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NOTE

FEDERAL TAXATION

SALE OF A PARTNERSHIP INTEREST—A CAPITAL GAIN?

A current prediction of the tax treatment to be accorded the sale of a partnership interest involves considerations which have in recent years crystallized into recognizable form. They must be distilled from pertinent tax cases; for the Code presents, without choosing from, alternatives between capital gains and ordinary income taxation.¹

The arguments advanced in favor of both Code sections have heavily utilized theoretical concepts as to the nature of a partnership. The dispute, ultimately, has been phrased in terms of whether a partnership is an entity or merely a co-ownership of assets. The Revenue Act does not explicitly adopt either theory² nor is it possible to infer an intent of Congress from the few separate sections which relate to some aspects of partnership taxation.³ Traditionally the characteristics of a partnership in other than tax relations cannot be considered binding.⁴

1. INT. REV. CODE §§ 11, 12 and § 117(c).

2. See INT. REV. CODE §§ 181-190, 113(a) (13); *cf.* INT. REV. CODE §§ 42(a), 43. INT. REV. CODE § 181 imposes the burden of payment on the individual partner. The tax payment is based on the partner's share of distributive income from the partnership for its preceding tax year. INT. REV. CODE §§ 182, 183, 188. The partnership, however, must file a return for information purposes. See INT. REV. CODE § 188. Thus these few sections view the individual, not the partnership, as the taxable entity. No mention is made of the tax treatment to be accorded the sale of a partnership interest. *Cf.* § 183 (capital assets of the partnership).

3. As to deduction of individual losses from partnership gains or partnership losses from individual gains, the decisions, which turn on precise statutory interpretation, recognize the partnership as an entity in certain cases while refusing to do so in others. See *Johnston v. Commissioner*, 86 F.2d 732 (2d Cir. 1936) (no cross deduction); *Jennings v. Commissioner*, 110 F.2d 945 (5th Cir. 1940) (allowed deduction of individual wagering losses from similar partnership gains); *Neuberger v. Commissioner*, 311 U. S. 83 (1940) (declared the pre-1933 and post-1937 law to be that cross-deduction could be taken); *Commissioner v. Lamont*, 156 F.2d 800 (2d Cir. 1946) (cross-deduction disallowed under 1936 Revenue Act).

As to the dual nature of a partnership for income taxation, *see Neuberger v. Commissioner*, 311 U. S. 83, 88 (1940).

Compare the numerous sections relating to taxation of corporations. See e.g., INT. REV. CODE §§ 13, 14, 15, 26, 27, 28, 52, 101, 113, 501-511. A tax is imposed upon the corporate entity itself, as distinct from the tax on each stockholder. INT. REV. CODE § 13.

4. *Commissioner v. Shapiro*, 125 F.2d 532, 535 (6th Cir. 1942). Mr. Justice Frankfurter once remarked, "The importation of . . . distinctions and controversies from the law of property into the administration of the estate tax precludes a fair and workable tax system. Essentially the same interests, judged from the point of view of wealth, will be taxable or not, depending upon elusive and subtle casuistries which may have their historic justification but possess no relevance for tax purposes." *Helvering v. Hallock*, 309 U. S. 106, 118 (1940). Compare, however, Judge Learned Hand's discussion of the common law, equity, and bankruptcy concepts of a partnership in *Commissioner v. Lehman*, 165 F.2d 383, 384-385 (2d Cir. 1948).

The official approach of the Bureau of Internal Revenue, partly supported and partly censured in the literature,⁵ has been that every partner owns an aliquot part of each partnership asset.⁶ Sale of the interest therefore is nothing more than sale of a moiety in each of the assets affected.⁷ Admittedly this theory of comminution has slight tacit support in the Revenue Acts⁸ and in the conception of a partnership in the Uniform Partnership Act.⁹ Not coincidentally, it also would produce the largest amount of revenue where gain results from sale—the increase from the sale of those assets which individually would not fit the tax definition of capital assets are thus taxed at ordinary rather than capital rates. The courts, in an overwhelming majority of cases, have ruled against the argument that the taxpayer owns but an undivided share of *each* asset.¹⁰

5. Brookes, *The Strange Nature of the Partnership Under the Income Tax Law*, 5 TAX L. REV. 35 (1949); Rabkin and Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942).

