d 310 (C.C.A. 5th 1946), 164 A.L.R. 1030.

The main logical difficulty apparently lies in the assumption that the partnership cannot be an entity so long as its individual members are liable for its debts. There is, however, some corporate precedent to the contrary. Until 1930 the California Constitution (Art. XII, Sec. 3) provided that corporate shareholders were proportionately liable for the corporate debts, but California corporations were not denied the other characteristics of legal personality, such as domicle, suability, ability to own and convey, and the like. The same is true of banks, whose shareholders customarily do not enjoy limited liability.

partnership is an entity or is not by cutting out a segment of a genuine affair [illegible] of a [illegible] question of a corporation, the law does not say that a corporation is an entity and leave us to glean the qualifications of that status. The law engineers—in [illegible] the corporations which [illegible] like [illegible] then [illegible] to categorize them as entities. [illegible] shorthand [illegible] the [illegible] which lies in a particular [illegible] [17]

BASIC PATTERNS OF PARTNERSHIPS

1. The Uniform Partnership Act [illegible] partnerships is [illegible] false [illegible] for the [illegible]

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17. Contrast, with the [illegible] the partnership [illegible] than its [illegible] Supply Co., 136 [illegible] Henderson v. [illegible] A.L.R. 1030.

The main logical difficulty [illegible] assumption that the partnership [illegible] as its individual members are liable for its debts [illegible] is, however, [illegible] Until 1930 the California [illegible] provided that [illegible] liable for the corporate debts, but [illegible] were not [illegible] ality, such [illegible] and the like. [illegible] customarily [illegible] limited liability.

admirably reflect the admonition:[18]

> . . . it is clear, therefore, that a doctrainaire assertion that a partnership is not an entity affords no key to the determination . . . Considered thus realistically, without being overwhelmed by concepts, the issue is not foreclosed . . . a partnership is treated sometimes as an entity and sometimes not. . . .

The income tax statutes present a pattern which meshes very well with the private law pattern typified by the Uniform Partnership Act. It will be seen that while the partner and not the partnership is liable for tax on the partnership net income, he is not deemed the owner of the net income before the end of the partnership taxable year. He is entitled to claim benefits from particular classifications of partnership income and deductions, as explained below, but only where Congress has specifically so provided. Finally, he is regarded not as the direct owner of an aliquot portion of the partnership assets, but as the owner of a partnership interest, a thing with a basis and a holding period of its own.

The relevant statutory provisions are grouped in Supplement F, Internal Revenue Code Sections 181 to 190, inclusive, except for the basis provision, which is found in Section 113 (a)(13). The entire supplement contains only nine short sections. Section 181 requires that partners

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18 Edward B. Archbald, 27 B.T.A. 837, 841 (1933), aff'd, 70 F.2d 720 (C.C.A. 2d 1934), cert. denied, Helvering v. Archbald, 293 U.S. 594 (1934).

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pay income taxes upon partnership profits only in their individual capacity.[19] This section is consistent with fundamental common law theory that the partnership has no existence as an entity apart from the individual partners of which it is composed.[20] Under the terms of Section 182,[21]

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19 Int. Rev. Code Sec. 181: "Partnership not taxable. -- Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

20 In interpreting similar provisions in the Federal Income Tax Act of 1913, the Court of Appeals for the Sixth Circuit in the leading case of United States v. Coulby, 251 Fed. 982 (N.D. Ohio, 1918), aff'd, 258 Fed. 27 (6th Cir. 1919), approved a district court opinion in which the court stated: "The law, therefore, ignores for taxing purposes the existence of a partnership. . . . The law looks through the fiction of a partnership and treats its profits and its earnings as those of the individual taxpayer. Unlike a corporation, a partnership has no legal existence aside from the members who compose it. The Congress, consequently, it would seem, ignored, for taxing purposes, a partnership's existence, and placed the individual partner's share in its gains and profits on the same footing as if his income had been received directly by him without the intervention of a partnership name."

21 Int. Rev. Code Sec. 182. "Tax of partner. -- In computing the net income of each partner, he shall include, whether or not distribution is made to him --
(a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months. (b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains or losses of the partnership from sales or exchanges of capital assets held for more than 6 months. (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b)."

pay income taxes [illegible] in [illegible]
dividual capacity [illegible] "as such" [illegible] in [illegible]
mental concept [illegible] that the [illegible]
existence as an entity [illegible]
which it is composed.[30] [illegible]

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19 Int. Rev. Code [illegible] "Partnerships not tax-
able. -- Individuals carrying on business in partnership
shall be liable for income tax only in their individual ca-
pacity."

20 In interpreting [illegible] the
Income Tax Act of 1913, [illegible]
Circuit in the [illegible]
Fed. 958 (S.D. Ohio, 1919), [illegible]
1919), approved [illegible] court [illegible]
stated: "The law, [illegible]
the existence of a partnership [illegible]
the fiction of a [illegible]
earnings as those of the individual [illegible]
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been paid [illegible]
partnership [illegible]."

21 Int. Rev. Code [illegible] "Capital gains and [illegible] -- In
computing the net income of [illegible]
whether [illegible] --
(a) As part of his gross [illegible]
of capital assets held [illegible] 6 months, his dis-
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from sales or exchanges of capital [illegible]
than 6 months. [illegible]
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months, [illegible]
partnership from sales or exchanges [illegible]
for more than 6 months. (c) [illegible]
ordinary [illegible]
ably, [illegible] section 183 (b)."

the partnership profits upon which the individual is required to pay an income tax retain their character as long-term and short-term capital gains and losses, and as ordinary income and ordinary losses when received by the partner. Thus, the nature of the profits remains unchanged as a result of having passed through the partnership. This section again consistently applies the common law aggregate theory and ignores the existence of the partnership as an entity.

Although the two above sections of Supplement F consistly follow the common law aggregate theory, Section 183[22] provides that the net income of the partnership shall be computed in the same manner as in the case of an individual. The statute thus recognizes the partnership as an entity for the purposes of computing income arising from the ownership of property and the activities carried on by the enterprise. In Section 183 of the Code, Congress has recognized the

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22 Int. Rev. Code Sec. 183. "(a) General rule. -- The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual, except as provided in subsections (b), (c), and (d).

"(b) Segregation of items. -- (1) Capital gains and losses. -- There shall be segregated the gains and losses from sales or exchanges of capital assets.
(2) Ordinary net income or loss. -- After excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed -- (A) An ordinary net income which shall consist of the excess of the gross income over the deductions; or (B) An ordinary net loss which shall consist of the excess of the deductions over the gross income. . . ."

the partnership [illegible] shall not be liable

to pay an income tax [illegible]

short-term capital gains [illegible]

and ordinary income [illegible]

nature of the capital gains [illegible]

ing passed through the conduit [illegible]

sistently applies the conduit [illegible]

ignores the existence of the partnership [illegible]

Although the [illegible]

sistly follows the conduit [illegible] Section 183[22]

provides that the net income of the partnership shall be

computed in the same manner and on the [illegible]

The statute thus recognizes the partnership [illegible]

the purposes of computing [illegible]

of property and [illegible]

In Section 183 of the Code, Congress [illegible]

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22 Int. Rev. Code Sec. 183 [illegible] --
The net income of the partnership shall be computed in the
same manner and on the same basis as in the case of an
individual, except as provided in subsections (b)
and (c).

(b) Segregation of items. -- (1) Capital gains and
losses. -- There shall be segregated the gains and losses
from sales or exchanges of capital assets.
(2) Ordinary net income or loss. -- After excluding all
items of gain and loss from sales or exchanges of capital
assets, there shall be computed -- (A) An ordinary net in-
come which shall consist of the excess of the gross income
over the deductions; or (B) An ordinary net loss which shall
consist of the excess of the deductions over the gross
income. . . .

overwhelming demands of practical partnership accounting. Provisions regarding tax-paying might have been set up under either the entity or the aggregate theory without too serious a disruption of everyday partnership activities. But in the method of accounting for income, Congress had little choice, politically speaking. Because businessmen universally accept the "firm" as the basic accounting unit, partnership books are maintained as though the enterprise were an entity. To have required a method of computing partnership income so completely different from this universal approach would have resulted in little less than accounting chaos.

Paralleling the recognition of the partnership as an income-computing entity, Section 187[23] of the Code recognizes the partnership as an entity for the purposes of informational tax reporting. Of the remaining sections, three recognize the aggregate theory by providing additional

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23 Int. Rev. Code Sec. 187. "Partnership returns. -- Every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners."

overweighing quantity of [illegible]

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either [illegible] the [illegible]

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would be [illegible]
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The return [illegible]

details concerning the computation of tax by the individual partner upon his share of partnership income.[24] One of the remaining sections, Section 188,[25] implements the entity theory, since it explains the method of correlating the

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24 Int. Rev. Code Sections 184, 186, and 189.
"184. Credits against net income. -- The partner shall, for the purpose of the normal tax, be allowed as a credit against his net income, in addition to the credits allowed to him under section 25, his proportionate share of such amounts (not in excess of the net income of the partnership) of interest specified in section 25(a) as are received by the partnership. If the partnership elects under section 125 to treat the premiums on bonds, the interest on which allowable as a credit under section 25(a)(1) or (2), as amortizable, for the purposes of the preceeding sentence the partner's proportionate share of the interest received by the partnership shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 23(v) as is attributable to such share.

"186. Taxes of foreign countries and possessions of the United States. -- The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

"189. Net operating losses. -- The benefit of the deduction for net operating losses allowed by section 23(s) shall not be allowed to a partnership but shall be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary."

25 Int. Rev. Code Sec. 188. "Different taxable years of partnership and partner. -- If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner."

details concerning the computation of [illegible] partner upon his share of partnership income [illegible] remaining section, section 188,[25] [illegible] theory, since it excludes the analysis of [illegible]

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[24] Treas. Reg. 111, Sec. 29.184, 29.185, 29.189:

"184. Credits against net income. — The partner, for the purpose of the normal tax, shall be allowed as a credit against his net income, in addition to the credits allowed him under section 25, his proportionate share of such amount (not in excess of the net income of the partnership) of interest specified in section 25 (a) as is received by the partnership. [illegible] the [illegible] of the partnership [illegible] treat the provisions of section [illegible] as a credit under section [illegible] for the purposes of the [illegible] proportionate share of the [illegible] of each partner in the partnership shall be his proportionate share [illegible] determined without regard to [illegible] of the section [illegible] such share.

"185. Taxes of foreign countries and possessions of United States. — The amount of income, war-profits, and excess-profits taxes imposed by foreign countries or possessions of the United States shall be allowed as a credit against the tax of the member of a partnership to the extent provided in section 131.

"189. Net operating losses. — The benefit of the deduction for net operating losses [illegible] shall not be allowed to a partnership but [illegible] be allowed to the members of the partnership under regulations prescribed by the Commissioner with the approval of the Secretary."

[25] Int. Rev. Code Sec. 188, "Different taxable years of partner and partnership. — If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner."

payment of tax by a partner with the reporting of income by the partnership when the partner and partnership have different taxable years. On the other hand, the remaining section, Section 190,[26] fully recognizes the partnership as an entity for the purpose of allowing an amortization deduction on certain emergency facilities owned by the partnership.

If we turn to the basis section (Internal Revenue Code Section 113(a)(13)), we find that the partner has a "partnership interest", with a basis of its own. Section 113(a)(13) provides as follows:

> (13) Partnerships. -- If the property was acquired after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

The first sentence of this provision establishes a rule similar to that applicable to property acquired by a

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26 Int. Rev. Code Sec. 190. "Allowance of amortization deduction. -- In the case of emergency facilities of a partnership, the benefit of the deduction for amortization allowed by section 23(t) shall not be allowed to the members of a partnership but shall be allowed to the partnership in the same manner and to the same extent as in the case of an individual."

payment of each by a partner with the proceeds of his share of the partnership when the partner and partnership use different taxable years. On the other hand, the converse section, Section 190,[26] "Allowance of amortization deduction", treats the partnership as an entity for the purpose of allowing an amortization deduction on certain emergency facilities of the partnership.

If we turn to the basis provision (Internal Revenue Code Section 113(a)(13)), we find that the concept of "partnership interest", with a basis of its own. Section 113(a)(13) provides as follows:

> (13) Partnerships. -- If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any other paragraph of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

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corporation on its formation from its founders. The second sentence suggests that if assets are "distributed in kind" by a partnership to a partner, no gain or loss occurs, and provides that the basis of the partner's "partnership interest" is divided amongst the distributed assets.

A study of the birth of Section 113(a)(13) of the Internal Revenue Code tends to support the conclusion that the "partnership interest" under the income tax laws is a thing with a basis of its own, and therefore with a status of its own, just as it is under the Uniform Partnership Act. Section 113(a)(13) was enacted to change the result reached in the case of Edward B. Archbald, decided on February 28, 1933,[27] in which the Board of Tax Appeals, with a single dissent, held that the partnership had a stepped-up basis for property contributed by a partner, but that although the contribution of the assets caused them to acquire a new basis, it did not result in taxable gain to the partner at the time of making the contribution.

In the Archibald case the Board held that the fact that the partnership was not separately taxable did not mean

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27 27 B.T.A. 837 (1933). This decision, as well as that in a similar case, was affirmed on May 14, 1934, four days after Sec. 113(a)(13) became law. Helvering v. Archbald, 70 F.2d 720 (C.C.A.2d 1934), cert. denied, 293 U.S. 594 (1934); Helvering v. Walbridge, 70 F.2d 683 (C.C.A.2d 1934), cert. denied, 293 U.S. 594 (1934).

corporation on its formation from the [illegible]

sentence suggests that [illegible]

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A study of the [illegible] section [illegible] In-

ternal Revenue Code [illegible] partnership [illegible] consideration [illegible]

"partnership interest," which [illegible]

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tion 113(a)(13) was enacted [illegible]

the case of Edward D. [illegible]

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dissent, held that the partnership [illegible] basis

for property contributed by a partner [illegible]

contributions of the partners [illegible]

basis, it did not [illegible]

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In the [illegible] case the [illegible]

that the partnership was [illegible]

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27 27 B.T.A. [illegible] (1933). [illegible] that in [illegible] case, [illegible] days after Sec. 113(a)(13) became law. [illegible] held, 70 F.(2d) [illegible] 394 (1934); [illegible] 1934), cert. denied, [illegible]

it was to be disregarded in the chain of ownership.[28] In an analytical opinion, the Board concluded that since the partnership was a unit for purposes of computing net income, in the absence of a specific provision to the contrary, the basis to the partnership of its property was the value when acquired by it. From this the Board reasoned that the contributing partner was not taxed on the original increment when the property was sold by the firm, since receipts which were not income to the firm could not be income to him. The Board also refused to tax him in the year when the contribution was made, on the ground he had received nothing in exchange which was freely, separately disposable.

In due course, the Board was affirmed by the Court of Appeals for the Second Curcuit and the Commissioner's petition for certiorari was denied.[29] Judge L. Hand's opinion[30] contains the same reasons given by the Board, though the emphasis is somewhat different and the analysis is carried further. His opinion suggests that the untaxed increment

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28 The opinion refused to approach the case on doctrinaire grounds, using the language quoted supra, p. 11.

29 See footnote 27, supra.

30 The opinion is rendered in the Walbridge case, supra footnote 27, the Archbald case being disposed of per curiam on the authority of Walbridge.

it was to be airbrushed by the doctrine of [illegible]

analytical [illegible]

nership was a [illegible]

the absence of [illegible]

basis to the [illegible]

acquired by it. [illegible]

tributing partners [illegible]

When the property was sold by the [illegible]

were not [illegible]

Board also [illegible]

tion was made, [illegible]

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In due course, [illegible]

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contains the same [illegible]

appeals [illegible]

further. [illegible]

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28 [illegible]

[illegible]

[illegible]

will be eventually taxed on or after liquidation of the partnership, since the basis of the partner's interest will not be increased to include the untaxed increment.

