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Tax Considerations of Partnership Reorganizations

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TAX CONSEQUENCES OF PARTNERSHIP REORGANIZATIONS*

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The increasing industrial pace necessitated by a foreboding international atmosphere is being accompanied by an acceleration in business reorganizations, all designed to insure that organizational structure will adequately meet the needs of the current situation. Many of these involve changes in or from the partnership form.

The reorganization of an existing partnership may occur through a direct transfer of the assets, subject to liabilities, to a successor partnership; by the transfer of assets to a successor corporation; or by the admission of new partners to the old firm.[1] Each of these alternatives will involve various tax consequences to the old and new firms, as well as to the various parties involved.

In the determination of these consequences, an archaic but nevertheless vital conceptualistic conflict as to the legal nature of the partnership arises to haunt the taxpayer. This conflict stems from the refusal of the early English Chancellors to embrace the theory of partnerships developed by the Law Merchant which treated these organizations as legal entities. The equity courts on the other hand insisted that the partnership was a mere aggregate of its individual members. This view is reflected in the present day Uniform Partnership Act. The federal law of income taxation makes no such final choice. Depending on the situation, the Internal Revenue Code treats partnerships as both entities and aggregates. And, most confusing of all, there is no provision to indicate which of the two concepts is to be applied in cases other than those specified in the statute.

The various problems involved in these partnership reorganizations, and the effect of this conceptual conflict upon the solution of such problems are the subject matter of this article.

I. Successor Partnership

A. Introduction

Upon the termination of the old partnership, the partners may decide that they will cause its assets to be distributed to them in kind, and that

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† See Contributors' section, Masthead, page 503, for biographical data.

1 The reorganizations discussed herein are in addition to those which necessarily occur upon the sale or other disposition of partnership interests and upon the death of a partner.

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 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 therefor of the contributing partners.[2]

Therefore, the process of distributing assets and re-contributing them to another firm may result in a change in the income tax basis of such assets in the hands of the new firm. However, such changes are largely fortuitous and may vary considerably in amount depending upon the bases of the individual partners. In addition, once an income tax basis is established for the new partnership, it can be changed only as provided by statute.

On the other hand, a definite partnership basis might be established at a predetermined figure if it were possible for the old partnership to make a bona fide sale of its assets to the new partnership, which sale would be recognized for tax purposes. The sales price would then constitute the basis of the new partnership for the assets;[3] the old partnership would have a recoguizable gain or loss on the transaction. The partners should therefore consider the advisability of having the old partnership sell the assets directly to the new partnership.

B. *Aggregate Theory*

Under the aggregate theory, the partnership is not considered an entity capable of transferring its business and assets. In addition, even if capable of making such a sale, the buyer and seller are considered to be the individual partners of each partnership. Therefore, to the extent that the identity of the members of the two partnerships remains unchanged, it is probable that a court accepting this theory would refuse to recognize the sale on the theory that one cannot sell to himself. There are, however, no reported cases applying the aggregate theory upon such a sale between partnerships.

C. *Entity Theory*

Under the entity theory, such sales may not only be possible but desir-

2 INT. REV. CODE § 113(a)(13).

3 INT. REV. CODE § 113(a).

able, as shown by the principal case of *H. O. Wood, Jr.*[4] A brokerage partnership, composed of five members, owned certain securities which had declined in value to a point well below their income tax basis in the hands of the partnership. A new partnership was formed during the taxable year composed of the same five members plus one new member. All of the partners contributed new capital[5] and the interests of the old partners were readjusted slightly.[6] The additional capital contributed by the old partners consisted of their distributive shares of current earnings to the date of formation of the new partnership. The depreciated securities were transferred to the new partnership at their then fair market value, subject to the partnership liabilities. In the taxable year involved, the old partnership had earned income; the issue presented was whether it had suffered a loss in this transaction measured by the difference between the fair market value and the income tax basis of the securities.