6. In G. C. M. 10092, XI-1 CUM. BULL. 114 (1932), this position was carefully set forth. (But see Henry Wilson, 16 B. T. A. 1280 (1929), in which the Commissioner had won on the opposite theory.) An example by the Chief Counsel demonstrates the co-ownership theory applied to the problem of basis. A mill contributed by A cost him \$10,000 but at contribution was worth \$100,000. A would not be taxed on a \$90,000 gain at contribution because no gain was *realized*—not because no gain was *recognized*. B contributed \$100,000 in cash. Profits were to be shared equally. The partnership sold the mill for \$200,000. B would be taxed on \$50,000, A on \$140,000 (\$50,000 plus the \$90,000 the property had appreciated before its transfer to the partnership). Thus the partnership entity would be disregarded. Two early cases, very similar to the above example, went directly contrary to the Bureau's theory. *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934), *cert. denied*, 293 U. S. 594 (1934); *Helvering v. Archbold*, 70 F.2d 720 (2d Cir. 1934). Although the direct holdings of those cases were disapproved by Congress, Revenue Act of 1934, § 113(a)(13), 48 STAT. 708 (1934), their underlying theory is very much alive. See Robert E. Ford, 6 T. C. 499 (1946), and G. C. M. 26379, 1950 INT. REV. BULL. No. 10 at 4 (1950), which expressly revoked G. C. M. 10092.

7. Thus the underlying co-ownership theory of G. C. M. 10092, XI-1 CUM. BULL. 114 (1932), was carried over from its application to the basis issue to the problem whether there was a partnership "interest" which could be sold. The Bureau concluded that for tax purposes a partnership was not an entity, hence there was no "interest" which was a capital asset. See e.g., the government's position in *Commissioner v. Lehman*, 165 F.2d 383, 384 (2d Cir. 1948); *Kessler v. United States*, 124 F.2d 152, 154 (3d Cir. 1941); *Dudley T. Humphrey*, 32 B. T. A. 280, 282 (1935).

8. See note 2 *supra*.

9. Uniform Partnership Act §§ 6, 8, 18, 25, 31, 42.

10. *Swiren v. Commissioner*, 183 F.2d 656 (7th Cir. 1950); *LeSage v. Commissioner*, 173 F.2d 826 (5th Cir. 1949); *United States v. Shapiro*, 178 F.2d 459 (8th Cir. 1949); *Commissioner v. Smith*, 173 F.2d 470 (5th Cir. 1949), *cert. denied*, 338 U. S. 818 (1949); *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *cert. denied*, 334 U. S. 819 (1948); *United States v. Landreth*, 164 F.2d 340 (5th Cir. 1947); *Thornley v. Commissioner*, 147 F.2d 416 (3d Cir. 1945); *Commissioner v. Shapiro*, 125 F.2d 532 (6th Cir. 1942); *Davis v. United States*, 4 P-H 1950 FED. TAX SERV. ¶ 72,396 (1950); *Estate of Aaron Lowenstein*, 12 T. C. 694 (1949); *Estate of William T. Jones*, P-H 1944 TC MEM. DEC. ¶ 44,028 (1944); *George R. McClellan*, 42 B. T. A. 124 (1940); *Dudley T. Humphrey*, 32 B. T. A. 280 (1935). See also *Kessler v. United States*, 124 F.2d 152 (3d Cir. 1941); *Stilgenbaur v. United States*, 115 F.2d 283 (9th Cir. 1940); *Gene Bass*, P-H 1950 TC MEM. DEC. ¶ 50,055 (1950). *Cf.* *Bull v. United States*, 295 U. S. 247 (1935); *Doyle v. Commissioner*, 102 F.2d 86 (4th Cir. 1939); *Helvering v. Smith*, 90 F.2d 590 (2d Cir. 1937); *Hill*