These decisions, however, refused to follow G.C.M. 10092 (XI-1 Cum. Bull. 114, 1930) to the extent of the issue in the Archbald and Walbridge cases. In the G.C.M. ruling, the Bureau's legal officer held that there was no realization of gain when a partner contributed appreciated assets to a partnership, because the interest retained by the partner prevented the transaction from being a closed one. As a corollary, it was held in the ruling that the basis of the property to the partnership was the same as it had been to the partner. As a further corollary, it was held that on distribution of partnership assets in kind in "liquidation" of the partnership, no gain or loss is realized and the distributed assets take the basis of the recipient's "partnership interest".[31]

Section 113(a)(13) was enacted to alter the precise result reached in the Archbald and Walbridge cases, by having the partnership's bases the same as that of the contributing partner in accordance with the ruling in G.C.M.

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31 The ruling is one of the most argumentative and discursive Bureau rulings ever issued. There is a suggestion in the Board's Archbald opinion that the Board believed the ruling was written to serve as a brief in the cases then arising.

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10092 discussed above. The Committee reports,[32] submitted by the House Committee on Ways and Means and the Senate Finance Committee, in an apparent attempt to procure a reversal in the Archbald and Walbridge cases at that time undecided by the Court of Appeals, state that the amendment is declaratory of existing law.[33] The reports state the amendment is to make it clear that partnerships cannot be used as a medium of tax avoidance in the cases of sales of appreciated property. The reports then proceed to elaborate on the second sentence in Internal Revenue Code Section 113(a)(13) by illustrating it with the following case:

> Paragraph (13) further provides that if property is distributed in kind by a partnership to a partner, the basis to the partner shall be a proper proportionate part of the cost or other basis to him of his interest in the partnership. An example will make the operation of this proposal clear. Suppose that a partner, A, paid $10,000 for his interest in a partnership. Suppose that partnership distributes to the partners property in kind representing one half of its assets. Irrespective of the value of this property at the time of its distribution, the basis to A of the property distributed to him will be $5,000, and he will be taxed on any amount for which he thereafter disposes of the property in excess of $5,000. The Committee believes that this provision embodies merely the correct interpretation of the present law but it appears desirable to have an express statement of the rule in the statute.

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32 H.R. Rep. No. 704, 73d Cong., 2d Sess.; Sen. Rep. No. 448, 73d Cong., 2d Sess.; J. S. Seidman, Legislative History of Federal Income Tax Laws (New York: Prentice-Hall, Inc, 1938), pp. 347-8.

33 Other courts followed the Walbridge and Archbald decisions and refused to give effect to the statement in the Committee reports. Flannery v. United States, 25 F. Supp. 677, (D. Md. 1938), aff'd, 106 F.2d 315 (C.C.A.4th 1939)

10092 discussed above. The reports [illegible] by the House Committee on Ways and Means and the Senate Finance Committee, in an [illegible] in the Arrowsmith and Willey [illegible] by the Court of Appeals [illegible] ratory of existing law.[33] The reports [illegible] to make it clear that [illegible] law of tax avoidance in the [illegible] property. The reports then proceed to elaborate on the second sentence in [illegible] by illustrating it with the following case:

Paragraph (1) [illegible] provides that [illegible] distributed in kind [illegible] basis to the partner shall [illegible] part of the [illegible] in the partnership. [illegible] of this proposal clear. [illegible] paid \$10,000 [illegible] that partnership distributes [illegible] kind [illegible] of the value [illegible] bution [illegible] for which [illegible] sion [illegible] present law [illegible] statement of the rule [illegible]

[illegible] No. [illegible] History of [illegible] 1951 [illegible]

[33] Other [illegible] decisions and [illegible] Committee reports [illegible] 677, (N.D. [illegible] 1951) [illegible]

It is evident from this history that while Congress was dissatisfied with the precise result reached in the Walbridge and Archbald cases, and saw them as an avenue of tax avoidance, it intended no general overhaul of the law to insure approval of what Judge L. Hand called "the Commissioner's effort to treat the partnership pluralistically".[34] Instead, it accepted the concept that what the partner owned after he contributed property to the partnership was a "partnership interest", which was a thing itself, with a basis.

The foregoing discussion is intended to suggest a premise for the approach to those partnership income tax problems which are not controlled by a particular section relating to partnerships. There are several categories of such problems, all of which must be dealt with by analogies, and, since Congress has legislated in the light of the private law of partnerships, by concepts derived from that source.[35]

The principal categories of tax problems arising from changes in partnership interest will be discussed

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34 Helvering v. Walbridge, 70 F.2d 683, 685 (C.C.A. 2d 1934).

35 The usual plea for uniformity of application of Federal Law has relatively little force in this area, since 32 states have already adopted the Uniform Partnership Act.

It is evident from this history that the Congress was dissatisfied with the results reached in the Walbridge and Archbald cases, and saw them as an agency of tax avoidance. It intended a general overhaul of the law to insure approval of what Judge L. Hand called "the Commissioner's effort to treat the partnership pluralistically."[24] Instead, it accepted the concept that the partner owned, after he contributed property to the partnership, a "partnership interest", which was a thing itself, with a basis.

The foregoing discussion is intended to suggest a premise for the approach to those partnership income tax problems which are not controlled by a particular section relating to partnerships. There are several categories of such problems, all of which must be dealt with by analogies, and, since Congress has legislated in the light of the private law of partnerships, by concepts derived from that source.[25]

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separately as follows:

Basis of property, including partnership property as well as the partnership interest sold and the partnership interest acquired by the purchaser.

Holding period of partnership property and partnership interest.

The nature of gain or loss from the sale of a partnership interest as respects the selling partner.

Requisites, as interpreted by the Courts and the Commissioner, to constitute a sale of a partnership interest.

The taxability of partnership income in the year when a partnership interest is transferred.

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The taxability of partnership income in the year when a partnership interest is transferred.

CHAPTER II

BASIS OF PROPERTY WHERE THERE HAS BEEN A CHANGE IN PARTNERSHIP INTEREST

As an income-computing entity, the partnership necessarily must have an income tax basis for assets held by it which is independent of any basis which the individual partners may have for their interest in the partnership or its assets. This is the implication of Code Section 113(a)(13), and this principle is universally recognized by the Courts and the Commissioner.[1]

This chapter will discuss the methods of determining the income tax basis of partnership property and of a partnership interest. It will also discuss the effect the basis of partnership property has upon a sale by a partner of his interest in the partnership to the remaining partners who continue the operation of the business.

Partnership Property

As in the case of individual taxpayers, the basis of property in the hands of the partnership is its cost, properly adjusted pursuant to the provisions of Section 113 of the Internal Revenue Code. In the case of property contributed to it by an individual partner, the partnership

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1 See the discussion of this point on page 16 *et seq.* *supra*.

BASIS OF PROPERTY [illegible]

A CHANGE IN PARTNERSHIP [illegible]

As an income-computing entity the partnership necessarily must have an income tax basis for its assets which is independent of any basis which the individual partners may have for their respective interests in the partnership or its assets. This is the implication of Code Section 113(a)(13), and this principle is universally recognized by the Courts and the Commission.[1]

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assumes his basis for the property.[2]

When a partner, however, sells his partnership interest to the remaining partners under an agreement providing for the uninterrupted continuation of the partnership business, is the income tax basis of partnership property affected?

This problem is exemplified by the case of Robert E. Ford.[3] The facts were that five persons contributed property to a partnership in 1932. One partner individually owned a one-third interest in the partnership, and the remaining two-thirds interest was owned by the other four partners. In 1938, when the partnership assets were worth less than their basis, four partners bought the entire one-third interest of the fifth. The agreement provided for the uninterrupted continuation of the business by the partnership. Thereafter the partnership sold some of its assets and in computing its losses, the original cost basis to the partnership was used. The Commissioner adjusted this basis downward on the grounds that the basis of one-third of the firm's assets had become equal to the value on the day the four partners bought out the fifth.

The problem did not turn on the interpretation of the

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2 Int. Rev. Code Sec. 113(a)(13). Ibid.

3 6 T.C. 499 (1946), acq. in, 1946-2 Cum. Bull. 2.

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When a partner, however, sells his partnership interest to the remaining partners under an agreement providing for the uninterrupted continuation of the partnership business, is the income tax basis of partnership property affected?[2]

This problem is exemplified by the case of Edwards v. Ford.[3] The facts were that Ford's husband contributed property to a partnership in 1912. His basis in the property owned a one-third interest in the partnership, and the remaining two-thirds interest was owned by the other four partners. In 1936, when the partnership's assets were worth less than their basis, four partners bought the one-third interest of the fifth. The agreement provided for the uninterrupted continuation of the partnership business by the partnership. Thereafter the partnership sold some of its assets and in computing its losses, the original cost basis of the partnership was used. The Commissioner adjusted this basis downward on the grounds that the basis of one-third of the firm's assets had become equal to the value of the price the four partners paid for the fifth.

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2 Int. Rev. Code sec. 113(a)(13). Ibid.

3 6 T.C. 499 (1946), aff'd, 161 F.2d 293 (5th Cir. 1947).

language of Section 113(a)(13), Section 183, or any other single section. None of them purported to settle the problem. The fundamental issue which was presented, therefore, was whether the general theory of the income tax law pertaining to partnerships is that each partner owns an undivided share of the fee in the property, or whether the partnership owns the property and the partner owns, as a separate thing, a partnership interest.

The Commissioner presented its usual contention in two forms.[4] The first was that the partnership is not a juristic entity but an association of individuals, each of whom owns an undivided interest in each specific asset. If this proposition were accepted, it would follow that the four remaining partners had bought the undivided share of the fifth in specific assets at a reduced price, so that the combined bases of the owners of the assets would be less after the sale than before. The second form was that the withdrawal of one partner dissolved the existing partnership and substituted another, so that there was a distribution out of assets, a purchase of assets, and a contribution back. Both arguments were rejected.

The Tax Court held that because under the income tax law the partnership was a computing unit, its ownership of

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4 *Ibid.*, p. 501.

language of Section 113(a)(13) [illegible]
single section. [illegible]
blem. The fundamental [illegible]
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The Tax Court held that [illegible] let the partnership [illegible]

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[4] Ibid., p. [illegible].

its assets had to be accepted. "The partnership, as such, engaged in no transaction affecting it as a computing unit."[5] Therefore, the basis of its property should not be changed. The Court then disposed of the second argument by pointing out that under the Minnesota law adopting the Uniform Partnership Act, a partnership is continued in existence undisturbed by changes in interest of partners, and that under the generally accepted commercial law the result would be the same if the partners so provided, as they had here.

Although the Tax Court could have drawn support from Section 113(a)(13), it did not do so. As noted, that section distinguishes between the basis of partnership assets and the basis of the partner's partnership interest. Since we must reject any suggestion that the statute gives a basis to something it elsewhere declares is non-existent, the conclusion may be soundly drawn that a sale of a partnership interest is not treated by the tax law as a sale of an interest in the specific partnership assets. This approach leads to the same result as the Tax Court's equally sound ground. Between them, they appear to leave no avenue open under the existing statute to attack the Ford case.[6]

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5 Ibid.

6 See footnote 3, p. 24, supra.

its assets had to be apportioned.[5] The partnership was, even, engaged in no dissolution proceedings; it was a going concern unit.[6] Therefore, the basis of its property should not be changed. The Court then disposed of the second argument by pointing out that under the Minnesota law embodying the Uniform Partnership Act, a partnership is a continuing existence undisturbed by changes in interest of partners, and that under the generally accepted commercial law the result would be the same if the partners so provided, as they had here.

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5 Ibid.

6 See footnote 1, p. 24 supra.

Presumably the Commissioner's acquiescence[7] indicates that such is also his belief.

Situations may arise where a partnership sells its entire business, including current earnings to the date of sale. The Tax Court[8] has held that the amount of such earnings must be considered as a part of the cost of the assets sold for the purpose of determining gain or loss of the partnership upon the sale.

The question of whether or not the partnership has been technically terminated appears to be the governing factor in determining whether the basis of partnership assets will be affected upon a change in partnership interest. If the partnership agreement provides for the uninterrupted continuation of the partnership business upon transactions involving only the individual partners, the partnership is not terminated.[9] Otherwise, the partnership will be considas technically terminated.

Upon the termination of the old partnership, the

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7 1946-2 Cum. Bull. 2.

8 Henry F. McCreery, 4 B.T.A. 967, (1926), acq. in, VI-1 Cum. Bull. 4 (1927). However, the current earnings still must be considered as having been earnings of the partnership before they were transferred to the purchaser. Each partner is therefore taxed upon his distributive share of such earnings up to the date of sale.

9 See the discussion of the Ford case on page 24 <u>et seq</u>. <u>supra</u>.

Presumably the Comment [illegible]
such is also his belief.[illegible]

Sitkoff [illegible] the [illegible]
entire business, including [illegible] date of
sale. The Tax Court [illegible]
ings must be considered [illegible] of the items
sold for the purpose of [illegible]
partnership upon the sale.

The question of whether or not the partnership has
been technically terminated [illegible]
tor in determining [illegible]
will be affected upon a [illegible]
the partnership agreement provides [illegible]
continuation of the partnership [illegible]
involving only the [illegible]
not terminated.[9] Otherwise, the partnership will be consider-
ed technically terminated.

Upon the termination [illegible]

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7 1946-2 Cum. Bull. [illegible]

8 Henry F. Mulford [illegible]
7-1 Cum. Bull. [illegible]
still must be considered [illegible]
partnership [illegible]
each partner [illegible]
of each [illegible]

9 [illegible]
[illegible]

partners may decide that they will cause its assets to be distributed to them in kind, and that they will in turn contribute them to a new partnership. This new partnership may be formed by all or a part of the members of the original partnership. As a result of this distribution of the assets in kind, the basis of the old partnership for those assets will be extinguished. The distributees will then be required to allocate to their share of each asset so distributed, some portion of their individual bases for their interests in the partnership. Their bases for those interests need not, and probably will not, equal the total basis of the partnership for the distributed assets. The new partnership, on the other hand, will take as its basis the income tax basis of the contributing partners.[10]

When a member of a two-man partnership sells his partnership interest to the other partner, the transaction automatically terminates the partnership since by definition[11]

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10 Paul Little, Federal Income Taxation of Partnerships, (Boston: Little, Brown and Co., 1952), p. 288.

11 U.P.A. Sec. 6(1). "Partnership Defined. -- (1) A partnership is an association of two or more persons to carry on as co-owners a business for profit."
The case of Samuel Mnookin, 12 T.C. 744 (1949) is not contra. There the partnership agreement specifically provided that upon the death of one of the two partners, his interest nevertheless was to continue. This agreement was recognized under local law. However, note the contrary result in City Bank Farmers Trust Co., 29 B.T.A. 190 (1933), acq. in, XIII-1 Cum. Bull. 4 (1934), when state law did not recognize such agreement.

partners may [illegible]
distributed to [illegible]
tribute them to a new [illegible]
be formed by all or a part of the [illegible]
partnership. [illegible]
in kind, the basis of the [illegible]
will be [illegible]
to allocate to [illegible]
some portion of their [illegible]
in the partnership. [illegible]
not, and probably will not, [illegible]
partnership for the [illegible]
on the other hand, will [illegible]
basis of the contributing partners.

Upon a member of a [illegible]
partnership interest [illegible]
automatically [illegible]

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12 [illegible]
ships. [illegible]

11 [illegible]
partnership is an [illegible]
carry on as co-owners [illegible]
The name of [illegible]
[illegible]
upon the [illegible]
[illegible]
under local law. [illegible]
[illegible]
1 [illegible]
agreement.

that relationship requires the association together of two or more individuals. Thus, in the recent case of Frank J. Johnson,[12] one partner sold his interest in the partnership to the only other partner. It was held that this automatically terminated the partnership and the business now became a sole proprietorship.