The parties stipulated that there had been no distribution to the part-

[4] 33 B.T.A. 806 (1935), Non-Acq., XV-1 Cum. Bull. 48 (1936).

[5] The additional contributions of capital, amounting to $215,000, were reflected in the individual capital accounts of the old and the new firms as follows:

Name of Partner	Capital in Old Firm	Additional Contribution	Capital in New Firm
W. D. Wood	$ 632,000	$ 56,000	$ 668,000
J. F. B. Mitchell	420,000	35,000	455,000
C. O. M. Sprague	113,000	22,000	135,000
J. T. Terry, Jr.	285,000	17,000	302,000
H. O. Wood, Jr.	215,000	35,000	250,000
C. Dunham III	(a)	50,000	50,000
	$1,665,000	$215,000	$1,880,000

(a)—Not a partner.

[6] The following is a comparison of the interests of the partners in the old and new firms:

Name of Partner	Interest in Old Firm	Interest in New Firm
W. D. Wood	36.63%	32.8375%
J. F. B. Mitchell	22.77	20.35
C. O. M. Sprague	14.85	13.4125
John T. Terry, Jr.	10.89	10.175
H. O. Wood, Jr.	11.88	11.1
Carroll Dunham III	(a)	4.625
Total	97.02%	92.5000%
Interests of employees	2.98	7.5
Grand Total	100.00%	100.0000%

(a)—Not a partner.

ners of the old firm, and that the assets had not been transferred to the new firm and credited to the accounts of the old partners as capital contributions to the new firm. Instead, it was agreed that the assets had been transferred to the new firm and acquired by it for "specific money values," and that the capital of the partners of the old firm was released and contributed to the new partnership together with a part of the current profits. No payments of cash were made back and forth. Instead, the opening entry in the books of the new partnership showed the same net balance for firm securities which would have been shown if the new firm had actually paid cash to the old partnership based upon fair market value. Similarly, the book loss upon the disposition of the securities by the old firm was the same as if the new firm had actually paid it the fair market value of the securities in cash.

The first contention of the Commissioner was that the differences between the old and new partnership were so slight that they should be disregarded. Such a contention goes to the question of substance versus form. In order to strengthen his argument that there was a change only in form, the Commissioner contended that the motive for the transaction was to reduce income taxes. The Tax Court rejected this argument, stressing that here new capital had come in, interests were changed, a new partner had been admitted and had made a capital contribution, and assets had been taken directly by a new partnership.

In addition, the court found that a very good business reason existed for the transaction:

> The partners of the old firm were entitled to the gains of that firm. They determined those gains and divided them in accordance with the percentages provided in their old partnership agreement. The new partner had no right to share in the gains of the old partnership, but, on the other hand, he was not required to accept, as assets of the new firm, the securities of the old firm at their book values to the old firm, since those book values were less than the market value of the securities. Consequently the parties adopted the procedure outlined in the statement of facts.[7]

Having found that in fact two separate partnerships existed, the court then inquired into whether there had been a sale by the old to the new partnership. On this point the Commissioner contended for the application of the aggregate theory, arguing that "the partners can not deduct a loss by selling to themselves." In support of this position, the court pointed out that there was no mention in the stipulation of a bill of sale transferring the securities from the old firm to the new. It nevertheless found that the only fair conclusion to be drawn from the facts was that

[7] 33 B.T.A. 806, 814 (1935).

the securities had actually been sold.[8] The consideration for the sale was the assumption of the liabilities of the old firm and the credits given the old partners on the books of the new firm.

The court observed that the only alternative which could defeat the existence of a sale in this situation was a distribution of the assets in kind. Since it had been stipulated that there had been no such distribution, the transaction was held to be a sale. Once the sale was recognized, the loss of the old partnership was allowed, and the basis of the new partnership was established as being equal to the fair market value (the purchase price) of the assets.