An occasionally propounded hypothesis, based on comminution, that individual assets have not been held for the requisite period (although the taxpayer was a partner for that term) has been equally ill-fated.¹¹ The courts consistently have held the sale of a partnership interest (as distinguished from the sale of the entire partnership¹²) is the sale of a capital asset. In determining whether an interest has passed, inquiry has been directed, in each case, to whether a share of a *going concern* was sold.¹³ This deemphasis of the conceptualistic approach is most laudable. That the partnership interest is viewed as a capital asset should only incidentally, not causally, be related to the theory that the partnership is an entity.¹⁴

General Counsel's Memorandum 26379, issued in May, 1950,¹⁵ essentially realigns the Bureau with the judicial approach. Although the Commissioner has finally abandoned comminution, the memo states that the "transaction in substance and effect, as distinguished from form and appearance, [must be]

v. Commissioner, 38 F.2d 165 (1st Cir. 1930); Estate of Herbert B. Hatch, 14 T. C. 251 (1950); James W. McAfee, 9 T. C. 720 (1947); W. Frank Carter, 36 B. T. A. 60 (1937). *Contra*: City Bank Farmers Trust Co. v. United States, 47 F. Supp. 98 (Ct. Cl. 1942).

11. Commissioner v. Lehman, 165 F.2d 383 (2d Cir. 1948); Thornley v. Commissioner, 147 F.2d 416 (3d Cir. 1945); Frank Killian, P-H 1944 TC MEM. DEC. ¶ 44,244 (1944).

12. Sale of a whole partnership would not appear to differ from the sale of a going individual proprietorship. In Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (Judge Frank dissenting), Judge Learned Hand held that a "whole business" was not in Anglo-American law considered an entity and not therefore a capital asset. He acknowledged that the Second Circuit had held that a partner's interest in a partnership was a capital asset. This, it seems, could logically be applied where the "interest" amounts to ownership of the whole. Compare Commissioner v. Shapiro, 125 F.2d 532, 535 (6th Cir. 1942).

13. See note 21 *infra*. "The decision must turn on the meaning of the phrase 'capital assets' as that phrase is ordinarily understood. . . . [I]t means all capital invested plus all surplus accounts or undivided profits left in the business . . . and in addition . . . good will. . . . [W]here . . . there is a sale of a part interest in a *going concern*, no change is wrought [by dissolution] in the character of the property sold." (Italics added.) Commissioner v. Shapiro, 125 F.2d 532, 535 (6th Cir. 1942).

14. ". . . [A] decision of this more or less troublesome question [whether a partnership is an entity] would throw no light on the present controversy. . . ." Commissioner v. Shapiro, 125 F.2d 532, 535 (6th Cir. 1942).

15. G. C. M. 26379, 1950 INT. REV. BULL. No. 10 at 4 (1950) states: ". . . 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. [Citations omitted.] See also [citation omitted] wherein the court . . . held that the basis for computing gain or loss on an asset purchased by a partnership and sold after the retirement of one of the partners was the original cost of such asset when acquired by the firm.

"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 under the provisions of section 117 of the Internal Revenue Code. 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. (See *Estate of Herbert B. Hatch et al. v. Commissioner*, 14 T. C. 251.) For example, payments made to a retiring partner which represent his distributive share of earnings for past services should be treated as ordinary income rather than the proceeds derived from a sale of his interest. [Citations omitted.] . . .

