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TAXATION - FEDERAL INCOME TAX - CAPITAL GAIN ON SALE OF PARTNERSHIP INTEREST

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TAXATION — FEDERAL INCOME TAX — CAPITAL GAIN ON SALE OF PARTNERSHIP INTEREST — In 1936, a taxpayer sold his interest in a partnership the assets of which were mainly acquired subsequent to his entering the partnership in 1932. The government contended that the taxpayer acquired and disposed of an interest in specific partnership assets and that the period for determining the capital gains percentages was properly measured from the date of acquisition of the specific capital assets. In his suit for refund on part of the tax thus computed, the taxpayer claimed that the partnership was a separate juristic entity, that his interest therein was an intangible capital asset, and that the period for determining the applicable capital gains percentages should be dated from his acquisition of the interest in the partnership.[1] *Held*, that a partnership is an association of individuals vested with co-interests in specific partnership property and that the date of the acquisition of the specific assets marks the beginning of the period for ascertaining capital gain percentages. *City Bank Farmers Trust Co. v. United States*, (Ct. Cl. 1942) 47 F. Supp. 98.

In recent years, our law has been torn by a conflict over the question whether the partnership is a separate juristic entity or an association of co-owners of partnership property,[2] but this controversy is not of recent origin. Before the commissioners agreed on a draft of the Uniform Partnership Act, there was serious consideration which theory should be embodied;[3] after the Uniform Partnership Act was drafted the controversy continued, but the dispute of the antagonists centered around the question which theory had been incorporated into the act.[4] The cases demonstrate that the holdings must be carefully

[1] Revenue Act of 1936, § 117, 49 Stat. L. 1691. Cf. 53 Stat. L. 869 (1939), 26 U. S. C. (1940), § 117 (b), and Pub. L. 753, 77th Cong., 2d sess. (1940), § 150.

[2] For a broad analysis of partnership tax problems, see Rabkin and Johnson, "The Partnership Under the Federal Tax Laws," 55 HARV. L. REV. 909 (1942). Tending to make the partnership look like a separate juristic entity is the requirement that partnerships file information returns. 53 Stat. L. 70 (1939), 26 U. S. C. (1940), § 187; TREAS. REG. 103 (1940), § 19.187-1. On the other hand, we find that "Individuals carrying on business in partnership shall be liable for income taxes only in their individual capacity." 53 Stat. L. 69 (1939), 26 U. S. C. (1940), § 181.

[3] Drake, "Partnership Entity and Tenancy in Partnership: The Struggle for a Definition," 15 MICH. L. REV. 609 (1917). The first draft of the Uniform Partnership Act by Dean Ames was to be along the lines of the mercantile theory of partnership, and he submitted a draft in which the partnership was defined as "a legal person formed by association." After the death of Dean Ames the committee found what seemed insurmountable difficulties and went back to the association theory.

[4] The views of an author of the act (Lewis) and a sponsor of the entity theory (Crane) were aired in the law reviews: Lewis, "The Uniform Partnership Act," 24 YALE L. J. 617 (1915); Crane, "The Uniform Partnership Act—A Criticism," 28 HARV. L. REV. 762 (1915); Lewis, "A Reply to Mr. Crane's Criticism," 29 HARV.

limited to their facts, because a given court will treat the partnership as a separate juristic entity for some purposes [5] while for others it will refuse so to

L. REV. 158, 291 (1915); Crane, "The Uniform Partnership Act and Legal Persons," 29 HARV. L. REV. 838 (1916).

Judge Learned Hand is convinced that the Uniform Partnership Act did not make the partnership a separate juristic entity, but that the commissioners chose to retain pluralistic notions about the partnership. Rossmore v. Commissioner of Internal Revenue, (C. C. A. 2d, 1935) 76 F. (2d) 520; Helvering v. Smith, (C. C. A. 2d, 1937) 90 F. (2d) 590. Michigan also adopted the Uniform Partnership Act and in Michigan the partnership is a separate entity. Schram v. Wrubel, (D. C. Mich. 1940) 38 F. Supp. 357.

The separate entity argument under the Uniform Partnership Act is mainly dependent on the following sections of the act:

(a) Sec. 26: "The partner's interest in the partnership is his share of profits and surplus, and the same is personal property."

(b) Sec. 8 is entitled "Partnership Property," and implies ownership by the partnership entity, distinct from the partners.

(c) Sec. 8(3) enables the partnership to take title to real estate in the partnership name and such property can only be reconveyed in the partnership name.

(d) Sec. 9(1) makes every partner the agent of the partnership, not his partners.

(e) Sec. 12 refers to fraud by a partner on the partnership, not on his copartners.

(f) Sec. 21 makes the partner accountable to the partnership, not to his copartners.

(g) Sec. 35 speaks of the partner's power to bind the partnership, not his copartners, after dissolution.

The usefulness of the state law on this question is considerably impaired by Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74 (1932), and Lyeth v. Hoey, 305 U. S. 188, 59 S. Ct. 155 (1938). These cases give expression to the idea that the federal income tax law is an exercise of a plenary power of Congress and is to be given a uniform construction of nationwide application except in so far as Congress makes its operation dependent on state law.

[5] In the following cases it was held that the partnership is a separate entity:

W. J. Burns, 12 B. T. A. 1209 (1928), where it was held that the debt of a partnership on an accrual basis could be deducted by a partner whose other matters were on a cash basis. See also Lord Farres, 25 B. T. A. 154 (1932), following the Burns holding.