Five of the sixteen members of the Tax Court who reviewed the *Wood* opinion dissented. They accepted the concept of the partnership as an entity for the purpose of this issue, but based denial of the loss upon two points. First, they argued that under applicable state law the admission of a new partner to a partnership did not effect a dissolution thereof. Therefore no new partnership was created in contemplation of law and the sale was merely from the original partnership to itself. The implication in the opinion is that the admission of a new partner to a new partnership which is otherwise composed of the same members as an old partnership is in substance an admission of the new partner to the old partnership. This is another way of saying that the similarity of members and interests in the old and new partnerships was so great that in substance no new partnership was created.

This is confirmed by the alternative ground upon which the dissent is based. Pointing out that if two separate partnerships were created, there was no proof of a sufficient sale in respect of which a loss could be established, the opinion stresses that the changes in capital interests were minor, that all of the old partners remained in the new partnership and that the business of the original and the successor partnerships was the same. In addition, the opinion emphasizes that no "new money" was contributed to the new partnership, except for the capital contribution of the new partner. This contribution was held to have made "no substantial change in the picture presented."[9] The opinion therefore refuses to consider the dedication of current profits to capital account as a true contribution to capital for this purpose, although it was so considered by the majority.

8 Despite the contention of the Commissioner that a partner could not sell to himself, the court apparently felt that if two valid partnerships could be found to exist, the Commissioner would not contend that there was no sale in fact. Thus, the court remarks:

> The respondent expects and is content to have the issue decided upon the basis of a sale of the securities by the old firm to the new firm for cash.

9 33 B.T.A. 806, 821 (1935).

In summary, the dissenters would have disallowed the loss on either of two alternative grounds because they thought the two partnerships were too nearly identical in nature to allow the transaction to be considered closed. This point of difference with the majority is primarily a matter of degree. The loss apparently would have been allowed even under the dissenting opinion if there had been a sufficient change in membership and interests in the new partnership, and a substantial amount of cash had been contributed thereto for the first time.

(1.) *Insufficient Proof of Sale.* The case of *Lester W. Fritz,*[10] involved a very similar situation. The parties again had stipulated the facts, but the stipulation was considerably less complete than in the *Wood* case. Here the old partnership was composed of five members. It had disposed of most of its assets by sales to outsiders, retaining only assets which had depreciated in value, having a cost basis of some \$180,000. A new partnership was formed composed of the same individuals with slightly readjusted interests, but not including trustees holding a 1/24 interest in the old partnership.[11] The depreciated assets owned by the old partnership were transferred to the new partnership at a price of \$70,000. The consideration was entered as an account receivable on the books of the new partnership. No evidence was offered on whether the old partnership continued in business, or whether it closed its books without collecting or intending to collect the account. The old partnership then sought to deduct its loss upon the transaction.

The Tax Court held that no actual sale had been shown and disallowed the loss for lack of evidence. It ruled that the stipulated facts established nothing more than "a readjustment of partnership interests" with the new partnership owning the property alleged to have been sold by the old partnership. The case thus stands for the proposition that although property is actually transferred to a new partnership, this transfer

10 28 B.T.A. 408 (1933), *aff'd,* 76 F.2d 460 (5th Cir. 1935).

11 The following is a comparison of the interests of the partners in the old and new firms:

Name of Partner	Interest in Old Firm	Interest in New Firm
J. I. Staley	13/24ths	13/24ths
J. C. Wynne	4/24ths	6/24ths
L. W. Fritz	3/24ths	4/24ths
J. E. Hall	1/24th	1/24th
P. P. Langford and J. A. Staley, Trustee (sic)	1/24th	None
Undisclosed	2/24ths	None
Total	100.00%	100.00%

should be ignored for tax purposes when in substance it is a mere readjustment of partnership interests.[12]

The Court of Appeals for the Fifth Circuit affirmed. The facts, it said, showed no closed transaction in which the property could be said to have been disposed of. The primary factor in the eyes of the court was the virtual identity of partners in the old and new partnerships.[13]

(2.) *Effect of Formal Sale for Cash.* Both the *Wood* and *Fritz* cases involved attempts to establish a sale by a series of book entries or paper transactions. However, in *Alphonzo E. Bell Corp.*,[14] the Tax Court was presented with a case in which there was an actual transfer of cash, from the new partnership to the old, in consideration for the transfer of assets.[15] The plan involved the formation of a new partnership by six of the eight original partners, followed by a purchase of the assets of the old partnership for cash and a liquidating distribution of cash to the old partners. This sale resulted in a loss.