"G. C. M. 10092 (C. B. XI-1, 114 (1932) is hereby revoked . . ."

essentially the sale of a partnership interest." Passage of title to only the interest in a part of the assets will not suffice to obtain capital gains treatment. "Payments made to a retiring partner which represent his distributive share of earnings for past services should be treated as ordinary income rather than the proceeds derived from a sale of his interest."¹⁶

The standards which the Commissioner will follow in allowing capital rates are predictable. But of primary concern to the counselor are definitions of the elements necessary to a strong bargaining position or to successful litigation and cases unfavorable to the Bureau which present a dissimilar interpretation of what constitutes an interest.¹⁷

A synthesis of the cases reveals it to be indispensable that a convincing picture of earning potential be shown.¹⁸ And, although the Code definition of capital assets does not coincide with the business usage of the term,¹⁹ the two become essential equivalents in this area. If the sale has been of income or the right to income, as distinguished from earning potential, the more desired taxation will not be attained.²⁰

The most important consideration in finding an earning potential is the presence of partnership assets, although these need not be the primary producers of income to the business. Even though certain assets included in the

16. *Ibid.*

17. See e.g., H. R. Smith, 10 T. C. 398 (1948), *affirmed*, 173 F.2d 470 (5th Cir. 1949), *cert. denied*, 338 U. S. 818 (1949); L. F. Long, P-H 1947 TC MEM. DEC. ¶ 47,155 (1947), *affirmed*, 173 F.2d 471 (5th Cir. 1949), *cert. denied*; 338 U. S. 818 (1949); Estate of William T. Jones, P-H 1944 TC MEM. DEC. ¶ 44,028 (1944).

18. See note 10 *supra*. The criteria necessary to prove actual sale of an interest and intent to sell it are the same criteria which were necessary to obtain capital gains rates when the Commissioner expounded commutation. During that period the courts invariably required these indicia before they would follow the court-established principle that an interest was a capital asset.

19. See note 13 *supra*. INT. REV. CODE § 117(a)(1)(B) excludes property used in the trade or business, of a character subject to allowance for depreciation, or real property used in the trade or business from the term "capital assets"; this obviously departs from the common understanding of "capital assets." Compare, however, the effect of § 117(j) which in effect cancels out the above exclusion.

20. *Hort v. Commissioner*, 313 U. S. 28 (1941). In *Helvering v. Smith*, 90 F.2d 590 (2d Cir. 1937), S retired from a law firm. The articles provided that on withdrawal the lease, library, and other named assets were to belong to the continuing business. The payment was to be for S's share of earnings up to the time of withdrawal. The gain to S was taxed at ordinary rates. This was so although as evinced by later cases the Second Circuit adopted capital gains treatment of a sale of a partnership interest where more than the right to income was sold. *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948). See also *Munson v. Commissioner*, 100 F.2d 363 (2d Cir. 1938). *Cf. Merrill v. Commissioner*, 173 F.2d 310 (2d Cir. 1949).

Upon leaving a law partnership a partner agreed that for his interest in accounts receivable and for unbilled claims he should be paid a lump sum of \$20,000. But the agreement specified that if this was more or less than his actual share, remittance was to be made. The dispute in this case was whether a further remittance made to him according to the agreement was capital gain. Held: A mere distribution of earnings, hence ordinary income. *James W. McAfee*, 9 T. C. 720 (1947). See also *Doyle v. Commissioner*, 102 F.2d 86 (4th Cir. 1939).

"interest" sold will not qualify as capital assets individually, lumping them together in an income-producing unit results in an asset which is capital.²¹ An almost infinite variety of assets can be supposed which are sufficient evidence of earning power. Real property, plant and machinery, and inventories are tangibles which are normally fruitful of income. But most intangibles, such as securities, good will, contracts, and firm names are also productive.²² Bona fide capital accounts, indicating earning or investment power, tend to persuade tribunals that partnership assets consist of other than earned income standing alone.²³

In order to create an earning unit in which an interest may be held, assets must necessarily be contributed or accumulated²⁴ by a partner or partners. Thus one who fails to add to the assets which constitute the productive foundation of the earning entity can inferentially be said not to own an "interest." That this is at best a questionable inference is indicated by a case which upheld the application of capital rates where the seller made no contribution.²⁵ In the ordinary arms length transaction contribution would be made; but in other cases in the absence of an initial cash contribution, a record in favor of capital gains taxation may be inexpensively built. If only good will or prestige are contributed, a valuation of these on the firm books could be

21. *Commissioner v. Shapiro*, 125 F.2d 532, 535 (6th Cir. 1942): ". . . The price paid . . . may have been based partly on assets excluded under the act from the phrase 'capital assets' . . . but the sale made by respondent was not a sale of those assets. . . . Respondent sold all of his interest in the partnership . . . as a *going concern*, which in all essentials is different from the ordinary assets of the partnership used in the usual course of business . . ." (Italics added.)