Partnership Interest

The sale of a partnership interest, or the receipt of a distribution in kind from the partnership, will require that the partner involved determine his basis for his interest in the partnership. In addition, various other transactions also may affect this basis, or require its computation, as explained below.

Once the partner acquires an interest in a partnership, the statute recognizes that his basis therefor is quite distinct from any basis which the partnership may have for its assets.[13] Fundamentally, the basis to the partner for his interest in the partnership is its cost to him.[14] The burden is placed upon the partner of proving this cost

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12 Frank J. Johnson, 9 CCH TC Mem. 277 (1950).

13 Int. Rev. Code Sec. 113(a)(13); Daniel Gartling, 6 CCH TC Mem. 879 (1947), aff'd per curiam, 170 F.2d 73 (9th Cir. 1948 (by implication).

14 Int. Rev. Code Sec. 113(a); Ellen Fuller, CCH TC Mem. Dec. 12,865-A (1942).

that relationship [illegible]
or more individuals. The [illegible]
Johnson,[12] one partner sold [illegible]
to the only other partner [illegible]
ally terminated [illegible]
a sole proprietorship.

Partnership [illegible]

The sale of a [illegible]
a distribution [illegible]
that the partner [illegible]
est in the partnership [illegible]
tions [illegible]
as [illegible]

Once the [illegible]
ship, the status [illegible]
quite distinct from any [illegible]
for its assets.[13] [illegible]
for his [illegible]
The burden is [illegible]

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12 Frank [illegible]

13 [illegible]
6 CCH TC Mem. [illegible]
Cir. [illegible]

14 [illegible]
TC Mem. Dec. [illegible]

basis in any particular transaction.[15] Once cost has been established, this amount cannot be amortized despite the fact that the term of the partnership may be limited.[16] Nor is it affected by the use to which the money constituting that cost is put by the recipient thereof.[17]

The basic element of a partner's cost for his interest in the partnership is the amount of his original contribution thereto.[18] If this contribution is in cash, the amount thereof establishes cost. If property is contributed, the cost of such property to the partner becomes his cost for that portion of the interest in the partnership acquired as a result of the contribution.[19] Similarly, if a partner

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15 In George R. Craven, 21 B.T.A. 78 (1930), the burden was placed upon a withdrawing partner of proving what portion of the amount received upon withdrawal constituted a return of capital.

16 George v. Rotan, 17 B.T.A. 1192 (1929), aff'd, 56 F.2d 153 (5th Cir. 1932); Rotan v. United States, 43 F.2d 232 (S.D. Tex. 1930). Cf. Carmen P. Gaskins, 10 B.T.A. 416 (1928).

17 This has been held to be true though the contributor himself receives back a part of his payment for the partnership interest as partnership profit. Hathaway Watson, CCH BTA Mem. Dec. 8919-E (1935), aff'd, 82 F.2d 345 (7th Cir. 1936).

18 Comm'r. v. Lehman, 165 F.2d 383 (2d Cir. 1948).

19 Leonard M. Japp, 9 CCH TC Mem. 705 (1950). This holding parallels the general rule of Code Sec. 113 applicable to non-taxable transactions that the basis of property acquired in such an exchange shall be the cost of the property exchanged. This result is logical inasmuch as the

basis in any particular [illegible]

established, [illegible]

fact that the [illegible]

is it affected by [illegible]

that cost [illegible]

The basic [illegible]

in the partnership [illegible]

tion thereto.[19] If this [illegible]

thereof establishes cost [illegible]

cost of such property [illegible]

that portion of the [illegible]

a result of the contribution [illegible]

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15 In George [illegible] the hus-band was placed [illegible] portion of the amount [illegible] a return of capital.

16 George v. [illegible] F.2d 153 (5th Cir. 1948); [illegible] 282 ([illegible]) (1929).

17 This has been held [illegible] tor himself receives back [illegible] nership interest as [illegible] Gen'l Mem. Doc. [illegible] 1956).

18 Comm'r. v. [illegible]

19 Leonard [illegible] holding [illegible] ble to non-taxable [illegible] acquired in [illegible] perty exchanged [illegible]

contributes his interest in one partnership to a second partnership, the cost basis of his interest in the second partnership will be equal to the total of cash or other property contributed plus the cost basis to him of his interest in the first.[20]

Another common element of cost consists of amounts[21] paid by a partner to purchase an interest in the partnership. Thus, amounts paid to withdrawing partners[22] or to the estates of deceased partners[23] in exchange for their partnership interests constitute capital expenditures which increases the basis. In addition to the cost incurred in acquiring another's interest in the partnership, a partner's basis may

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partnership is then required to take the basis for the property which it had in the hands of the contributor. In addition, a contrary result would give the contributor an increased basis for his interest in the partnership equal to the unrealized appreciation inherent in the contributed property. If, for example, he withdrew from the partnership prior to the sale by it of the property, he would escape tax on this amount entirely. In addition, if the partnership distributed the property in kind to a partner with a relatively high basis for his partnership interest, this appreciation in value might escape tax altogether.

20 Warren E. Brown, 4 B.T.A. 56 (1926), acq. in, VI-1 Cum. Bull. 1 (1927); Roy E. Crummer, 4 B.T.A. 54 (1926).

21 William Gordon Means, 29 B.T.A. 590 (1933).

22 James B. Lapsley, 44 B.T.A. 1105 (1941), acq. in, 1941-2 Cum. Bull. 8.

23 J. Renz Edwards, CCH B.T.A. Mem. Dec. 10,036-I (1938), aff'd, 102 F.2d 757 (10th Cir. 1939).

contributes his interest in the property [illegible]
partnership, the [illegible]
partnership will be equal [illegible]
perty contributed [illegible]
in the first.

Another common [illegible]
paid by a partner [illegible]
Thus, amounts [illegible] withdrawing [illegible] to the
estates of deceased partners [illegible]
ship interests [illegible]
on the basis [illegible] in addition to the [illegible]
another's interest in the partnership [illegible]

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partnership is then required to [illegible]
perty which it had in the hands of [illegible]
addition, a partner [illegible]
increased basis for his interest [illegible]
the unrealized appreciation inherent in the [illegible]
perty. If, for example, he withdrew from the [illegible]
prior to the sale by it of the property, he would [illegible]
on the amount [illegible]
distributed the property [illegible]
it high basis [illegible]
tion in value [illegible]

20 [illegible]
Cum. Bull. 1 (1957); [illegible]

21 Williams [illegible]

22 [illegible]
1941-2 Cum. Bull. [illegible]

23 [illegible]
(1958), [illegible]

be increased by the amount of his share of undistributed earnings.[24] If a partner sells his interest in the partnership, including his share of current profits to the date of sale, the basis for his partnership interest should include his share of the undistributed profits up to the date of sale. In Warren E. Brown,[25] the partner reported income on the calendar year basis and sold his interest in the partnership on May 15. At that date the partnership had earned substantial profits since the beginning of its taxable year. The Tax Court held that the basis of the partner's interest in the partnership should include his distributive share of partnership profits for the period ended May 15.[26] This principle was again applied by the Tax Court in two recent decisions.[27] It is believed that this result may also

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24 The Commissioner's regulations indicate that the partner's basis for his interest is increased by "the amount of his share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid". U. S. Tres. Reg. 111, Sec. 29.113(a)(13)-2.

25 4 B.T.A. 56 (1926), acq. in, VI-1 Cum. Bull. 1 (1927).

26 The same result was reached upon a similar set of facts in T. B. Noble, 12 B.T.A. 1419 (1928), agreed judg. entered without opinion (5th Cir., Oct. 17, 1929). Compare the result in Henry F. McCreery, 4 B.T.A. 967 (1926), acq. in, VI-1 Cum. Bull. 4 (1927), in which the basis of the partnership for assets owned by it was held to include the amount of its current earnings.

27 Anna Neuman, 9 CCH TC Mem. 877 (1950); Charles Goodman, 9 CCH T.C. Mem. 789 (1950).

be increased by the amount of [illegible] earnings.[24] If a partner [illegible] his [illegible] ship, including his share of [illegible] sale, the basis for his partnership [illegible] his share of the undistributed [illegible] sale. In Warren T. Brown,[25] [illegible] the selling partner [illegible] ship on May 15. At that date the partnership [illegible] substantial profits [illegible] The Tax Court held that [illegible] in the partnership should include [illegible] partnership profits for the period ended May 15.[26] This principle was again applied by the Tax Court in two [illegible] decisions.[27] It is believed that [illegible]

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24 The Commissioner's regulations [illegible] partner's basis [illegible] of his share in [illegible] earned since he became a partner [illegible] been paid". U. S. Treas. Reg. 111, [illegible]

25 4 B.T.A. [illegible] (1926), [illegible] VI-1 [illegible] (1927).

26 The same result was reached [illegible] facts in [illegible] Poble, 12 [illegible] entered without opinion [illegible] the result in [illegible] VI-1 Cum. Bull. 4 (1927), in which [illegible] partnership for [illegible] amount of its current earnings.

27 Anna Goodman, [illegible] Goodman, [illegible] T.C. Mem. [illegible] 144.

represent current practice of the Bureau of Internal Revenue.[28]

Other elements of cost that may increase the partner's basis of his partnership interest are legal expenses incurred in defense of a partner's right and title to his interest in the partnership[29] and costs of purchasing the dower rights of the wife of another partner.[30]

Although basis is established by a determination of the cost to the partner of his interest in the partnership, Internal Revenue Code Section 113(a) requires that such basis be adjusted under certain circumstances.[31] For example, Section 113(b)(1)(B) requires such adjustment for "receipts, losses, or other items" properly chargeable to "capital account". The Tax Court has found that the partner's share of partnership losses reduces his capital investment in the partnership and, therefore, also reduces the cost of his interest.[32] If the transaction involving basis

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28 The Commissioner acquiesced in the Brown case, 4 B.T.A. 56 (1926), acq. in, VI-1 Cum. Bull. 1 (1927), and advanced the principle over the objection of the taxpayer in the Goodman case, supra. note 27.

29 A. J. Rassenfoss, 4 CCH TC Mem. 1004 (1945).

30 Lester G. Hathaway, 16 B.T.A. 1318 (1929).

31 These circumstances are generally set out in Int. Rev. Code Sec. 113(b).

32 Anton M. Meyer, 3 B.T.A. 1329 (1926), acq. in, VI-1 Cum. Bull. 4 (1927). Cf. James B. Lapsley, 44 B.T.A. 1105

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Although basis is [illegible] by [illegible] of the cost to the partner of his interest in the partnership, Internal Revenue Code Section 113(b) requires that such basis be adjusted under certain circumstances.[31] For example, Section 113(b)(1)(A) requires that [illegible] for "receipts, losses, or other items" properly chargeable to "capital account". The [illegible] that the partner's share of partnership losses [illegible] in the partnership and, [illegible] the [illegible] cost of his interest.[32] If the [illegible]

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28 For [illegible] application of the principle [illegible] G.C.A. 56 (1926); [illegible] the principle, even the [illegible] in the Goodman case, supra, [illegible].

29 A. L. [illegible]

30 [illegible]

31 [illegible] Rev. Code Sec. 113(b).

32 [illegible]

occurs during the partner's taxable year, the current loss of the partnership to the date of the transaction, if any, should be determined. This loss should then be deducted from the partner's basis just as current profits would be added.[33]

The partner's basis must also be adjusted downward by the amount of his withdrawals properly chargeable to capital account. There is a similar reduction in capital investment upon the sale by a partner of a portion of his interest in the partnership. In this case, a portion of the total basis must be allocated to the part of the interest which is sold, in order to compute gain or loss upon the sale. This portion of the total basis should be a percentage thereof equal to that percentage of the total partnership interest which is being sold. The amount allocated as the basis of the interest sold should then be deducted from the total basis of the partnership interest in order to arrive at the net basis

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(1941), acq. in, 1941-2 Cum. Bull. 8. There, the partnership operated continuously at a loss. Although the amount of these losses doesn't appear, the Tax Court reduced the basis of the partners by their share of the total allowable depreciation upon the building which was the subject of the partnership.

33 Such was the contention of the Commissioner in Ella Pipes Cline, 15 B.T.A. 934 (1929) (Fifth issue). The taxpayer conceded this point so the issue was not considered by the court. However, the Commissioner filed his acquiescence upon the issue, VIII-2 Cum. Bull. 10 (1929), and this apparently represents his current view.

occurs during the partner's taxable year, the [illegible] of the partnership [illegible] of the [illegible] should be determined. This amount [illegible] from the partner's basis [illegible] added. [illegible]

The partner's basis must also be adjusted [illegible] the amount of his withdrawals currently charged to his [illegible] account. There is a similar [illegible] upon the sale by a partner of a [illegible] the partnership. In this [illegible] must be allocated to the part of the interest which is sold in order to compute gain or loss [illegible] of the total basis should bear [illegible] that percentage of the total partnership interest [illegible] being sold. The amount [illegible] and sold should then be deducted [illegible] partnership [illegible] a portion of the [illegible]

[illegible]

[illegible]

after the sale.[34] These various adjustments downward may even reduce the partner's basis for his interest to a minus quantity,[35] producing troublesome questions upon the occurrence of a transaction involving such a basis.[36]

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34 This method was apparently that used by the Tax Court in Warren E. Brown, 4 B.T.A. 56 (1926), acq. in, VI-1 Cum. Bull. 1 (1927). It should be noted that in Frederick S. Pendleton, 5 CCH TC Mem. 571 (1946), the Tax Court reduced the basis by the amount of cash received upon the sale of a portion of the partner's interest. The facts indicate that this sale was made roughly at cost. Therefore, this result appears to be correct although the method by which it was reached may be somewhat misleading. Upon any variation between cost and amount received, this method would clearly produce an erroneous result.

35 Herman Senner, 22 B.T.A. 655 (1931); Philip Scheyer, CCH BTA Mem. Dec. 7574-C (1932). See page 66 *et seq. infra*. for a full discussion of the Senner case.

36 See Greenlee and Kramer, "The Mortgagor with a 'Negative Basis'" 27 Taxes 887 (1949).
The tax consequences arising from the sale of a partnership interest with a negative basis are discussed in page 66 *et. seq. infra*.

after the sale. [illegible]

even reduce [illegible]

quantity, [illegible]

rates of [illegible]

[illegible]

[illegible]

for a full [illegible]

[illegible]

CHAPTER III

HOLDING PERIOD OF PARTNERSHIP PROPERTY AND PARTNERSHIP INTEREST

The Internal Revenue Code recognizes a partnership as an entity capable of having an income tax basis[1] and a holding period[2] separate and apart from its partners. Section 183(a) of the Internal Revenue Code requires the net income of the partnership to be computed "in the same manner and on the same basis as in the case of an individual" but makes an exception in that capital gains and losses are to be segregated. There can be little doubt that the partnership is authorized an independent holding period under this section in order to allow it to compute income from the enterprise as an entity.

The problems regarding the determination of holding period of partnership property and partnership interest present basically the same issue as the two preceeding, namely, whether the partner's property in the partnership is the partnership interest or an undivided interest in the basic assets. The majority view has, consistently with the conclusions reached in the previous problems, been that what

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1 Int. Rev. Code Sec. 113(a)(13). See the discussion on this point on page 16 *et seq.* *supra*.

2 Int. Rev. Code Sec. 183(a). See footnote 22, p. 13 *supra*.

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1 Int. Rev. Code sec. 113(a)(13). See the discussion on this point on page 16 et seq. supra.

2 Int. Rev. Code sec. 117(h). See footnote 12, p. 12 supra.

the partner owns is the partnership interest.