As in the *Fritz* case, the Tax Court in effect found that no new partnership had been created, pointing out that no new members had joined the venture and that no new capital had been contributed. The amount which had been used to satisfy the liability of the old partnership to the two partners who did not become members of the new venture was ignored. The court therefore found that the transaction was really a mere readjustment of partnership interests among the partners. Nevertheless, in contrast to the *Fritz* case, which ignored the withdrawal of trustees having a 1/24 interest in the old partnership, here there was

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12 Although the withdrawal of a partner normally dissolves the partnership, the Tax Court apparently ignored the withdrawal of the trustees holding a 1/24th interest in the partnership. However, this point was considered on appeal and was held not to be decisive.

13 The court at 76 F.2d 460, 462, stated that although two partnerships having one or more common members might buy and sell to each other,

> . . . when an extraordinary transaction occurs which amounts to a reorganization whereby all assets are transferred to a successor partnership *composed of the same individuals,* it may easily he that there is no real conversion of capital.

14 CCH BTA Mem. Dec. 12,585-F (1942), *aff'd on another point,* 145 F.2d 157 (9th Cir. 1944).

15 The cash was represented by check. Although there was a formal transfer of the check, the steps by which the transaction was completed apparently involved only a limited economic disbursement by the partners of the new partnership. Cash was first contributed to the new partnership in an amount equal to the purchase price of the assets. The following steps were then taken in the order indicated, but within a short space of time:

First: The old partnership distributed checks to the old partners in amounts equal to their share of the purchase price. These checks were not cashed immediately by the payees.

Second: The assets were conveyed from the old to the new partnership.

Third: The new partnership issued a check to the old partnership.

After these steps were completed, the old partners then cashed the checks which they had received in step number one above. Of the old partners, only two did not become members of the new partnership.

ample evidence to show that two of the original eight partners had received cash in the amount of their capital investment and had retired from the venture. The Tax Court treated this as a purchase by the continuing members of the partnership interests of the two retiring members. Although the partnership loss was disallowed, the basis of each partner for his interest was increased by his proportionate share of this purchase price.

(3.) *Comparison of Cases and Conclusions.* A comparison of the *Wood, Fritz* and *Bell* cases[16] indicates that although the partnership is recognized by the Tax Court and the Court of Appeals for the Fifth Circuit as an entity for the purpose of selling its property to a successor, certain safeguards have been erected to prevent unrestricted use of the successor partnership as a tax avoidance device.

The first safeguard is the requirement that a sale actually take place between the two partnerships. This requirement appears to be somewhat formal. In addition, to the extent that it is concerned with substance, it overlaps the second safeguard, which is the requirement that a new partnership actually be created. The regard for the substance of the transaction makes the latter requirement the true deterrent to tax avoidance in such cases.

Basically, the problem here is one of determining whether there has been a closed transaction sufficient to justify its recoguition as a taxable event upon the particular facts of the case under consideration. However, the open opportunity for tax avoidance through manipulation of the year of realization of loss injects an additional element into the problem. In the field of corporate income taxation, problems of this general nature are met by statutes which define corporate reorganizations[17] and which disallow losses in certain instances upon sales to a corporation by a stockholder who controls the corporation, or by another corporation controlled by such stockholder.[18] The element of tax avoid-

16 The case of James B. Lapsley, 44 B.T.A. 1105 (1941), Acq., 1941-2 Cum. Bull. 8, involved the transfer of property from one partnership to another by means of a transfer to a nominee, who reconveyed to the new partnership for a stated consideration of $100. The issue before the court was the basis for gain or loss upon the subsequent disposition of the property. However, it appears that the disposition of the property was made by the partners themselves, since the court examined into their basis, rather than that of the new partnership. Therefore, the *Lapsley* opinion actually sheds no light upon this issue. See 2 MONTGOMERY, FEDERAL TAXES 778 (1949-50) for a brief discussion of the *Wood* and *Fritz* cases.