22. *Swiren v. Commissioner*, 183 F.2d 656 (7th Cir. 1950) (partnership name, good will, fixtures, library, cash, billed and unmatured fees, and accounts receivable); *United States v. Shapiro*, 178 F.2d 459 (8th Cir. 1949) (apartment house); *Commissioner v. Smith*, 173 F.2d 470 (5th Cir. 1949) (cash, accounts receivable, inventory and fixed assets); *United States v. Landreth*, 164 F.2d 340 (5th Cir. 1947) (contracts, plant and machinery); *United States v. Anderson*, 161 F.2d 942 (9th Cir. 1947) (patents and trade marks); *Thornley v. Commissioner*, 147 F.2d 416 (3rd Cir. 1945) (contracts, good will, real and personal property). See also *Stilgenbaur v. United States*, 115 F.2d 283 (9th Cir. 1940) (bonds, real estate, leases, and inventory); *Munson v. Commissioner*, 100 F.2d 363 (2d Cir. 1938) (stock exchange seat).

23. *LeSage v. Commissioner*, 173 F.2d 826 (5th Cir. 1949); *Munson v. Commissioner*, 100 F.2d 363 (2d Cir. 1938); *James W. McAfee*, 9 T. C. 720 (1947); *George R. McClellan*, 42 B. T. A. 124 (1940).

24. See *Gustav Hirsch*, P-H 1942 TC MEM. DEC. ¶ 42,073 (1942); 97 U. OF PA. L. REV. 52, 59 (1948).

25. In *Walter J. Gresham*, 8 T.C.M. 77 (1949), the Commissioner contended that since taxpayer had made no contribution, gain from the sale of his interest was ordinary income. The court, however, held that the portion received which was attributable to income should be taxed as income and that portion disclosed to be capital gain should be so taxed (with basis of zero). Compare *Bull v. United States*, 295 U. S. 247 (1935). One ground for upholding an income tax levied on payments received by the estate for deceased's interest in the partnership was that no capital contribution had been made. Perhaps this alone would not have been controlling without the presence of other elements in the case. One of these was that the payment was to be as if the estate were a partner for a year after the decedent's death.

made.²⁶ This should be done at the time of entry or at least a reasonable length of time before sale. Likewise, a small cash donation to the partnership might weaken the objection that there has been no contribution in fact.

Accounts receivable and unbilled claims for services or goods, alone, are not assets which produce earnings—they are earnings.²⁷ Nevertheless, current decisions indicate that when a partnership owns assets in addition to accounts receivable or unmatured claims, the combination will support treating the entire “sale” as that of a capital asset. The question then is one of determining how large a ratio of other assets to accounts receivable will be required before capital gains treatment may be achieved.

The Commissioner, protesting against this approach, has taken the position, at least where a service firm is involved,²⁸ that the sale price of an interest should be divided between what is earned income (accounts receivable and unbilled claims as well as distributable income) and what represents the sale price for the interest. The former would be taxed at ordinary, the latter at capital rates. His argument for allocation is implicit in G.C.M. 26379. A number of valid grounds support the Commissioner’s stand. Accounts receivable are thought of as ordinary income by most businessmen. Unlike cash on hand or bank accounts, decision whether the amounts represented by uncollected accounts are to be distributed as profits or plowed back into the firm as investment usually awaits their liquidation. And in sale of a deceased partner’s interest such lumping apparently is disallowed by statute.²⁹ But a split of case authorities leaves clouded the question, and hence the practical propriety, of allocation.³⁰ In certain instances, therefore, non-allocation between what is

26. Prestige, in service firms, is one of the most important factors necessary to success in business and there appears no reason why a valuation set upon it should not be respected.