Partnership Property

To the extent that its income is required to be computed as a unit, the partnership must be recognized as an entity in order to carry out the legislative intent inherent in Section 183 of the Code.[3] Thus, the partnership is required to segregate the gains and losses from sales or exchanges of capital assets.[4] It is further required to segregate the gains and losses from sales or exchanges of capital assets held for not more than six months from those held for a period of more than six months. A partnership is further entitled to the provisions of Internal Revenue Code Section 117(j)[5] which allows capital asset treatment of

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3 Ibid.

4 Int. Rev. Code. Sec. 117(a)(1). "Definition of Capital Assets. -- The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), . . . or real property used in the trade or business of the taxpayer."

5 Int. Rev. Code. Sec. 117(j). "Gains and losses from . . . the sale or exchange of certain property used in the trade or business. -- (1) Definition of property used in the trade or business. -- For the purposes of this

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Partnership Property

To the extent that its income is to be computed as a unit, the partnership must be recognized as an entity in order to carry out the legislative intent expressed in Section 183 of the Code.[3] Thus, the partnership is required to segregate the gains and losses from sales or exchanges of capital assets.[4] It is further required to segregate the gains and losses from sales or exchanges of capital assets held for not more than six months from those held for a period of more than six months. A partnership is further entitled to the provisions of the Internal Revenue Code Section 117(j)[5] which allows capital asset treatment . . .

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5 Int. Rev. Code, Sec. 117(j). "Gains and losses from . . . the sale or exchange of certain property used in the trade or business. -- (1) Definition of property used in the trade or business. -- For the purposes of this

gains and losses from the sale or exchange of certain property used in the trade or business, which has been held for more than six months.[6]

A partnership may acquire property either by purchase,

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subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable. (2) General Rule. -- If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . ."

6 Int. Rev. Code Sec. 117(b). "Percentage taken into account. -- In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months.

50 per centum if the capital asset has been held for more than 6 months.

gains and losses from the sale or exchange of such property used in the trade or business which has been held for more than six months.[5]

A partnership may acquire depreciable property by ...

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subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable. (2) General Rule. -- If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . ."

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100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

by contributions thereof from partners, or by exchanging its own property for other property.

There is no question as to the holding period of property purchased by the partnership. As in the case of any income computing entity, the holding period runs from the date of purchase to the date that the property is disposed of.

As respects the holding period of property contributed by partners, Internal Revenue Code Section 117(h)(2) states that:

> In determining the period for which the taxpayer has held property however acquired, there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

Thus, where a partner contributes property to a partnership, the holding period runs from the date the partner acquired the property to the date the partnership disposed of it.[7] Similarly, where a partnership exchanges its own property for other property of a like kind without recognizing gain or loss as provided for in Internal Revenue Code Section 112(b)(1), the holding period of the property acquired runs from the date the property exchanged was

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7 Hogg v. Allen (DC Ga, 1952), 105 F.Supp. 12, Sec. 72,439 P-H Fed. 1952.

by contributions thereof from partners, or by exchanging its own property for other property.

There is no question as to the holding period of property purchased by the partnership. As in the case of any income computing entity, the holding period runs from the date of purchase to the date that the property is disposed of.

As respects the holding period of property contributed by partners, Internal Revenue Code Section 117(h)(2) states that

> In determining the period for which the taxpayer has held property however acquired, there shall be included the period for which such property was held by any other person, if under the provisions of section 113, such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

. . . .

Thus, where a partner contributes property to a partnership, the holding period runs from the date the partner acquired the property to the date the partnership disposed of it.[7] Similarly, where a partnership exchanges its own property for other property of a like kind without recognizing gain or loss as provided for in Internal Revenue Code Section 112(b)(1), the holding period of the property acquired runs from the date the property exchanged was

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7 Hogg v. Allen (ND Ga. 1952); 105 F. Supp. 12, Dec. 72,439 P-H Fed. 1952.

acquired. Internal Revenue Code Section 117(h)(1) states:

> In determining the period for which the taxpayer has held property received on an exchange there shall be included the period for which he held the property exchanged, if under the provisions of section 113, the property received has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged. For the purposes of this paragraph, an involuntary conversion described in section 112(f) shall be considered an exchange of the property converted for the property acquired.

Similarly, where partnership property is distributed in kind to the partner, the date of acquisition for distributee partner is held to be the date on which the partnership acquired the specific property by purchase.[8]

Partnership Interest

All the litigation regarding the determination of holding period of a partnership interest has presented the same issue as has heretofore been discussed; whether the partner's property in the partnership is the partnership interest or an undivided interest in the basic assets.

The holding period of a partnership interest was first discussed by the Court of Claims in City Bank Farmers Trust Co. v. United States.[9] A partnership interest in a large stock brokerage firm was inherited in 1932 and sold by the

8 G.C.M. 20251, Cum. Bull. 1938-2, p. 169.

9 47 F. Supp. 98 (Ct. Cl. 1942).

acquired. Internal Revenue Code Section 1223(1) [illegible]

In [illegible] by the [illegible] for the [illegible] half property the [illegible] in exchange [illegible] included the property [illegible] exchanged, [illegible] property [illegible] gain or loss [illegible] whole or in part [illegible] For the purposes of the [illegible] described in Section 1223(1) [illegible] an exchange of the property [illegible] acquired.

Similarly, where partnership property is distributed in kind to the partner, the date of acquisition by the distributee partner is held to be the date on which the partnership acquired the specific property or properties.[8]

Partnership Interest

All the litigation involving the determination of the holding period of a partnership interest has [illegible] the same issue as the [illegible] the partner's property in the partnership [illegible] interest or an undivided interest in the firm's assets.

The holding period of a partnership interest was discussed by the Court of Claims in [illegible] Co. v. United States.[9] A partnership [illegible] the firm [illegible]

8 G.C.M. 20251, Cum. Bull. 1938-2, p. [illegible]

9 87 F. Supp. [illegible] (Ct. Cl. 1950).

heir in 1936. The taxpayer contended that he had sold a partnership interest held by him for four years before sale, with the result that only 60 per cent of his capital gain was taken into account. The Commissioner agreed that his gain was a capital gain but contended that two-thirds of it was short term since that percentage of the partnership assets had been held less than a year. Basing its decision squarely on the pluralistic concept of the partnership, and citing as authority the Second Circuit Court of Appeals decision in Helvering v. Smith,[10] the Court agreed with the Commissioner.

The problem next arose in Thornley v. Commissioner,[11] where a large advertising partnership incorporated and it became necessary on a later sale of its stock to determine whether the holding period began when the partner had acquired his partnership interest or when the partnership had acquired the various assets it owned at the time of incorporation. The Tax Court thought the partnership had been dissolved and its assets distributed before the incorporation and thus agreed with neither contention. The Court of Appeals, however, reversed and adopted the taxpayer's

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10 90 F.2d 590 (C.C.A. 2d 1937).

11 147 F.2d 416 (C.C.A. 3rd 1945), reversing 2 T.C. 220 (1943).

sold in 1925. The [illegible]

partnership [illegible]

with the result that only [illegible]

was taken into account. [illegible]

gain was a capital gain but [illegible]

was short-term since the [illegible]

assets had been held less than [illegible]

squarely on the pluralistic concept of the partnership, and

citing as authority the [illegible]

sion in Helvering v. Smith,[10] the Court [illegible] the

Commissioner.

The problem next arose in [illegible][11]

where a large advertising partnership [illegible]

became necessary on a later sale of the [illegible]

whether the holding period began when the [illegible]

quired his partnership interest or when the [illegible]

acquired the various assets it owned at the time of [illegible]

poration. The Tax Court thought the partnership had been

dissolved and the assets distributed [illegible]

tion and thus agreed with neither [illegible]

Appeals, however, reversed and [illegible]

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10 90 F.2d 590 (2d Cir. 1937).

11 147 F.2d 946 (2d Cir. 1945), [illegible] 326 (1945).

contention, holding that the period the partnership interest was held should be tacked on to the period the stock was held. It regarded its prior decision in Kessler v. United States[12] as controlling, and expressly refused to follow the Court of Claims decision in the City Bank Farmers Case.[13]

The latest presentation of the problem was in the Allan S. Lehman case.[14] As in the City Bank Farmers case, the issue was whether, when a partnership interest in a large stock brokerage firm was sold, its holding period should be computed from the date the partnership interest was first acquired or from the various dates the partnership acquired the assets it owned at the time of the sale. Citing the Humphrey, Shapiro, and Ford Cases,[15] the Tax Court held the partnership interest was what was sold, it had its own holding period, and this began when the partner was

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12 124 F.2d 152, (C.C.A. 3rd 1941).

13 See footnote 9, p. 40 *supra*.

14 Allan S. Lehman, 7 T.C. 1088 (1946), aff'd, 165 F.2d 383 (C.C.A.2d 1948), cert. denied, 334 U.S. 819 (1948).

15 Dudley T. Humphrey, 32 B.T.A. 280 (1935), N.A. XIV-2 Cum. Bull. 34 (1935). Comm'r. v. Shapiro, 125 F.2d 532 (C.C.A. 6th 1943). This case involved the capital nature of a partnership interest. After analyzing the components of such interests, the Court found that these interests consist of the partner's invested capital, his share of undivided accumulated profits and his share of such good will as may have been accumulated over the years of existence of the business. Robert E. Ford, 6 T.C. 499 (1946), acq. in, 1946-2 Cum. Bull. 2. See the discussion of the Ford case on page 24 *et seq. supra*.

contention, holding that [illegible]

was held should be [illegible]

held. It [illegible]

States[12] as controlling, [illegible]

Court of Claims decision [illegible]

The [illegible]

Allan S. Lehman case.[14] [illegible]

the issue was whether, when a partnership [illegible]

large stock brokerage firm was [illegible]

should be computed from the date the [illegible]

was first acquired or from the [illegible]

acquired the assets it owned [illegible]

ing the Humphrey, [illegible] and Ford [illegible][15] [illegible]

held the partnership [illegible]

own holding period, [illegible]

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12 124 F.2d 155 [illegible] 1941).

13 See footnote 9, p. 4, supra.

14 Allan S. Lehman, [illegible] (1946), [illegible] F.2d 383 (C.C.A. 2d 1948), cert. denied, [illegible] (1948).

15 Budd v. Humphrey, [illegible] XIV-2 Cum. Bull. 98 (1935). [illegible] 532 (C.C.A. [illegible]). [illegible] of a partnership interest. [illegible] of such interests, the Court [illegible] sist of the partner's interest in partnership [illegible] ed accumulated profits and also [illegible] may have been accumulated over the years [illegible] purposes. [illegible] Ford, [illegible] 2 Cum. Bull. 2. See the [illegible] of the Ford case on pp. 24 25 [illegible] infra.

admitted to the firm. The Second Circuit Court of Appeals, per Judge L. Hand, affirmed. Both Courts noted that the City Bank Farmers case was to the contrary and both expressly refused to follow it. The Commissioner petitioned for certiorari, presumably because of the substantial conflict with the City Bank Farmers case, but certiorari was denied.[16]

The more recent decision of a different panel of judges of the same Court of Appeals in Commissioner v. Whitney[17] had the appearance of inconsistency with the Lehman case, and of even greater inconsistency with their Lamont decision.[18] The Whitney decision held that section 24(b)(1)(B) disallowed deduction of losses realized by the transfer of partnership assets to a corporation formed to succeed the partnership and controlled by the former partners. The opinion expressed respect for Judge L. Hand and the Lehman decision, but refused to apply any analogies

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16 334 U.S. 819 (1948). Conceivably the denial of certiorari was because the Commissioner was in the logically inconsistent position of admitting that what was sold was the partnership interest and was a capital asset, but of denying that it was capable of having a holding period of its own. This same inconsistency, it may be noted, did not prevent the Court of Claims from deciding the City Bank Farmers case for the Government.

17 Commissioner v. Whitney, 169 F.2d 562 (C.C.A.2d 1948), cert. denied, 335 U.S. 892.

18 Commissioner v. Lamont, 156 F.2d 800 (C.C.A.2d 1946), cert. denied, Lamont v. Helvering, 329 U.S. 782 (1946).

admitted to the firm. The Second Circuit Court of Appeals, per Judge L. Hand, affirmed, [illegible] City Bank Farmers case [illegible] ly refused to follow it.[16] [illegible] certiorari, presumably [illegible] with the City Bank Farmers case, and the petition was denied.

The more recent decision [illegible] judges of the same Court of Appeals [illegible] Whitney[17] had the appearance of [illegible] with the Lehman case, and of even greater importance [illegible] Lamont decision.[18] The Whitney decision [illegible] 24(b)(1)(B) disallowed deduction of losses realized by the transfer of partnership assets to a partner [illegible] succeed the partnership and continue in the former business. The opinion expressed [illegible] the Lehman decision, but refused to apply [illegible]

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16 334 U.S. 819 (1948). [illegible] certiorari was because the [illegible] inconsistent position of admitting [illegible] the partnership interest and was [illegible], but of denying that it was capable of having a holding period of its own. This same inconsistency [illegible] prevent the Board of [illegible] Farmers case [illegible]

17 Commissioner v. Whitney, 169 F.2d 562 (2d Cir. 1948), cert. denied, 335 U.S. 892.

18 Commissioner v. Lamont, [illegible] (2d Cir. 1946), cert. denied, Lamont v. Commissioner, [illegible] (1946).

based on it to the facts before the Court. The reason assigned for this refusal was that in the area of tax law before it, Congress had acted to correct a specific abuse, i.e., the deduction of losses which were for practical purposes not yet realized, and the Court could see no substantial difference between a transfer by an individual where he was a partner and a transfer where he was not.

The Court concluded that the partnership had not yet become sufficient of a legal entity to compel the Court to allow the loss. It is evident that the apparent inconsistency between the Whitney and Lehman cases is superficial only, for recognition of the partnership interest as a distinct asset was not urged nor would it have been particularly helpful. If the Court had held that a partnership interest had been transferred, any overall loss would still have been non-deductible under section 24(b)(1)(B), although the effect of such a doctrine would probably have been to disallow recognition of capital gains as well as capital losses, a result the Whitney case did not actually reach.

Accordingly, the Whitney decision is not a distinct brake on the trend heretofore discussed. It appears, however, that the various courts have taken positions on this point consistent with their views as to the nature of the interest in the partnership.

based on it to the Court below [illegible]. The Commissioner de-
signed for this method was that [illegible]
Burford, Commission had ruled in [illegible]
i.e., the deduction of losses which had [illegible]
posed not yet realized, and the Court [illegible] substan-
tial difference between [illegible]
he was a partner and a [illegible].

The Court concluded that [illegible] had not yet become sufficient of a legal [illegible] to allow the loss. It is evident that the [illegible] ancy between the Whitney and [illegible] only, for recognition of the [illegible] asset was not [illegible] would [illegible] have been [illegible] ly helpful. If the Court had held that [illegible] interest had been transferred, [illegible] have been [illegible] deduct [illegible], the effect of such a [illegible] would [illegible] to disallow recognition of capital gains [illegible] losses, a result the [illegible] did not actually want.

Accordingly, the Whitney decision [illegible] break on the trend [illegible]. [illegible], however, that the [illegible] point consistent with [illegible] inherent in the [illegible].

Thus, the Tax Court[19] and the Courts of Appeals for the Second, Third, Fifth and Ninth Circuits,[20] having found that a partnership interest is a capital asset, hold that the period during which that asset has been held is the period during which the seller has been a partner. The Tax Court has also held that where the selling partner has been a continuing partner in a series of successive partnerships carrying on the same business, so that both the business and his investment therein are continuous, the holding period for the partner's interest extends back to the time of his admission to the original partnership.[21]

The Commissioner formerly followed the view of the City Bank Farmers Trust Co. case, but it may be presumed that he has now changed his position in order that it will be consistent with his recent concession that a partnership interest actually constitutes a specifically identifiable

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19 Dudley T. Humphrey, 32 B.T.A. 280 (1935), non-acq. in, XIV-2 Cum. Bull. 34 (1935); Ellen Fuller, CCH BTA Mem. Dec. 12,865-A (1942); and cases cited in footnote 20, infra.