17 INT. REV. CODE § 112(g)(1).

18 INT. REV. CODE § 24(b)(1):

> In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly . . . .
>
> (B) Except in the case of distributions in liquidation, between an individual and

ance in the field of corporate reorganizations has been countered by the courts through the inauguration of a requirement that the reorganization must serve some business purpose.[19]

By insisting upon the creation of a new partnership in substance, courts which accept the entity theory in this type of situation are applying a somewhat similar "business purpose" test. For example, the *Fritz* case indicates that a mere readjustment of interests in the old partnership through the medium of a new partnership will cause the transfer of assets to be ignored for tax purposes, since this result could as well be accomplished by a readjustment of interests in the existing partnership. Cases involving successor partnerships generally, but in which there is no attempted sale to the successor, will probably not be helpful in outlining the limits of similarity and difference under this test. In such cases there is usually a business purpose for the creation of the successor, and the effect of the termination of the old partnership and the creation of the successor is simply to impose the normal tax consequences prescribed by statute. The tax avoidance element will usually be present only when by means of a sale there is a change in the basis of the assets and a recognized loss to the old partnership.

Under the *Wood* case, the admission to a new partnership of a new partner who makes a substantial contribution to capital plus substantial contributions of additional capital by the original partners will apparently be enough to satisfy this test. As indicated in that opinion, the problems created by the admission of a new partner may often be sufficient to give a business reason for the creation of the new partnership. Any narrower limits to the test must be defined by litigation.

The creation of such a test is essential where the courts accept the partnership as an entity. The alternative would be an open invitation to tax manipulation and avoidance. In addition, if wisely administered, the test should meet the need for a safeguard against such avoidance. The critical elements of this test are the withdrawal of old members and the addition of new capital partners, significant changes in interests and substantial additions of cash. The cases indicate that the mere withdrawal of partners will not normally be sufficient. The addition of one

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a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

19 Gregory v. Helvering, 293 U.S. 465 (1935).

or more new partners probably would cause the new partnership to be recognized if the amount of their contributions to capital were substantial from the standpoint of the partnership as a whole. It is very doubtful, however, that even the most extensive additional contributions to capital and changes in partnership interests will alone be sufficient for recognition of the new partnership when its partners consist only of some or all of the members of the old firm.

II. Successor Corporation

A. *Exchange by Partnership of Assets for Stock*

One relatively common method of reorganizing the partnership is through the creation of a corporation to which the partnership conveys its assets in exchange for stock. A reorganization of this nature immediately raises the problem of whether gain or loss will be recognized upon such a transfer.

(1.) *Recognition of Gain or Loss Under Section 112(b)(5).* Section 112(b)(5) of the Internal Revenue Code provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, if immediately after the exchange such persons are in control[20] of the corporation.

This provision first made its appearance in the income tax law as Section 202(c)(3) of the Revenue Act of 1921.[21] Its substantial equivalent is contained in all succeeding acts. The cases which have come up since the effective date of the 1921 Act,[22] indicate that a transfer of assets to a corporation by a partnership may come within the scope of the non-recognition provisions.[23] This result obtains whether the stock of the corporation is transferred to the partnership[24] or to the partners

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20 Int. Rev. Code § 112(h) defines control as meaning:

> . . . the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

21 42 Stat. 227 (1921).