27. *Doyle v. Commissioner*, 102 F.2d 86 (4th Cir. 1939). See note 20 *supra*.

28. G. C. M. 26379, 1950 INT. REV. BULL. No. 10 at 4 (1950). Including earned income in the sale price for the interest will not evade the Bureau’s position. The Commissioner could assess ordinary rates on the entire sale price but the existence of such an intention is denied. Hence he will allocate to ordinary income that proportion of the sale price which stems from ordinary earnings.

Quaere: Will this position be followed as to a non-service firm? Accounts receivable possessed by such a firm cannot be equated to income in the course of business, for a large part of these accounts receivable will serve only to cover costs. That part which can be traced to cost represents the equivalent of inventories and certainly should be included in the “interest” since inventories are properly includible. Only the margin would be a proper subject of apportionment. It is doubtful that such a policy will be adopted for the methods of figuring how much is margin, or profit, vary. And lack of information regarding pertinent factors may make such a task difficult. Compare, however, *Louis Karsch*, 8 T. C. 1327, 1332 (1947).

29. See INT. REV. CODE §§ 42(a), 126, 182. See Note, *The Death of a Partner and the Federal Income Tax*, 50 COL. L. REV. 658 (1950).

30. Against the Bureau the most clear cut cases are *Swiren v. Commissioner*, 183 F.2d 656 (7th Cir. 1950); *Estate of William T. Jones*, P-H 1944 TC MEM. DEC. ¶ 44,028 (1944) (in both of which the partnerships were law firms); *Mignonette E. Luhrs*, P-H 1950 TC MEM. DEC. ¶ 50,160 (1950) (partnership to operate orange grove); *H. R. Smith*,

obviously earned income and such other items as good will, furniture, fixtures, library, and cash appears of questionable desirability in the handling of the partner-taxpayer's problem.

In *Swiren v. Commissioner*,³¹ the most recent case to consider the allocation question, an agreement of sale specified that taxpayer assign "all his share and interest" in the name and good will, all furniture, fixtures, library, cash, fees earned whether or not billed, and accounts receivable.³² The taxpayer reported the entire increase as capital gain, but the Commissioner divided the items so that the favorable rates would not apply to the fees and accounts receivable.³³ This apportionment the Tax Court sustained³⁴ but the Seventh Circuit reversed, relying on the proposition, which abstractly is valid, that the "sale of an interest in a partnership is the sale of a capital asset, regardless of the nature of the partnership properties."³⁵ No distinction was drawn between the Bureau's position on allocation and the comminution argument which apparently had not been made.³⁶ As a result, insufficient consideration was given to the fairness and reason of the policy behind allocation.

Even though the argument for apportionment ultimately was rejected in the *Swiren* case, it is unlikely that the Commissioner will abandon it; some cases favor the Commissioner's approach.³⁷ Despite the conflict of authority, a firm stand by a taxpayer against allocation, even at the risk of litigation,

10 T. C. 398 (1948), *affirmed*, 173 F.2d 470 (5th Cir. 1949) (an oil field supplies firm); L. F. Long, P-H 1947 TC MEM. DEC. ¶ 47,155 (1947), *affirmed*, 173 F.2d 471 (5th Cir. 1949) (a partnership to hold oilfield leases, rigs, and other assets). See also Thornley v. Commissioner, 147 F.2d 416, 418 (3d Cir. 1945); Walter J. Gresham, 8 T. C. M. 77 (1949). *Contra*: LeSage v. Commissioner, 173 F.2d 826 (5th Cir. 1949) (automobile dealership—here the earnings during negotiations for sale were lumped as part of the interest. Held: Such earnings are taxable at ordinary rates and the interest at capital rates); Doyle v. Commissioner, 102 F.2d 86 (4th Cir. 1939) (law firm); Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937) (law firm); James W. McAfee, 9 T. C. 720 (1947) (law firm); Louis Karsch, 8 T. C. 1327 (1947) (partnership to manufacture thread—that portion disclosed by an audit to be income was taxed as income; the remainder was taxed as capital gain.)