Dudley T. Humphrey, 32 B. T. A. 280 (1935). The board relied on Blodgett v. Silberman, 277 U. S. 1, 48 S. Ct. 410 (1927), where it was held that the interest in a partnership was an intangible whose transfer was subject to death duties only at the domicile of the decedent. The board held that the interest in a partnership was a capital asset apart from specific partnership assets.

The case of Jennings v. Commissioner of Internal Revenue, (C. C. A. 5th, 1940) 110 F. (2d) 945, indicates that the partnership is recognized as an entity apart from the partners in bankruptcy proceedings but not in income taxation. In this case it was held that a partner could offset his net gambling gains against his distributive share of partnership gambling losses. [Gambling losses are deductible only from gambling gains, 53 Stat. L. 13, 26 U. S. C. (1940), § 23 (h).]

In Neuberger v. Commissioner of Internal Revenue, 311 U. S. 83, 61 S. Ct. 97 (1940), Justice Murphy indicates that "Cases variously emphasizing the character of partnerships as business units or as associations of individuals but not involving [the

do.[6] Therefore, the legislative purpose underlying the capital gains provision in the Revenue Act of 1936 [7] should determine which theory is properly employed in settling a controversy like that in the principal case. The capital gains provision was designed to treat an appreciation in value arising over a period of years, but realized in one year, in such fashion that the tax would roughly approximate what it would have been had a tax been paid each year upon the appreciation in value for that year.[8] An interest in a going concern is more than mere ownership of specific assets. A partner is entitled to (1) an accounting and recovery of his share, (2) co-ownership in the partnership assets, and (3) earnings and surplus.[9] A sale of his interest involves a disposition of all of these rights, but emphasis on the third would lead to a consideration of the partnership as a separate legal entity while emphasis on the second would lead to the conclusion that the partnership is an association of co-owners of specific assets.[10] It is conceded that appreciation in the value of specific tangible assets of an enterprise may be a determinant of the gain realized on the sale of a partnership interest, but a more important determinant is enhanced earning power resulting from such factors as superiority of production and distribution methods, the favorable reaction of customers, the willingness of employees to work for the employer as against his competitors, the favorable attitude of credit institutions and investors, and the various other factors contributing to the com-

section of the Revenue Act controlling the litigation] are of little aid in ascertaining its meaning." (Headnote 4.) "In requiring a partnership informational return although only individual partners pay any tax, Congress recognized the partnership both as a business unit and as an association of individuals." 311 U. S. at 88.

[6] In the following cases it was held that the partnership is not a separate legal entity:

Jenning v. Commissioner of Internal Revenue, (C. C. A. 5th, 1940) 110 F. (2d) 945, where it was held that a partner could offset his net gambling gains against partnership gambling losses.

United States v. Coulby, (C. C. A. 6th, 1919) 258 F. 27, per curiam affirming (D. C. Ohio 1918) 251 F. 983, where it was held that dividends paid a partnership were exempt in the partners' hands as income from dividends.

Harris v. Commissioner of Internal Revenue, (C. C. A. 2d, 1930) 39 F. (2d) 546, where it was held that an assignment of profits independent of a conveyance of partnership assets could not relieve the taxpayer of the duty to pay income taxes on partnership profits. But this case may mean only that one owning the partnership assets is a partner for the purpose of the income tax law, even if he is not entitled to earnings.

Craik v. United States, (Ct. Cl. 1940) 31 F. Supp. 132, where it was held that a partner could claim that income of a domestic partnership from sources outside the United States should be treated as if received directly by the partner.

[7] Revenue Act of 1936, § 117, 49 Stat. L. 1691.

[8] Kenan v. Commissioner of Internal Revenue, (C. C. A. 2d, 1940) 114 F. (2d) 217 at 220.

[9] Commissioner of Internal Revenue v. Shapiro, (C. C. A. 6th, 1942) 125 F. (2d) 532. A partner has no right to individual specific assets, but has rather a right to the surplus after the partnership debts are paid. It was also stated that an interest in a going concern is in its main essentials different from the interest in the ordinary assets of the partnership.

[10] Stilgenbaur v. United States, (C. C. A. 9th, 1940) 115 F. (2d) 283.

mercial advantage of an enterprise.[11] In essence, the price increment giving rise to the gain is paid for an expected superiority of future returns, and to the extent that the enhanced value of the partnership is attributable to such factors it would seem that the gain has accrued from the date of the acquisition of the partnership interest. To the extent, however, that the gain is attributable only to an enhancement in the value of the tangible assets of the enterprise, it would seem logical to date the gains from the acquisition of the specific assets.[12] Such an apportionment, though, is not feasible because of the administrative difficulties to which it would give rise. Even the parties to a sale of a partnership interest in a going concern seldom endeavour to apportion the purchase price. Their primary concern is with the earning prospects of the enterprise; the ownership of the specific business assets is incidental to that purpose. It would seem, therefore, that business usage would justify emphasis on the right to earnings and the conclusion that, for the purpose of the capital gains tax, an interest in a partnership is property in a separate juristic entity and is therefore an asset apart and distinct from the co-ownership of specific partnership property.

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[11] For further development of goodwill and the other elements that enhance the value of a going concern over the sum of values of the component tangible assets, see: YANG, GOODWILL AND OTHER INTANGIBLES (1927); DICKSEE, GOODWILL AND ITS TREATMENT IN ACCOUNTS, 4th ed., c. 8 (1920); LEAK, COMMERCIAL GOODWILL, 2d ed., c. 2 (1930); PATON, ADVANCED ACCOUNTING 397 (1941).

[12] Where an enterprise is liquidated by sale of the specific assets, it would be simple to prorate the gain to specific assets. But, it is unlikely that a gain would be realized where circumstances compel the the liquidation of the enterprise.

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