22 Prior to the enactment of § 202(c)(3) by the Revenue Act of 1921, the Tax Court held that the transfer of its assets by a partnership to a corporation was a taxable exchange. T. B. Noble, 12 B.T.A. 1419 (1928), *aff'd without opinion,* 5th Cir. October 17, 1929; George A. Riker, 10 B.T.A. 11 (1928); William Reibert, 7 B.T.A. 1198 (1927); Warren E. Brown, 4 B.T.A. 56 (1926); Charles T. Plunkett, 3 B.T.A. 1265 (1926).

23 The Bureau accepts this proposition. S.M. 3748, IV-1 Cum. Bull. 17 (1925). The one case *contra* is an early Tax Court case, Louis Abrams, 3 B.T.A. 385 (1926), in which the action of the Commissioner in asserting a tax upon such an exchange was upheld without opinion. The many subsequent Tax Court cases holding to the contrary indicate that this case may now safely be disregarded.

24 Labrot v. Burnet, 57 F.2d 413 (D.C. Cir. 1932); Sehtam Corp. v. Comm'r., 125

individually.[25]

The courts generally agree that it is the partnership and not the individual partners who are the "persons" transferring the assets and obtaining control of the corporation. Both the Court of Appeals for the District of Columbia Circuit and the Tax Court recognize the partnership as an entity for this purpose.[26] In a somewhat surprising reversal of his usual insistence upon an application of the aggregate theory of partnerships, the Commissioner also apparently so recognizes the partnership.[27] Under either theory, however, the gain or loss upon the exchange will not be recognized if the other requirements of Section 112(b)(5) are met.[28]

One such requirement is that if the assets are transferred by two or more persons, the amount of stock and securities received by each must be substantially in proportion to his interest in the property prior to the exchange. Therefore, if the stock is transferred by the corporation directly to the partners, the amount of stock received by each must meet the proportionate interest test.[29] As between partners, this normally should present no difficulty. The amount of stock each partner receives will ordinarily be proportionate to his economic interest in the assets transferred. In addition, the requirement that stock received be "*substantially* in proportion" should allow a reasonable rounding off of shares when the total number involved is small. If the partners make capital contributions at one percentage rate but share profits at another, the interest in capital most nearly represents an interest in the assets being transferred.[30]

F.2d 655 (2d Cir. 1942), *affirming* 44 B.T.A. 258 (1941); Halliburton v. Comm'r., 78 F.2d 265 (9th Cir. 1935); Joplin Ice Co. v. United States, III-A CCH 1934 FED. TAX REP. ¶ 9448 (W.D. Mo. 1934), *dism. on other grounds*, 87 F.2d 174 (8th Cir. 1936); Paradox Land & Transport Co., 23 B.T.A. 1229 (1931).

25 Earle v. Comm'r., 38 F.2d 965 (1st Cir. 1930), *affirming* 15 B.T.A. 668 (1929); Kessler v. United States, 124 F.2d 152 (3d Cir. 1941); Ethel Gary, 18 B.T.A. 1204 (1930), Acq. IX-2 Cum. Bull. 22 (1930); Schmieg, Hungate & Katzian, Inc., 27 B.T.A. 337 (1932); Planters Gin Co., 28 B.T.A. 22 (1933). The Commissioner has also accepted this view. G.C.M. 11,557, XII-1 Cum. Bull. 128 (1933).

26 Labrot v. Burnet, 57 F.2d 413 (D.C. Cir. 1932). The Tax Court has vacillated on the point but now holds that the partnership is capable of transferring the assets. Schmieg, Hungate & Katzian, Inc., 27 B.T.A. 337 (1932); *contra*, Ethel Gary, 18 B.T.A. 1204 (1930), Acq. IX-2 Cum. Bull. 22 (1930).

27 G.C.M. 11,557, XII-1 Cum. Bull. 128 (1933). This is despite the fact that the aggregate theory is also applied to other portions of the identical transaction.

28 In Paradox Land & Transport Co., 23 B.T.A. 1229 (1931), the Tax Court reached a similar conclusion when the stock was transferred directly to the partners individually.