31. 183 F.2d 656 (7th Cir. 1950).

32. *Id.* at 658.

33. The Commissioner in an amended answer unsuccessfully attempted to make a much stricter allocation than his first. The second would have applied capital gains rates only to the amount representing the value of the tangible assets. Petitioner contended the added price was for good will. Max Swiren, 8 T. C. M. 924, 928 (1949).

34. Max Swiren, 8 T. C. M. 924 (1949).

35. Swiren v. Commissioner, 183 F.2d 656, 659 (7th Cir. 1950).

36. The Commissioner recognized in his deficiency notice to Swiren that the latter had a proprietorship interest in the law firm. Max Swiren, 8 T. C. M. 924, 927 (1949). Pervading the Tax Court opinion was an assumption that petitioner did have such an interest. The Seventh Circuit, however, thought that the Bureau had followed its old argument that a partnership "interest" must be broken into its segments—that a sale was of the interest in each specific asset. The Commissioner's deficiency notice would seem to negative the correctness of the Circuit Court's position. See Swiren v. Commissioner, 183 F.2d 656, 658 (7th Cir. 1950).

37. See note 30 *supra*.

may sometimes be warranted. Within the seventh circuit non-allocation may well be hazarded. And in other jurisdictions the attractiveness of a tax saving in excess of litigation costs suggests the same approach.

When the conclusion is reached, in a particular case, that there is little chance of total success on non-allocation, it will be more expedient for the taxpayer, when filing, to allocate by his own formula; the imposition of an unfavorable formula computed by the Bureau may be avoided.³⁸ The amounts which may be allotted to income represented by accounts receivable are often variable. But once challenged, and it becomes impossible to secure a desirable compromise, the taxpayer's allocation may be upheld.³⁹

The second major condition to application of capital gains rates is the six month holding period.⁴⁰ The time passing between acquisition and sale of a partnership interest is the measure of the holding period;⁴¹ the time the partnership has held each of the individual assets comprising the interest is not controlling.

Finally, the language of the agreement of sale and articles of partnership deserves note.⁴² They may be indicative of an intent to pass an interest rather than a share in specific assets as such; they can evince that the transfer of an interest was actually effected.⁴³ Thus a characterization in the sale agreement that "all the right and title in the partnership business is transferred"⁴⁴ is advisable. Such characterization indicates that an interest in an earning unit has passed and negates the idea that the several assets are desired for their use individually. Including a list of the assets in addition to the omnibus

38. See note 33 *supra*.

39. "Inasmuch as the petitioner and the members of his former law firm made no allocation between the various items involved in the settlement and there is no factual basis by which the court may make an allocation, and as the determination made by the respondent is, in our judgment, eminently fair to petitioner, it will not be disturbed . . ." Max Swiren, 8 T. C. M. 924, 928 (1949). Had petitioner made a reasonable allocation, the Tax Court may have approved it.

40. INT. REV. CODE § 117(b). See also INT. REV. CODE § 117(c)(2).

41. *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948); *Thornley v. Commissioner*, 147 F.2d 416 (3d Cir. 1945). See also *Commissioner v. Smith*, 173 F.2d 471 (5th Cir. 1949); *Kessler v. United States*, 124 F.2d 152 (3d Cir. 1941).

42. Compare *Kessler v. United States*, 124 F.2d 152 (3d Cir. 1941) (in which there was almost a complete lack of such evidence with a resulting decision that partnership interests had not been exchanged for stock of a corporation formed to take over the partnership business) with *Thornley v. Commissioner*, 147 F.2d 416 (3d Cir. 1945) (where in subsequent litigation involving the same transfers much more evidence introduced as to the agreement and bill of sale was held to indicate exchange of an interest).