20 Allen S. Lehman, 7 T.C. 1088 (1947), non-acq. in, 1947-1 Cum. Bull. 5, aff'd, 165 F.2d 383 (2d Cir. 1948); Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945); L. F. Long, 6 CCH TC Mem. 614 (1947), aff'd on this issue, 173 F.2d 471 (5th Cir. 1949); Daniel Gartling, 6 CCH TC Mem. 879 (1947), aff'd per curiam, 170 F.2d 73 (9th Cir. 1948).

21 Allen S. Lehman, Loc. cit. See the discussion of this case on page 42 et seq. supra.

The [illegible]

the Second C[illegible] [illegible]

that a partner's [illegible] that the

particular [illegible]

during [illegible] when

has also [illegible]

tinuing partners [illegible]

ing on the same basis, [illegible] and all

investment interests [illegible]

the partner's interest [illegible]

mission to the [illegible]

The Commissioner [illegible]

City Bank Farmers Trust Co., [illegible]

that he [illegible]

be considered [illegible]

interest [illegible]

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19 [illegible]

sed. [illegible]

Rep. Dec. [illegible]

[illegible]

20 [illegible]

1947-1 Cum. Bull. [illegible]

[illegible]

173 [illegible]

Rep. [illegible]

1949).

21 [illegible]

this case [illegible]

capital asset.[22]

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22 G.C.M. 26,379, 1950-1 Cum. Bull. 58, contains the following statement:

"An opinion is requested whether, for Federal income tax purposes, the Bureau should continue to treat a sale of a partnership interest as a sale of the selling partner's undivided interest in each specific partnership asset.

"The overwhelming weight of authority is contrary to the position heretofore taken by the Bureau, viz., that the sale of a partnership interest is a sale of the selling partner's undivided interest in each specific partnership asset. (Citing cases.) . . .

"It is accordingly the opinion of this office that the sale of a partnership interest should be treated as the sale of a capital asset. . . . The application of this rule should, of course, be limited to those cases in which the transaction in substance and effect, as distinguished from form and appearance, is essentially the sale of a partnership interest. . . ."

CHAPTER IV

NATURE OF GAIN OR LOSS FROM THE SALE OF A PARTNERSHIP INTEREST

When a partner sells his interest in a partnership is the gain or loss realized therefrom a capital gain or loss? Section 117(a)(1) provides in part that "the term capital assets means property held by the taxpayer (whether or not connected with his trade or business), . . ." followed by a number of exceptions of which none are applicable if the 'property' referred to is the partnership interest. If, however, the underlying assets of the partnership are the 'property' sold, then to the extent they consist of inventory and stock in trade, they will not be capital assets under either section 117(a)(1) or section 117(j). Nothing in section 117 purports to answer the problem, so again resort must be had to the general trend of the treatment of partnerships for guidance.

Mercantile Partnerships

The problem is fundamentally the same as that settled by the Ford case and the Commissioner's acquiescence therein.[1] The Ford issue and that now under discussion are actually nothing but two facets of the same fundamental

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1 See footnote 3, page 23. This case is fully discussed on page 23, et seq. supra.

[illegible]

When a partner sells his interest in a partnership is the gain or loss realized therefrom a capital gain or loss? Section 117(a)(1) [illegible] capital assets [illegible] property held by the taxpayer [illegible] or not connected with his trade or business [illegible] lowed by a number of exceptions [illegible] ble if the "property" referred to [illegible] interest. If, however, the underlying assets of the partnership are the "property" itself, then to the extent they consist of inventory and stock in trade, they would not be capital assets under either section 117(a)(1) or section 117(j). Nothing in section 117 [illegible] the problem, so again resort must be had to the [illegible] of the treatment of partnerships [illegible].

Mercantile [illegible]

The [illegible] by the Ford case and the [illegible] in.[1] The Ford [illegible] essentially nonincome [illegible]

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[1] See [illegible] 7, [illegible] quoted on page 73, et seq., supra.

problem. This problem is whether a sale by a partner of his interest in the partnership is to be treated taxwise as a sale of that interest as a property or as a sale of an undivided interest in specific assets. The Ford case held that the sale is of the partnership interest as a property, and from this as a premise concluded that the basis of the partnership assets was not affected by a transfer of a partnership interest. The result was expressed in terms of basis for gain or loss on sale, but would be equally applicable to the basis for depreciation.[2]

This premise, when applied to the instant problem, leads to the result that the partnership interest can be the "property" within section 117(a)(1).[3] The further result is that if held for over six months, it is a long-term capital asset since the conclusion is evident at a glance that none of the exceptions in that section are applicable.

Accordingly, the inference would appear justified

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2 Alphin J. Cameron, 8 B.T.A. 120 (1927) and Cameron v. Comm'r., 56 F.2d 1021 (C.C.A.3rd 1932), affirming 20 B.T.A. 305 (1930), hold that the basis of partnership assets is not changed by the sale of an interest in the partnership.

3 So many exceptions have been carved out of the definition in Sec. 117(a)(1) that nothing else comes to mind to give continued meaning to the parenthetical clause in the following quotation from that section: "The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include . . ."

problem. [illegible]

interest in the partnership [illegible]

sale of that interest [illegible]

divided interest [illegible]

that the [illegible]

and from [illegible] as a [illegible]

partnership [illegible]

nership interest. [illegible]

basis for [illegible]

able to the basis [illegible]

This [illegible]

leads to the result that [illegible]

the "partnership" [illegible]

sult is that [illegible]

capital [illegible]

that none of the [illegible]

Accordingly, the [illegible]

[illegible]

2. [illegible]

A. [illegible]

not [illegible]

[illegible]

to give [illegible]

follow [illegible]

[illegible]

side . . .

that the Tax Court and the Commissioner, since he acquiesced in the Ford case, would treat the gain or loss from the sale of any interest in a partnership held over six months as a long-term capital gain or loss. Such inference is thoroughly justified as far as the Tax Court is concerned. The Tax Court held the gain or loss was capital gain or loss in Dudley T. Humphrey,[4] and it has adhered to that view.[5]

The Appellate Courts, however, got off to a strong start in the direction the Commissioner wanted them to go. In Helvering v. Smith[6] the Court of Appeals for the Second Circuit had before it the Commissioner's appeal from a Board of Tax Appeals decision allowing capital gains treatment to the amount paid to a lawyer on his retirement from his law firm. The pertinent facts of the case were:

> . . . The partnership agreement provided that a retiring partner had no interest in the physical assets but was entitled to payment of his share of the earnings. Mr. Smith received $125,000 for a "sale of his partnership interest," and in return released his partners from all liability and acknowledged receipt of his share of the earnings.

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4 32 B.T.A. 280 (1935), N.A. XIV-2 Cum. Bull. 34 (1935).

5 A few of its recent decisions to this effect are Allan S. Lehman, 7 T.C. 1088 (1946); H. R. Smith, 10 T.C. 398 (1948), aff'd, 173 F.2d 470 (C.C.A.5th 1949); and Aaron Lowenstein Estate, 12 T.C. 694 (1949), acq. in, 1949-2 Cum. Bull. 2.

6 Comm'r. v. Smith, 173 F.2d 470 (C.C.A.5th 1949), affirming 10 T.C. 398 (1948); Comm'r. v. Long, 173 F.2d 471 (1949), affirming on this issue a memorandum decision of the Tax Court.

that the Tax Court and the Court of Appeals, [illegible]

in the Ford case, would [illegible]

of any interest in a partnership [illegible]

long-term capital gain [illegible]

ly justified as far as the Tax Court is concerned [illegible]

Court held the gain ordinary income [illegible]

Dudley T. Humphrey.[4] [illegible]

The Appellate Court [illegible]

start in the direction [illegible]

In Helvering v. Smith[6] the Court of Appeals for the [illegible]

Circuit had before it the [illegible]

of Tax Appeals decision [illegible]

the amount paid to a lawyer on his [illegible]

firm. The pertinent facts of the case are:

> . . . . The partnership agreement [illegible] retiring partner had no interest in the [illegible] but was entitled to payment of [illegible] Mr. Smith [illegible] ship interest." [illegible] all liability [illegible] the earnings.

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4 32 B.T.A. 280 (1935), [illegible]

5 A few of [illegible] Allen [illegible] (1948), [illegible] Lowenstein [illegible] Bull. 2.

6 Helvering v. Smith, [illegible] affirming 10 T.C. [illegible] (1949), affirming [illegible] Tax Court.

Judge L. Hand rejected the concept of the partnership as an entity owning the income against which the partner has merely a cause of action. Then, however, he laid emphasis on the fact all the partner was entitled to and did receive was his share of earnings for past services, all of which would have been ordinary income if paid to him in the ordinary course instead of a lump sum. He concluded his opinion by drawing an analogy to the treatment of the proceeds of a sale of a declared dividend payable in the future.[7]

Doyle v. Commissioner[8] next arose, and while it did not properly involve the point, because it was a sale of an interest in a particular fee after the partnership had been dissolved, the Court cited Helvering v. Smith respectfully and interpreted it somewhat broadly.

The next cases that arose involved losses and accordingly the Commissioner reversed his theory. In Stilgenbaur v. United States,[9] a partner sold out to his remaining partners in a general produce business for a $67,485.94 loss, of which only $2,000 was deductible if it was a capital loss. Some of the firm assets consisted of stock in trade, which

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7 In Rhodes' Estate v. Comm'r, 131 F.2d 50 (C.C.A. 6th 1942), this precise problem was raised and the seller's proceeds were held taxable as ordinary income.

8 102 F.2d 86 (C.C.A.4th 1939).

9 115 F.2d 283 (C.C.A.9th 1940).

then as now was not a capital asset. The Ninth Circuit Court of Appeals concluded that the taxpayer had sold his co-ownership interest, that this was a capital asset, and that the loss was a capital loss.[10]

A few months later, in McClellan v. Commissioner,[11] the Second Circuit held retiring partner's loss was a capital loss. Although this case has been interpreted by the Court which decided it as dealing a death blow to Helvering v. Smith,[12] it might have been more narrowly interpreted, since nothing appears in the statement of facts in the Court's opinion to suggest that the underlying assets were not themselves capital assets.[13]

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10 It may appear to some that on Judge Menman's analysis of the problem and facts, the decision could as easily have gone the other way. However, the case has attained some historical weight as a precedent and has influenced the trend which followed.

11 117 F.2d 988 (C.C.A.2d 1941).

12 Williams v. McGowan, 152 F.2d 570, 571 (C.C.A.2d 1945).

13 The Board of Tax Appeals, which was affirmed, does not suggest that the underlying assets included any stocks and bonds which, to a brokerage firm, would be stock in trade. The Board held that the sale was a partnership interest and the loss was a capital loss. 42 B.T.A. 124 (1940). Both the Board and the Court cited Munson v. Comm'r, 100 F.2d 363 (C.C.A.2d 1938). That case, however, did not involve the problem being discussed. There one partner sold a stock exchange seat and accounted to the other for part of the profit. The gain was held to be a capital gain because the seat was a capital asset, not on any theory of the nature of a partnership interest.

then as now was not a capital asset. [illegible] the Court of Appeals concluded that [illegible] co-ownership interest, [illegible] that the loss was a capital loss.[11]

A few months later, in Williams v. McGowan, [illegible] the Second Circuit held that [illegible] loss. Although this case [illegible] which decided it [illegible] Smith,[12] it might have [illegible] nothing appears in the [illegible] opinion to suggest that [illegible] selves capital assets.

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10 It may [illegible] analysis of the problem [illegible] easily have gone [illegible] altered some [illegible] flected the trend which followed.

11 117 F.2d [illegible] ([illegible] 1941).

12 Williams v. McGowan, 152 F.2d 570 ([illegible] 1945).

13 The Board of Tax Appeals, [illegible] not suggest that [illegible] and bonds which [illegible] trade. [illegible] Both the Board and [illegible] 265 (C.C.A. 2d 1936). [illegible] problem [illegible] This gain [illegible] capital asset [illegible] ship interest.

Since these decisions, a partnership interest has uniformly been held to be a capital asset, giving rise to capital gain or loss regardless of the character of the underlying assets. The problem has arisen in four courts of appeal, all of which have given that answer.

All controversies on this issue were settled, however, early in 1950 upon acquiescence of the Commissioner stating:[14]

> The overwhelming weight of authority is contrary to the position heretofore taken by the Bureau, viz., that the sale of a partnership interest is a sale of the selling partner's undivided interest in each specific partnership asset. (Citing cases). . . . It is accordingly the opinion of this office that the sale of a partnership interest should be treated as the sale of a capital asset . . . The application of this rule should, of course, be limited to those cases in which the transaction in substance and effect, as distinguished from form and appearance, is essentially the sale of a partnership interest. . . .

The Courts have found that this so-called partnership interest is capable of subdivision, thus allowing only a part to be sold. Thus, in the Lehman case,[15] one partner continued as a member of the partnership but sold a part of his interest therein to another partner and an additional portion to outsiders. Both the Tax Court and the Court of Appeals for the Second Circuit agreed that the taxpayer had sold an interest in the partnership, which should be treated

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14 G.C.M. 26,379, 1950-1 Cum. Bull. 58.

15 Allen S. Lehman, see footnote 20, p. 45, supra.

as a capital asset. The Commissioner's acquescence in the capital asset treatment of a partnership interest would further strengthen this subdivision.

<u>Personal Service Partnerships</u>

One very important exception to the general principle discussed above that the sale by a partner of his interest in the partnership will be considered a sale of a capital asset is an attempted sale of an interest in a partnership which is engaged primarily in rendering personal services. In the absence of an attempted sale, the income from such services is taxed as ordinary income when earned. However, if the sale by a withdrawing partner of the right to such income can convert that ordinary income into a capital gain, he is immediately presented with a most attractive tax motive for selling. The first case involving an attempted sale of an interest in a personal service partnership was the Heber Smith case.[16] The essential facts of the case were as follows:

> One partner withdrew from a law partnership of which there was no substantial capital investment. Upon his withdrawal, he received a cash payment in exchange for his share of fees earned but uncollected to the date of withdrawal. It was stipulated, however, that the remaining partners had orally agreed that they were

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16 Hever Smith, CCH BTA Mem. Dec. 9405-G (1936), Rev'd. sub nom., Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937).

as a capital asset. The Court's [illegible]
capital asset [illegible] of [illegible]
their [illegible] this [illegible].

Personal [illegible]

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the Hebrew [illegible]
were as follows:

[illegible]

12 [illegible]
Reg'd. [illegible]
1977).

purchasing his interest in the firm. By the terms of the agreement, a withdrawing partner was entitled only to receive his share of uncollected fees. The tangible assets of the firm were to belong to those partners who continued the business.

The Tax Court held that the withdrawing partner realized capital gain upon the sale of his partnership interest. On appeal, however, the Court of Appeals for the Second Circuit disagreed. It pointed out that:[17]

> . . . except for the purchase and release of the withdrawing partner's right to income, all his collections would have been ordinary income. The Court then held that the sale did not change the character of the income; the commuted payment merely replaced the right to future income with cash and the sum must be considered compensation for personal services.

The effect of this opinion was to disregard the entity theory and to base the holding upon the nature of the assets and relationships underlying the partnership interest. However, this result is clearly explainable in view of the tax avoidance possibilities inherent in a contrary holding. The Tax Court in subsequent cases[18] reversed its own holding in the Heber Smith case and followed the rationale of the Appellate Court.

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17 As pointed out by Judge Learned Hand in that opinion, this was the solution suggested by the Supreme Court for such situations in Bull v. United States, 295 U. S. 274 (1935).