43. "If the executors intended to part with the interests of their estates in the good will of the old firm, and the new firm . . . intended to acquire the same, the question is whether the agreements . . . and the acts of the parties constitute sufficient evidence from which such a deduction could reasonably be made." *Pope v. Commissioner*, 39 F.2d 420, 423 (1st Cir. 1930). *Estate of William T. Jones*, P-H 1944 TC MEM. DEC. ¶ 44,028 (1944), similarly considered the partnership agreement although intent, as such, was not discussed. See *W. Frank Carter*, 36 B. T. A. 60, 63 (1937).

44. *Frank Killian*, P-H 1944 TC MEM. DEC. ¶ 44,244 (1944).

phrase, as is commonly done, will not detract from the inference that an earning unit has passed if the compilation is complete.⁴⁵ Provisions in partnership articles that grant remaining partners the option of buying a withdrawing partner's interest indicate that the partners themselves considered the interest valuable beyond the worth of the individual assets.⁴⁶ This is evidence that earning capacity, not mere value, was the subject of the transfer. Inquiry into the true nature of the sale justifiably will not be forestalled, however, by the use of the description, "all the business and assets" of X, "a co-partnership," when facts reveal the disposal of a share in only a portion of the partnership assets.⁴⁷

The quest for capital gains rates presupposes gain rather than loss upon sale of an interest. Most contemporaneous sales produce profit to the seller. However, the future may herald a price recession during which the greater number of such sales will result in loss to the retiring or deceased partner. What can be done to minimize the tax if this contingency occurs?

Comminution should not be argued; it is dead for both the Bureau and the taxpayer.⁴⁸ The partnership might liquidate its assets singly in order to reduce business capacity. Loss sustained arguably could be business loss, and thus deductible under §23(e). But since this is a weak argument, it may be advisable for the partnership to liquidate gradually over years, with several yearly capital loss allowances more nearly absorbing the loss. If a taxpayer desires sudden severance from the partnership, and wishes to avoid capital loss limitations,⁴⁹ he might argue that the interest sold was an asset used in his trade or business,⁵⁰ thus ordinary loss deductions would be available under

45. For example, in *Estate of Herbert B. Hatch*, 14 T. C. 251 (1950), which involved a partnership to sell, distribute, and repair motor vehicles, the vendors "as co-partners . . . [sold] . . . all the business and assets of the Hatch Motor Company," except the General Motors franchise, two automobiles, a substantial amount of cash, and the partnership name. Only part of the liabilities were assumed by the purchaser. Held: No attempt was made to buy interests, and the sale was of partnership assets as such. Taxation depends on whether each specific asset did or did not conform to the § 117 definitions.

46. "Another indication that the partners recognized that their interest in the firm had value was the right granted to buy a deceased partner's interest by payment of a lump sum equal to his share of the firm's profits for the 30 months preceding his death, thereby clearly indicating that the sum to be paid was determinable by the deceased partner's interest in profits, not as such, but as a yardstick to value his interest in the partnership at the time of his death. *Estate of Bavier C. Miller*, 38 B. T. A. 487, 493 (1938).

47. See note 45 *supra*. The factual line of demarcation now lies somewhere between the *Hatch* case and *United States v. Shapiro*, 178 F.2d 459 (8th Cir. 1949). The Shapiro partnership operated and owned an apartment house. It also owned a small percentage of the bonds of another apartment company. In the sale taxpayer did not part with his share of the latter. The sale was nevertheless held to be of an interest in a partnership.

48. Where an interest had been disposed of and loss had been sustained, taxpayers had no success, even before G. C. M. 26379, in arguing that only title to specific assets was transferred. See, for example, *Estate of Aaron Lowenstein*, 12 T. C. 694 (1949); *George R. McClellan*, 42 B. T. A. 124 (1940).

49. INT. REV. CODE §§ 117(d), 117(e).

50. *Cf. Merrill v. Commissioner*, 173 F.2d 310 (2d Cir. 1949).

either §117(a) or §117(j). However, the most intelligent advice would probably be for the withdrawing partner to dispose successively of his share in the various assets; he should also refrain from describing the assignment as that of an "interest." This may result in ordinary loss deductions to him as to those items which are not capital assets under §117(a).