18 Richard S. Doyle, 27 B.T.A. 323 (1938), aff'd, 102 F.2d 86 (4th Cir. 1939); James Wesley McAfee, 9 T.C. 720 (1947).

As a result of the ruling on the recent case of Max Swiren,[19] however, it is still questionable what the ultimate conclusion of the courts will be. The facts of this case as presented to the Tax Court were:

> A partner desired to withdraw from a law partnership and had an unrecovered capital outlay therein of $18,000 plus a right to a percentage of future fees. Upon his withdrawal, he received a lump sum to cover both his proprietary interest and his right to these fees. The Commissioner allocated the total amount received between the proprietary interest and the right to future fees, treating the latter as ordinary income. In the allocation, he applied the amount received to the partner's capital investment to the extent thereof, and treated the balance as ordinary income.

The Tax Court upheld this allocation, pointing out[20] that no allocation had been attempted by the taxpayer and that there was no factual basis upon which it could make a

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19 8 CCH TC Mem. 924 (1949), rev'd. and remanded, 183 F.2d 656 (7th Cir. 1950).

20 The Court stated: "We think it is now well settled that a partner's sale of his distributive interest in past earnings upon which no tax has been paid does not convert the transaction into a capital item and such sale does not relieve a partner from the necessity of paying a tax thereon as ordinary income." The Court then cited and discussed the Heber Smith case, 90 F.2d 590 (2d Cir. 1937), and Richard S. Doyle, 27 B.T.A. 323 (1938), aff'd, 102 F.2d 86 (4th Cir. 1939). The context in which the words "part earnings" appear in the above quotation apparently indicates they are intended to mean earnings to be received in the future as a result of personal services rendered in the past. Therefore, it is possible that this rationale may be limited to personal service partnerships. Accord. Bernard J. Long, "Sale of a Partnership Interest in a Service Partnership." Proceedings of New York University Eighth Annual Institute on Federal Taxation 950 (1949).

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Swiren,[19] however, [illegible]
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19 [illegible]
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more accurate allocation. The Court of Appeals for the Seventh Circuit, with one dissent, took the view, however, that the withdrawing partner had sold his partnership interest and that this constituted the sale of a capital asset.[21] This decision was reached despite the fact that the partnership was engaged in rendering personal services.

The decision of the Court of Appeals in the Swiren case will no doubt encourage further litigation of the point, with each Circuit Court making a choice between the entity and the aggregate theory, as it sees fit. Nor will the concession by the Commissioner that the sale of a partnership interest is the sale of a capital asset prevent opposition to the taxpayer. By its terms, this particular issue was expressly excluded from the scope of that concession.

While the Swiren decision may be a desirable solution from the standpoint of the selling partner, it leaves the purchaser with a serious problem when the earned fees are collected. If the buying partner has obtained an interest in the partnership, the entire purchase price goes to make up or increase his basis for his partnership interest.

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21 Compare the early case of Maurice B. Saul, 13 B.T.A. 705 (1938), acq. in, VIII-1 Cum. Bull. 40 (1939). There the withdrawing partner sold his interest in intangibles of a law firm. He had received this interest by inheritance and had a basis therefor equal to its value at the date of sale. The Tax Court held that the sale of these intangible assets resulted in no gain or loss since the amount received and the basis of the intangibles were equal.

more accurate allocation. The Court of Appeals for the Seventh Circuit, with one dissent, [illegible] however, that the withdrawing partners did not [illegible] their interest and that this constituted the sale of a capital asset.[71] This decision was reached [illegible] that the partnership was engaged in [illegible] business.

The decision of the [illegible] in the [illegible] case will no doubt [illegible] with each Circuit Court [illegible] and the aggregate theory [illegible] by the Commissioner [illegible] interest [illegible] capital asset [illegible] in the taxpayer's [illegible] expressly [illegible].

. . . While the [illegible] from the [illegible] purchaser with a [illegible] collected [illegible] of the [illegible] in the partnership, the [illegible] up or increase his [illegible] interest.

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71 Compare [illegible] A. 705 (1938), [illegible] the withdrawing partner [illegible] a law firm [illegible] and had [illegible] sale. [illegible] asset [illegible] and the basis of [illegible].

Under the entity theory embodied in Section 113(a)(13) of the Code, no part of his basis can relate to any asset held by the partnership until such time as it is distributed to the partners.

The uncollected fee will constitute an account receivable of the partnership, or if unbilled, at least a chose in action. As such, the claim may be considered a partnership asset. If assets are distributed to the partners in kind, some portion of their bases is normally allocated to those assets. Under the rationale of the Heber Smith case discussed above, however, this probably would not be true in the case of earned but uncollected fees. It is even more doubtful that it would be true when a cash basis partnership renders a bill and collects the fees. In such case, the receipts become current partnership income and the taxpayer will have great difficulty arguing that any part of the amounts constitute a return of capital. If he succeeds, what would have been ordinary income will go largely tax-free in his hands, and will be subject only to capital gains rates in the hands of the seller. Few courts can be expected to agree with such a result.

To the extent that a withdrawing partner has only an interest in earned but uncollected fees to sell, there appears to be no reason for requiring the purchaser to pay a tax thereon at ordinary income rates, except to the extent

Under the entity theory embodied in [illegible] 1111(a)(1) of the Code, no part of [illegible] any [illegible] paid by the partnership until [illegible] the partners.

The [illegible] ceivable of the [illegible] those [illegible] partnership [illegible] here in [illegible] cated to the [illegible] Smith [illegible] be true in the case of [illegible] even more [illegible] partnership [illegible] ance. The [illegible] taxpayer will have [illegible] the [illegible] what would [illegible] free in [illegible] rates in the [illegible] ed to [illegible]

[illegible] interest [illegible] appears [illegible] a tax [illegible]

that the fees collected exceed the amount paid therefor. In substance, he has purchased ordinary income and should be allowed an income tax basis therefor in an amount equal to the purchase price. On the other hand, the selling partner is in no position to object because he is required to treat as ordinary income an amount which he has earned and which must be treated as ordinary income in someone's hands in order to prevent tax avoidance.

It is believed that the approach of the Tax Court to the problem through the medium of an allocation of purchase price between uncollected fees and partnership interest presents a reasonable solution, logically recognizing the entity of the partnership to the greatest extent possible in the face of the possibilities of tax avoidance and the equities as between the buyer and seller.

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to the purchase price. [illegible]

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CHAPTER V

REQUISITES TO CONSTITUTE A SALE OF A PARTNERSHIP INTEREST

Because of the conflicting opinions of the Commissioner and the Courts, great care must be exercised by the parties to the contract of sale of a partnership interest to show that what the parties intended to sell and buy was in fact a partnership interest and not an interest in the assets. The agreement must also provide that the partnership business is to continue uninterrupted after the sale. These considerations, as well as the method of payment to the selling partner and consequences of a selling partner with a deficit, which have resulted in much litigation, will be discussed below.

Agreement to Sell Partnership Interest

There is a very good possibility that the Commissioner will contend that the transaction covering the withdrawal does not provide for a sale of the partnership interest. The withdrawing partner is therefore faced with this anomalous situation: If he agrees to sell his interest in the partnership, the Courts will recognize the sale and find that the asset sold is a capital asset. If he agrees merely to withdraw upon the receipt of the value of his share of the partnership assets in cash, the Commissioner will in all

Because of the [illegible]

siness and the Courts, [illegible] parties to the [illegible] to show that [illegible] in fact a partnership [illegible] assets. The agreement [illegible] that the partner- ship business [illegible] These considerations [illegible] the selling partner [illegible] with a definite [illegible] will be discussed [illegible].

<u>Agreement to Sell [illegible] Interest</u>

There is a very [illegible] that the [illegible] or will contract [illegible] does not [illegible] The withdrawing partner [illegible] sions of [illegible] partnership, the [illegible] that the [illegible] ly to [illegible] the partnership [illegible]

likelihood contend and the courts may find that he has nevertheless made a sale. However, in this case he will be found to have sold only an interest in partnership assets, and the capital nature of the gain or loss will depend upon the nature of each asset involved in the transaction.[1]

This situation is the result of the Commissioner's attempt to apply the aggregate theory of partnerships to every situation in which he is not prevented from doing so either by the Courts or by his own long-standing regulations.[2] In the usual situation involving an attempted sale of a partnership interest, the parties will clearly spell out the existence of that sale by the terms of the agreement governing the transaction. Such cases present no particular problem even when the sale is to the remaining partners. The only issue is the construction of the agreement.[3] If the agreement is cast in the form of a sale and there is evidence that the sales price has been negotiated, the sale

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1 Paul Little, Federal Income Taxation of Partnerships (Boston: Little, Brown and Co., 1952), p. 262.

2 Note, for example, his failure to completely apply the aggregate theory upon the contribution of property to the partnership, discussed on page 17 *et seq.* *supra*. See also the regulations with respect to the non-recognition of gain or loss to the recipient of a distribution of partnership assets in kind. U.S. Treas. Reg. 111, Sec. 113(a)(13)-2.

3 For example, see L. F. Long, 6 CCH TC Mem. 614 (1947) rev'd. on other grounds, 173 F.2d 471 (5th Cir. (1949); Bass v. Comm'r., 175 F.2d 52 (5th Cir. 1949).

likelihood [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]
nevertheless [illegible] [illegible] [illegible] [illegible] found to have [illegible] [illegible] and [illegible] [illegible] and the [illegible] [illegible] of [illegible] [illegible] [illegible] the nature of [illegible] [illegible] implied by the agreement.[1]

This situation is the result of the [illegible] attempt to apply the [illegible] [illegible] of [illegible] [illegible] every situation in which [illegible] [illegible] [illegible] either by the Courts or by [illegible] [illegible] [illegible] tions.[2] In the usual [illegible] [illegible] of [illegible] [illegible] of a partnership [illegible] [illegible] [illegible] out the existence of [illegible] [illegible] of the [illegible] governing the [illegible] [illegible] [illegible] [illegible] problem even when [illegible] [illegible] [illegible] The only issue is [illegible] [illegible] of the agreement. [illegible] the agreement is [illegible] [illegible] [illegible] evidence [illegible] [illegible] [illegible] [illegible]

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1 [illegible] [illegible] ships (Boston [illegible]) [illegible]

2 [illegible], for example, [illegible] the approach [illegible] [illegible] his [illegible] [illegible] [illegible] [illegible] [illegible]

3 [illegible] (1947) [illegible] (1948) [illegible]

will normally be recognized.[4] Thus, in the L. F. Long case[5] this subject was discussed under the following facts:

> Taxpayer had a one-third interest in a partnership composed of three partners. In an instrument cast in form of an assignment, the taxpayer conveyed to the remaining two partners all of his right, title and interest in the principal partnership assets with the exception of certain of such assets listed therein. The instrument stated that the taxpayer desired to withdraw from the partnership in exchange for a cash payment from the remaining partners. By a deed and a bill of sale dated the same date, the remaining partners conveyed to the taxpayer all of the partnership assets listed in the assignment.

The Commissioner attacked the transaction on the ground that the assets of the partnership were distributed in dissolution and that the taxpayer had then sold all of his share thereof to the remaining partners except those actually retained by him. The Tax Court treated this transaction as a distribution in kind to the taxpayer of a portion of the partnership assets and the payment of cash for the taxpayer's remaining partnership interest.[6] The Tax

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4 The partnership agreement may provide that the remaining partner is to buy, and the withdrawing partner is to sell his interest in the partnership. In the face of such an agreement, the fact that the sale price provided therein merely equals the seller's capital investment plus his interest in the application of certain partnership assets will apparently not prevent the transaction from being considered a sale of a partnership interest. Cf. George R. McClellan, 42 B.T.A. 124 (1940), aff'd. 117 F.2d 988 (2d Cir. 1941).

5 L. F. Long, _op. cit_.

6 In the Long case it is not entirely clear whether the cash was paid by the remaining partners or by the partnership. The statement of facts, 6 CCH TC Mem. 614, 617

Court emphasized the following factors as indicative of a sale by the withdrawing partner of the remainder of his partnership interest:

(1) The transaction was cast in the form of a sale rather than in the form of a dissolution.
(2) The consideration paid the withdrawing partner bore no direct relation to the value of his partnership interest (which was the opposite of what it would have been in an ordinary dissolution).
(3) The transaction did not specifically mention numerous partnership assets or any partnership liabilities.

These factors caused the Court to find a complete absence of any plan under which one or more of the partners were to receive from the partnership their proportionate shares of the net assets of the business, or their equivalent.

Therefore, as long as the parties can prove an intention to buy and sell a partnership interest, this intention will be upheld, and the courts will force the Commissioner to accept the entity theory with the results noted above. If, instead, the transaction is merely a partnership distribution, the Commissioner will continue to apply the

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indicates that payment was made directly by the remaining partners. However, the opinion, at page 618, states: "To acquire the interest of petitioner, new capital was put into the venture by Joe Long and his capital investment thereafter as the owner of one-half interest in the partnership differed from what it was before petitioner retired from the firm." To the extent that the cash was distributed by the partnership itself, the case presents a situation which is even closer to that in which there is a mixed distribution in cash and kind by the partnership.

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sale by the [illegible]

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(B) [illegible]

(5) The [illegible]
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These factors caused the Court [illegible]

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aggregate theory in the absence of decisive court decisions to the contrary.[7]

Continuation of Partnership Business

Another requirement to constitute a sale of an interest in the partnership is that the partnership business

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7 If a sale of an interest in the assets is made by the withdrawing partner to the remaining partners, in order to compute their basis in the hands of the seller, his distributive share of the partnership cash and assets must first be deemed distributed to him by the firm. The finding of a distribution in kind by operation of law is not unusual in such cases. For example, in Planters Gin Co., 28 B.T.A. 22 (1933), the partnership was terminated by the death of a partner but the survivors continued the business under a new partnership. The Tax Court found that there had been a distribution of the assets in kind followed by their contribution to the new partnership by operation of law. Note also these cases commonly cite Munson v. Comm'r., 100 F.2d 363 (2d Cir. 1938), in which the assets were actually distributed in kind.

The distributee's bases applies first to the cash received. Any balance then applies to the assets. I.T. 2010, III-1 Cum. Bull. 46 (1924). The distributee will then be deemed to have kept his distributive share of cash and to have exchanged his share of the assets for the balance of the total cash actually received by him.

On the other hand, the buying partner will be deemed to have withdrawn cash equal to the excess amount thereof actually received by the withdrawing partner. The buyer will then be deemed to have paid that amount over in exchange for the undivided interest of the selling partner in the asset. He then is deemed to have contributed the purchased interest to the partnership. The partnership will, of course, take a new basis for such property equal to its cost in the hands of the buying partner. This is reported to have been the approved Bureau practice prior to G.C.M. 26,379, 1950-1 Cum. Bull. 58. Thus, Jackson, "Parthership Distributions," Proc. Tax Inst. U.S.C. School of Law 65, 93 (1950), reports that "until the recent swing to the entity theory the field agents have been allowing a step up in basis on a purchase of an interest in the partnership assets."

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the withdrawing partner [illegible] to [illegible] distribution [illegible] first [illegible] of a distribution [illegible] in [illegible]. For example, [illegible] 22 (1953), [illegible] partner [illegible] the [illegible] partnership [illegible] tion to [illegible] these [illegible] (2d Cir. 1955), [illegible] in kind.

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On the other [illegible] to [illegible] actually [illegible] will [illegible] charge [illegible]

[illegible]

continue following the sale. The fact that the partnership itself is terminated by the withdrawal will not affect the sale of the partnership interest.[8] Nor must the business be continued by the purchaser with all the partnership assets intact. In the case of L. F. Long,[9] for example, the Tax Court found that upon the withdrawal of one partner there was a distribution to him in kind of assets equal to a part of his interest, and a sale to the other partners of the remainder of his partnership interest.

It may be concluded from these cases that if a partner enters into a specific agreement to sell his interest in the partnership, there is a very good possibility that this agreement will be recognized as long as a substantial portion of the partnership business is continued in some form. The fact that only a part of the interest is sold and the remainder is liquidated will apparently not prevent this result. Each case, however, must necessarily turn upon its own facts.

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8 In Frank J. Johnson, 9 CCH TC Mem. 277 (1950), one partner sold his interest in the partnership to the only other partner. This automatically terminated the partnership and it became a sole proprietorship. The Commissioner contended that there had been a sale of a partnership interest which resulted in a capital loss. The Tax Court agreed.

9 See footnote 3, p. 60, _supra_. The Long case is discussed on page 61 _et seq_. _supra_.

continue following the sale. The fact that the partnership itself is terminated by the withdrawal will not affect the sale of the partnership interest.[8] Nor must the business be continued by the purchaser with all the partnership assets intact. In the case of E. J. Lamb,[9] for example, the Tax Court found that upon the withdrawal of one partner there was a distribution to him of [illegible] part of his interest, and a sale to the other partners of the remainder of his partnership interest.

It may be concluded from these cases that if a partner enters into a specific agreement to sell his interest in the partnership, there is a very good possibility that this agreement will be recognized so long as a substantial portion of the partnership business is continued in some form. The fact that only a part of the interest is sold and the remainder is liquidated will generally not prevent this result. Each case, however, must necessarily turn upon its own facts.

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9 See footnote 3, p. 58 supra. The Lamb case is discussed on page 61 et seq. supra.

<u>Method of Payment</u>

A special problem is created when the withdrawing partner is to receive installment payments out of partnership profits for a period of time. The primary issue in such cases is whether these profits are received in payment for the interest of the withdrawing partner in the firm, or whether they are received as a distribution of partnership profits. The problem is further complicated when the partnership is primarily engaged in rendering personal services for profit. The Tax Court has quite logically indicated that the principles to be applied in the solution of this problem are identical, whether the case involves a withdrawal by a deceased or by a living partner.[10]

In the case of a partnership rendering personal services, and in which capital is not a material income-producing factor, the problem is complicated by the fact that in such partnerships, the members often have no capital account and no capital investment. If the partnership has no tangible or intangible assets such as good will, the withdrawing partner or decedent will then be held to have no partnership interest capable of being sold.[11] The Supreme Court has

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10 William T. Jones, 3 CCH TC Mem. 97 (1944).

11 See the discussion on this point on page 53 *et seq*. *supra*.

Method of [illegible]

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held in Bull v. United States[12] that such payments then constitute a distribution of partnership profits. However, this opinion has been criticized,[13] and when the payments have been required as a purchase price for the interest in the partnership, both the Tax Court and the Court of Appeals for the First Circuit have held these payments not to be a distribution of profits, but consideration for the sale of the partnership interest.[14]

Selling Partner with a Deficit

In addition to the preceeding problems, the attempted sale of a partnership interest by a partner who has a deficit in his partnership capital account has proved troublesome. In the Herman Senner case[15] the withdrawing partner had a negative capital account as a result of withdrawals of cash from the firm prior to the date of his retirement. The Tax Court held that the cash payments received from the partnership should be treated as ordinary income, and pointed out that the transaction had none of the elements of a sale since the partner had fully recovered his capital

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12 295 U.S. 247 (1935).

13 Randolph E. Paul, Federal Estate and Gift Taxation, (Boston: Little, Brown and Co., 1942 and 1946 Supplement 67), Sec. 4.08.

14 Aaron Lowenstein, 12 T.C. 694 (1949); Beaver C. Miller Trust, CCH BTA Mem. Dec. 11,041-A (1940).

15 22 B.T.A. 655 (1931).

held in [illegible], [illegible] [illegible] [illegible] con-
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the [illegible] [illegible] [illegible] [illegible]
for the [illegible] [illegible] [illegible] [illegible]
distribution, [illegible] [illegible] [illegible] [illegible]
the earlier [illegible] [illegible].

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sale of a partnership [illegible] [illegible] [illegible] [illegible]
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partnership [illegible] [illegible] [illegible] [illegible]
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sale [illegible] [illegible] [illegible]

[illegible]

[illegible] [illegible]
[illegible] [illegible]

investment and had no interest in the partnership of which he could dispose. However, in the Philip Scheyer case,[16] the withdrawing partner also had a negative figure in his capital account. Upon his withdrawal, the continuing partner paid him a lump sum plus his share of the current year's earnings. The Commissioner contended that the partner had a gain measured by the lump sum payment plus an amount equal to the deficit in his capital account. The Court, however, held that the gain could only be measured by the amount of the lump sum payment, thus holding in effect that the partner could not be deemed to have a basis of less than zero for computing gain or loss. There is no indication as to whether the gain was capital or ordinary gain in the hands of the taxpayer.

Therefore, in an arm's-length transaction, the payment of a substantial amount of cash by the continuing partner to a withdrawing partner who has a deficit in his capital account is an indication of that value. On principle, therefore, there is little reason to believe that the Tax Court would refuse to recognize an agreement specifically providing for the sale of a partnership interest merely because the capital account of the selling partner contains a negative figure.

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16 CCH BTA Mem. Dec. 7574-C (1932).

investment and ... [illegible] ... which
he could dispose. However, ... [illegible] ...
the ... [illegible] ...
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earnings. The majority ... [illegible] ... that the ... [illegible]
gain measured by the lump sum payment ... [illegible] ...
to the deficit in his capital account. The Court, however,
held that the gain could only be measured by the amount of
the lump sum payment, thus holding in effect that the part-
ner could not be deemed to have a basis of less than zero
for computing gain or loss. There is no indication as to
whether the gain was capital or ordinary gain in the hands
of the taxpayer.

Therefore, ... [illegible] ... the pay-
ment of ... [illegible] ... part-
ner to a withdrawing partner ... [illegible] ...
capital account is ... [illegible] ... in prin-
ciple, therefore, there is little reason to believe that the
Tax Court would refuse to recognize an agreement specifical-
ly providing for the ... [illegible] ...
because the capital account ... [illegible] ...
a negative figure.

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16 [illegible]

CHAPTER VI

TAXABILITY OF PARTNERSHIP INCOME IN THE YEAR WHEN A PARTNERSHIP INTEREST IS CHANGED

Treated as a single problem, the taxability of partnership income in the year when a change of a partnership interest occurs has a definite kinship with those problems previously discussed. It has two aspects: (1) when a partner dies in the course of the accounting period and under the agreement the death does not terminate the partnership, how is the income taxable; (2) when a partnership interest is sold in the course of the partnership's accounting period without dissolving the firm, how is the income taxed as between the seller and purchaser of the interest?

These problems are not presented if the partnership is dissolved by or at the time of the critical event. Dissolution closes the partnership's taxable year and causes the partners' various shares of the income to become distributive and taxable.[1] Normally, however, the partnership income is not taxable to the partners until, by virtue of the termination of the accounting period either by dissolution or lapse of twelve months, it becomes distributive.

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1 Guranty Trust Co. v. Comm'r, 303 U.S. 493 (1938). One of the requisites of a sale of a partnership interest is that the partnership is not dissolved immediately upon the transfer. See the discussion on this point on page 63 *et seq*. *supra*.

[illegible] TERMINATED

Treated as [illegible]

nership income [illegible]

interest [illegible]

previously [illegible]

partner dies in the course of [illegible]

under the agreement [illegible]

nership, [illegible]

interest is sold in the [illegible]

ing period without [illegible]

taxed as between the seller and purchaser of the interest.

These [illegible]

is dissolved by [illegible]

solution [illegible]

the partners' [illegible]

business and [illegible].[1] [illegible]

income is not [illegible]

the termination of the [illegible]

tion or lapse of [illegible]

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1 [illegible]

The question is whether the assignment or shift of ownership of an interest in the partnership also makes the income distributive as to one or more members, even though the partnership is not dissolved.

Change of Partnership Interest Because of Death

The death of a partner generally dissolves the partnership. This is the rule of the Uniform Partnership Act[2] and is probably the prevailing rule in the majority of the states. Some states, however, permit the partners by agreement to avoid dissolution at the time of the death of a partner. The Tax Court recently concluded that this was permissible under Alabama law and concluded that the estate of the deceased partner could not compute its distributive income on the theory there had been a dissolution with a distribution of assets, with a resulting change of basis for the assets and a contribution back.[3] This decision was reviewed by the entire Court without dissent. If the Court abides by its reasonable implications, the Court will also hold that the partnership accounting period is not terminated by the partner's death, so that income then becomes distributive. The Tax Court has already taken this position

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2 U.P.A. Sec. 31.

3 Aaron Lowenstein Estate, 12 T.C. 694 (1949), acq. in, 1949-2 Cum. Bull. 2.

The question is [illegible] of an interest [illegible] tributive [illegible] currently is not [illegible].

__Change of [illegible] Interest__

The death of a partner [illegible]

terminate [illegible] and is ordinarily the [illegible] states. Some states, however, [illegible] ment to avoid liquidation at the time of the death of a partner. [illegible] nominally [illegible] of the deceased partner [illegible] income on the [illegible] distribution of [illegible] the accrued [illegible] viewed by the [illegible] shiper by the [illegible] hold that the [illegible] tee by the partner's [illegible] distributive. [illegible]

[illegible]

as to the surviving partners even when the partnership is technically dissolved, so long as it is not terminated.[4]

As a solid foundation to this conclusion is the Supreme Court's decision in Heiner v. Mellon.[5] There a partner had died and the two remaining partners continued to operate the business for several years while in the process of liquidating it. They argued that they ceased to be partners on the death of the third partner and became, under local law, trustees in liquidation. This argument was rejected on the ground that a partnership, although dissolved by the death of one member, is not terminated until its affairs are wound up, and the remaining members therefore continued to be partners in a partnership for Federal income tax purposes even though under local law their relationship to the estate of the deceased partner made them trustees. Since the surviving partners continued to be treated as partners by virtue of their prior agreement and not by any agreement after the death of the third partner, the conclusion is fairly justified that at least as to the surviving partners the partnership is a continuing thing for tax purposes until it is terminated, and therefore what Justice

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4 Mary D. Walsh, 7 T.C. 205 (1946), acq., in, 1946-2 Cum. Bull. 5.

5 304 U.S. 271 (1938).

as to the surviving partner[illegible]
technically dissolved [illegible]

As a solid foundation [illegible]
Supreme Court's decision [illegible]
partner had died and the [illegible]
operate the business [illegible]
of liquidating it. They argued that [illegible]
made on the death of the [illegible]
local law, [illegible]
jected on the ground that [illegible]
by the death of one partner, [illegible]
affairs are wound up, and the [illegible]
continued to be [illegible]
tax purposes [illegible]
to the estate of the [illegible]
Since the surviving partners [illegible]
partnership [illegible]
agreement upon the death of [illegible]
and is fairly [illegible]
partners [illegible]
poses until it is terminated, [illegible]

[illegible] Comm. Bull. 3.

[illegible]

Brandeis referred to as its "technical dissolution"[6] does not close its taxable period at least as to the surviving partners.

Any conclusion that the same result can be applicable to the deceased partner as well must reckon with Guaranty Trust Co. v. Commissioner,[7] decided less than two months before Heiner v. Mellon discussed above. That case also involved a partnership which was "technically dissolved" but not terminated at the death of a member, and his share of the partnership income for the portion of the accounting period up to the date of his death was held taxable as of the date of his death. Some emphasis was laid on the fact that his death dissolved the partnership both under state law and in practical operation, and, unlike the Mellon case, the fact was that neither he nor his estate had any interest in the profits arising after his death.

The Tax Court has suggested the possibility that the repeal of the accrual at death rule formerly in section 41 would alter the rule today.[8] Certainly it might where the deceased partner's interest in the profits and losses continues for a period after his death, and this conclusion is strengthened by the fact that in the Guaranty Trust case

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7 Guaranty Trust Co. op. cit.

8 Mary D. Walsh, op. cit.

Brandeis referred [illegible]
not close its [illegible]
partners.

Any conclusion [illegible]
his to the deceased partner [illegible]
Trustees v. Woodward [illegible]
form holder [illegible]
volved a corporation which was [illegible]
not terminated by the change of partners [illegible]
the partnership [illegible]
period up to the date of [illegible]
the date of [illegible]
that his death dissolved the partnership [illegible]
law and to [illegible]
the fact that [illegible]
in the profits arising after his death.

The [illegible]
repeal of the [illegible]
would alter [illegible]
deceased partner's interest in the [illegible]
times for a period after his death [illegible]
strengthened by the fact that [illegible]

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7 [illegible]

8 [illegible]

some emphasis was laid on the accrual of the decedent's distributive share by his death.[9]

It appears, therefore, that unless there is a technical dissolution, the death of a partner will not terminate the accounting period as of his death, as to him or the survivors. The serious possibility exists that if the partnership is technically dissolved but not terminated by the death, and if the decedent's interest in the partnership and its profits and losses continues for a period after his death, none of the income becomes distributive to the decedent as of the date of his death and the accounting period is not then closed.[10]

Change of Partnership Interest Because of Sale.

The second facet of this problem is presented when a sale of a partnership interest occurs in the course of the partnership's accounting period and the sale, either by virtue of the Uniform Partnership Act[11] or of the partnership

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9 303 U.S. 493, 599-501 (1938).

10 The point becomes significant in the cases of fiscal year partnerships where there are changes in rates. It is also significant where there are partnership capital gains before a partner's death and partnership capital losses after his death, but within a single normal partnership accounting period. It may also be significant where there was a net profit before his death and a net loss after his death, if net loss carry-backs are further restricted by ligislation or construction. Cf. Joseph L. Merrill, 9 T.C. 291 (1947).

11 U.P.A. Sec. 27.

some analysis was lacking, the accuracy of [illegible]
tributive share in this case.

It appears, therefore, [illegible]
ual classifying [illegible]
the accounting [illegible]
survivor. [illegible]
nership is [illegible]
death, and if [illegible]
its profits [illegible]
none of the [illegible]
the date of his death [illegible]
closed.[10]

Share of [illegible] Interest [illegible] at [illegible]

The [illegible]
sale of a partnership interest, [illegible]
partnership's [illegible]
tue of the [illegible][11] [illegible]

---

9 [illegible] (1962).

10 [illegible] 291 (1957).

11 [illegible]

agreement, does not dissolve the partnership. In these circumstances there is nothing to close the partnership's accounting period and the income is not distributive.

The problem and its dimensions can best be understood if illustrated by a supposititious example. Assume a partnership on the calendar year basis and in July 1952 P, a partner, with a 25 per cent interest, received an attractive offer for his interest. The firm's assets, consisting of both fixed assets and stock in trade, had appreciated in value and in addition the firm had earnings of $60,000 for the first six months of the year. The purchaser is confident that those profits will not be lost in the last six months and accordingly figures that P's interest is worth $200,000, computed as follows: interest in fixed assets -- $140,000; interest in inventory -- $45,000; interest in current profits -- $15,000. This transaction would represent a profit to P of $60,000. Is it all capital gain, or must the $15,000 representing the interest in current profits be treated as ordinary income?

If the entire gain is capital gain, P has a tax incentive to sell instead of dissolve, since in the event of dissolution the current income would become distributive and be taxable as ordinary income. Not so obvious, but just as real, is the tax disadvantage to the purchaser if P's entire gain is capital gain, and the fact that the overall effect

agreement, does not dissolve the [illegible]

questions there [illegible]

accounting period [illegible]

The problem [illegible]

is illustrated by a [illegible]

months of [illegible]

partner, [illegible]

offer for his [illegible]

both [illegible]

value and is entitled [illegible]

the first six months [illegible]

dent that [illegible]

months and [illegible]

$200,000 [illegible]

$140,000 [illegible]

ment profits -- [illegible]

profit [illegible]

$25,000 representing [illegible]

at an ordinary income.

If the [illegible]

centive to sell [illegible]

dissolution [illegible]

be taxable [illegible]

real, [illegible]

gain in [illegible]

of the two choices on the revenue is probably a standoff. Thus, if P has sold merely a partnership interest and not an interest in underlying assets, his entire gain is capital gain. However, what P has sold is what the purchaser has bought, and when the calendar year ends the purchaser is taxable on 25 per cent of the partnership net income for the year, including some of the income he has just, so to speak, purchased.[12] The result is two taxes on this income, a capital gains tax to P and an ordinary income tax to the purchaser. This conclusion is founded on the theory that since the withdrawal and sale occurred in the middle of a partnership taxable year, no part of the profits were distributable at that time. Therefore, the withdrawing partner could not have sold current profits as such.[13]

The general rule, however, appears to be that the withdrawing partner must report his distributive share of partnership income up to the date of withdrawal in the taxable year during which the withdrawal occurs, as was held in the Robert S. LeSage case.[14]

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12 See the discussion on this point on page 57 <u>et seq.</u> <u>supra</u>.

13 Brooks, "The Strange Nature of the Partnership Under the Income Tax Law", 5 Tax Law Review, 35, 54 (1949).

14 Robert S. LeSage, 6 CCH TC Mem. 1263 (1947), aff'd. on this issue, 173 F.2d 826 (5th Cir. 1948).

of the two choices of the revenue is probably [illegible]

Thus, if I has sold more [illegible]

interest in underlying [illegible]

gain. However, [illegible]

bought; [illegible]

taxable [illegible]

year, including [illegible]

purchased.[18] The [illegible]

tal gains tax [illegible]

er. This [illegible]

withdrawal and [illegible]

taxable year, [illegible]

that time. [illegible]

have sold [illegible]

The [illegible]

withholding [illegible]

[illegible]

able year [illegible]

in the [illegible]

---

18 [illegible]

[illegible]

19 [illegible]

Under the [illegible]

[illegible]

on this [illegible]

On the other hand, the problem becomes acute when the partnership and the withdrawing partner report income upon the basis of different taxable years. If the withdrawal terminates the partnership, the Tax Court applies the general rule which is applicable to all partners. Thus, in Louis Karsh[15] the Court held that the withdrawing partner's share of partnership income up to the date of withdrawal must be reported in the taxable year of that partner during which the withdrawal occurred. The result is less clear, however, when the partnership is continued by agreement following the withdrawal, or is dissolved but not terminated as a result of that withdrawal. In the course of the Karsh opinion, Judge Opper remarked:[16]

> If the partnership had continued, instead of being dissolved by petitioner's withdrawal, its fiscal year would not have ended until February of the following year; and under the provisions of Section 188, Internal Revenue Code, the partnership income of that fiscal year might have been subject to inclusion in petitioner's then current taxable year, which would have been 1944, rather than 1943.

The need for an accounting to constitute a termination of a partnership and, therefore, a determination of a partner's distributive share of the profits is unnecessary.[17]

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15 Louis Karsh, 8 T.C. 1327 (1947).

16 Ibid., p. 1331.

17 Paul Little, Federal Income Taxation of Partnerships (Boston: Little, Brown and Co., 1952), p. 99.

On the other hand, the partial [illegible]

partnership [illegible]

the basis of [illegible]

terminates the partnership [illegible]

rule which is [illegible]

Karch[15] the [illegible]

of partnership [illegible]

reported [illegible]

the withdrawing [illegible]

when the partner [illegible]

withdrawal, [illegible]

that withdrawal [illegible]

[illegible]

[illegible]

The [illegible]

tion of a partnership [illegible]

partner's [illegible]

---

15 [illegible]

16 [illegible]

17 [illegible] ships [illegible]

The share of the current profits, as in the hypothetical example above, will have been determined as one indispensable step in the valuation of the interest being disposed of by the withdrawing partner. In the Karsh case, the selling partner sold his interest in current profits. The statement of facts indicated that the selling partner's accountant had access to the books, a balance sheet as of a date only a few days prior to the sale, and a profit and loss statement as of the same date. These documents formed the basis for valuation by the partner of his partnership interest and for determining his share of partnership profits to the date of sale. Therefore, while there was no accounting in the formal sense, there was no need for one.[18]

In the recent case of Charles Goodman,[19] the Tax Court held that the withdrawing partner's share of current profits to the date of sale was taxable to him as ordinary income, although his profit upon the sale of his partnership interest was treated as capital gain.[20] There the

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18 The Commissioners' note to Section 22 of the U.P.A. points out that when a partner has equal access with his partners to the partnership books, there is no reason to require his partners to render a formal account, which is the sense in which the term "account" is used in that section.

19 9 CCH TC Mem. 789 (1950).

20 However, the court then required these current profits to be included in the withdrawing partner's basis for his partnership interest.

The share of [illegible] the [illegible] cable above, will have been [illegible] step in the valuation of the [illegible] being [illegible] of the withdrawing partner. [illegible] the [illegible] partner sold his interest [illegible] of facts indicates that the entire [illegible] a three [illegible] days prior to the sale, and [illegible] of the same date. [illegible] valuation by the partners [illegible] determining the [illegible] of the [illegible] sale. Therefore, while [illegible] nal sense, there was [illegible].[18]

In the recent case of [illegible],[19] the Court held that [illegible] profits to the date of sale was [illegible] income, [illegible] interest was [illegible].[20]

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18 The [illegible] points out that [illegible] partners [illegible] quire his [illegible] sense [illegible].

19 [illegible]

20 However, [illegible] profits to [illegible] for his [illegible] interest.

partnership and the withdrawing partner were both apparently reporting income on the basis of a calendar year. The partner sold his interest in the partnership, together with his interest in current profits, to two of the remaining partners. This sale was completed on or about November 23 of the particular year. The partnership continued after the withdrawal. Therefore, while there may or may not have been a dissolution of the partnership, it clearly was not terminated.

The general trend, therefore, appears to be that where the partnership is not terminated upon the withdrawal of a partner, the dissolution will not affect the taxable year in respect of the continuing partners. However, the withdrawal will end such taxable year in respect of the withdrawing partner, and his distributive share of income up to the date of withdrawal is reportable as ordinary income in his taxable year in which the withdrawal occurred.

Although Judge Opper's opinion in the Karsh case[21] indicates that if the partnership is merely dissolved, the withdrawing partner's taxable year is not affected, his reference to "dissolved" may have been in error for he actually held the partnership terminated. Therefore, there is no indication in the opinion as to how this issue would be

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21 See page 75 <u>et seq.</u>, <u>supra</u>. for a discussion of the Karsh case and the opinion as rendered by Judge Opper.

treated if the partnership were dissolved rather than terminated.

treated if the partnership were dissolved rather than terminated.

CHAPTER VII

SUMMARY AND CONCLUSIONS

An analysis of the major problems surveyed in this study makes it apparent that most of the conflicting tax questions developed out of transactions between partner and partnership, or between partners, are almost all created because the partnership is recognized as an entity separate and apart from its partners for some purposes and not for others. In a few situations, the nature of the partnership in this respect is spelled out by the statutes. But in the great majority of cases, the taxpayer is left to the mercies of the Courts and the Commissioner of Internal Revenue in securing a final determination of the question.

Since most of the major problems arising in this field result from the confusion as to the nature of the partnership, the solution which comes immediately to mind is merely a choice between one or the other of the two conflicting theories. This solution is temptingly direct and simple. However, as a practical matter, it would never be acceptable. Special situations requiring special treatment would inevitably arise which would require exceptions to the general rule.

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It therefore appears likely that the taxpayer must be prepared to accept as a part of the general structure of the

income tax law, a continuation of the dual concept with respect to the nature of the partnership.

The adoption of the Uniform Partnership Act by some thirty two states has facilitated the interpretation of the Federal tax laws pertaining to partnerships by requiring a uniform application of these laws throughout the member states. It is believed that whenever all states adopt the Uniform Partnership Act, much of the conflicting concepts of taxation of partnerships will be solved.

This study has been undertaken with a view to discovering and analyzing the major income tax problems peculiar to changes in partnership interest resulting from a sale by one partner to another or to a stranger. It has been shown that the attempts of the Courts and the Commissioner of Internal Revenue to apply the provisions of the Internal Revenue Code have resulted in grave confusion in interpretation. This confusion has resulted from the presence of co-existing theories with respect to the nature of the partnership. The basic difficulty has been that there is substantial room, under the present statute, for disagreement as to how Congress may have intended the two theories to be applied in the vast areas of the field outside the scope of the present statute. As a result, the theory applicable in the large majority of partnership income tax problems is not readily ascertainable. Taxpayer, Commissioner, and Courts

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The adoption of the Uniform Partnership Act by some thirty-two states has facilitated the interpretation of the Federal tax laws pertaining to partnerships by establishing a uniform application of these laws throughout the various states. It is believed that whenever all states adopt the Uniform Partnership Act, much of the conflict and uncertainty in taxation of partnerships will be solved.

This study has been undertaken with particular reference to covering and analyzing the major income tax problems peculiar to changes in partnership interests resulting from a sale by one partner to another or to a stranger. It has been shown that the attempts of the Courts and the Commissioner of Internal Revenue to apply the prior sections of the Internal Revenue Code have resulted in varying and conflicting interpretation. This conflict has resulted from the presence of co-existing theories with respect to the nature of the partnership. The basic difficulty has been that little or no substantial ruling, under the present statute, has given guidance as to how Congress may have intended the two theories to be applied in the vast areas of the rights provided for under the present statute. As a result, the tax consequences in the large majority of partnership income tax problems are not readily ascertainable. Taxpayer, Commissioner, and Courts

are left to grope and surmise as to what Congress may have intended with respect to each such problem.

The Commissioner's usual contention has been that the partnership is not a juristic entity but an association of individuals, each of whom owns an undivided interest in each specific asset. Under this contention, the Commissioner has argued that the basis of partnership property changes upon a sale of a 'partnership interest'.[1] In the Ford case,[2] however, the Tax Court held that since under the income tax law the partnership was a computing unit, its ownership of assets had to be accepted, and therefore, the basis of its property should not be changed upon a change of a partnership interest. The Commissioner's acquiescence indicates that such is also his belief.[3]

Once the partner acquires an interest in a partnership, the statute recognizes that his basis therefor is quite distinct from any basis which the partnership may have for its assets, as provided for in Internal Revenue Code Section 113(a)(13).[4] The statute also recognizes a holding period for partnership property separate and apart

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1 Robert E. Ford, 6 T.C. 499 (1946). See the discussion on this point on page 24 <u>et seq</u>. <u>supra</u>.

2 <u>Ibid</u>.

3 See footnote 7, p. 27, <u>supra</u>.

4 See the discussion on this point on page 29, <u>et seq</u>. <u>supra</u>.

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from the interest partners hold in the partnership.[5] The basis of partnership property which is contributed to the partnership by the partners is the substituted basis of the individual partner, and the holding period runs from the date the partner acquired the property.[6]

The Commissioner was consistent in his position that a partnership interest constituted an ownership in the individual partnership's assets, with its basis and holding period, until 1950 when he recognized that a partnership interest actually constituted a specifically identifiable capital asset with a basis and holding period of its own.[7]

Despite the concession by the Commissioner that the sale of a partnership interest will be tréated as the sale of a capital asset, there still remain several areas in which this concession will not prevent further litigation. The primary issue in these areas is whether or not there has been a sale or exchange of such an interest. Thus, in G.C.M. 26,379, the concession is qualified by this statement: "The application of this rule should, of course, be limited to those cases in which the transaction in substance and effect, as distinguished from form and appearance, is

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5 See the discussion on this point on page 30, *et seq. supra*.

6 *Ibid*. footnote 4 and 5, *supra*.

7 See footnote 22, p. 46, *supra*.

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5 See the discussion on this point on pages 54, et seq. supra.

6 Ibid. footnote 4 and 5, supra.

7 See footnote 22, p. 46, supra.

essentially the sale of a partnership interest."[8]

One major area of conflict is that involving the distinction between liquidating distributions in cash and kind, and sales or exchanges of partnership interests. The position of the Tax Court in each of these two cases is exemplified in the Henry V. B. Smith[9] and McClellan[10] decisions, respectively. It may be noted that in G.C.M. 26,379 the McClellan case is not listed in the citations of authorities applying the entity theory, nor is the case of Henry V. B. Smith listed among those cited as contra. A second area is that in which there is some question in respect of whether the business formerly carried on by the partnership is to be continued following the withdrawal of one or more partners.

The area involving the nature of payments made to a withdrawing partner from partnership profits is also open to further litigation. However, to the extent that the withdrawing partner has sold some interest in the firm, it is believed the Commissioner will recognize such interest as a capital asset.[11] Also, the problems resulting from the sale

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8 Ibid.

9 5 T.C. 323 (1945).

10 42 B.T.A. 124 (1940).

11 See the discussion on this point on page 65, et seq. supra.

essentially the sale of a partnership interest.[8]

One major area of conflict in this area is the distinction between liquidating distributions of cash and kind, and sales or exchanges of partnership interests. The position of the Tax Court [illegible] cases is exemplified in the [illegible][9] and [illegible][10] decisions, respectively. [illegible] the [illegible] case [illegible] authorities [illegible] V. B. Smith stated among [illegible]. A second area is that in which [illegible] and whether the business [illegible] by the partnership is to be continued [illegible] or more partners.

[illegible] withdrawing partner [illegible] further litigation. [illegible] held that the withdrawing partner has [illegible] the first, it is believed the [illegible] will recognize interest as a capital asset.[11] Also, the problems resulting from the sale

8 Ibid.

9 5 T.C. [illegible] (19[illegible]).

10 [illegible] (1940).

11 See [illegible] [illegible].

of a partnership interest by a partner with a negative figure in his capital account cannot be regarded as entirely settled. However, on principle, there is no reason for a failure to recognize such a sale if the parties agree the partnership interest of the withdrawing partner, nevertheless, has value. In each case, the burden will be upon the taxpayer to prove that he has sold or exchanged an interest in the partnership.[12]

Finally, as respects the taxability of partnership income in the year a partnership interest is sold, the general rule appears to be that where the partnership is not terminated upon the withdrawal of a partner, the dissolution will not affect the taxable year in respect of the continuing partners. However, the taxable year of the withdrawing partner as respects his share of partnership income will end upon withdrawal, and his distributive share of income up to the date of withdrawal is reportable as ordinary income in his taxable year in which the withdrawal occurred. The sale of the partnership interest to the withdrawing partner, however, will be treated as a sale of a capital asset which includes as its basis the partner's undistributed share of income up to the date of withdrawal.[13]

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12 See the discussion on this point on page 66, *et. seq.*, *supra*.

13 See the discussion on this point on page 68, *et. seq.*, *supra*.

of a partnership interest by a partner with a negative figure in his capital account cannot be regarded as definite-ly settled. However, in principle, there is no reason for a failure to recognize such a [illegible] where the partnership interest of the [illegible] has value. In each case, the burden will be on the tax-payer to prove that [illegible] the partnership.[12]

Finally, as respects the taxability of partnership income in the year a partnership interest is sold, the gen-eral rule appears to be that where the partnership is not terminated upon the withdrawal of a partner, the withdrawal will not affect the taxable year of the remaining partners. However, the taxable year of the withdrawing partner as respects his share of partnership income will end upon withdrawal, and his distributive share of income up to the date of withdrawal is reportable as ordinary income for his taxable year in which the withdrawal occurred. The sale of the partnership interest by the withdrawing partner, how-ever, will be treated as a sale of a capital asset which includes as its base the [illegible] income up to the date of withdrawal.

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12 [illegible] sec., supra.

13 [illegible] sec., supra.

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