29 Halliburton v. Comm'r., 78 F.2d 265 (9th Cir. 1935); G.C.M. 11,557, XII-1 Cum. Bull. 128 (1933) (by implication).

30 In Strouse, Adler Company, 3 CCH TC Mem. 641 (1944), the Tax Court approved the distribution of stock in the percentage in which capital was contributed. The court

Nor should the proportionate interest requirement present difficulty when the stock is received directly by the partnership. If it is treated as an entity, only one "person" will be holding the stock and no question of proportionate interest arises. On the other hand, under the aggregate theory each partner has an undivided interest in the stock which is equal to his proportionate interest in all the partnership assets,[31] including those transferred in exchange for the stock. It is also possible for non-partners to acquire a part of the stock of the corporation in the same transaction and still have the exchange qualify under Section 112(b)(5) as non-taxable,[32] provided the proportionate interest requirements are met.

(2.) *Basis of Exchanged Assets in Hands of Corporation.* Once it is established that the exchange is non-taxable, the basis of the exchanged assets in the hands of the corporation is the same as the basis for those assets in the hands of the transferor.[33] Since the basis of the partners for their interests in the partnership may differ from the basis of the partnership for the assets transferred, the identity of the transferor of the assets becomes critical. As noted above,[34] the Tax Court ruled in a 1930 case that the partners were the transferors. The basis problem was not then before the court. In a decision handed down in 1931[35] the court squarely held that the corporation took as its own basis the basis of the individual partners for the assets transferred.[36] Despite this decision, in two subsequent cases dealing specifically with the basis question the Tax Court has ruled that the corporation must adopt the basis of the partnership after such an exchange. The more recent of these two cases was

apparently treated the subject matter of the transfer as one of the partnership assets. In the agreement governing the transfer the transferors were identified as, "We, the undersigned, co-partners as Strouse, Adler & Company . . ." 3 CCH TC Mem. 641, 642. Note the discussion of this case by Samuel H. Levy, *The Incorporation of Partnerships*, 25 TAX MAG. 43 (1947), and his suggested alternative.

31 G.C.M. 11,557, XII-1 Cum. Bull. 128 (1933).

32 Halliburton v. Comm'r., 78 F.2d 265 (9th Cir. 1935); Schmieg, Hungate & Katzian, Inc., 27 B.T.A. 337 (1932).

33 INT. REV. CODE § 113(a)(8):

> If the property was acquired . . . by a corporation . . . by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) . . . 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. . . .

34 Ethel Gary, 18 B.T.A. 1204 (1930), Acq., IX-2 Cum. Bull. 22 (1930).

35 Paradox Land & Transport Co., 23 B.T.A. 1229 (1931).

36 However, this decision is weakened by the fact that there was no evidence presented of the basis of the asset. In addition, the facts indicate that the asset had been directly acquired by the partnership.

affirmed by the Court of Appeals for the Second Circuit.[37] There are no other reported decisions on the point.

On principle there is little reason for a failure to recognize the partnership as an entity for the purposes of determining basis. In fact, to do otherwise not only adds to the complexity of the problem but also gives an artificial result. In the first place, the transfer of assets by the partnership to the corporation has no legal effect upon the basis of the partners under the tax law. Before that basis can be affected, there must be some transaction between the partnership and the partner. Therefore, in the absence of such a transaction, to the extent that a part of the basis of a partner is "allocated" to assets held by the partnership at the date of contribution, the word "allocate" is meaningless. The basis of the partner will remain unchanged following any such allocation. Any basis assigned to a corporation upon such an allocation will necessarily be an arbitrary figure, partially duplicating the basis of the partner for his interest in the partnership or its assets.

If such an allocation is made, the mere addition of the bases of all the partners is a simple enough task when all of the partnership assets are contributed to the corporation. But if only a part of the assets are contributed, the apportionment of the bases of the partners to those assets may prove extremely difficult. In the absence of decided cases one might lean toward accepting the partnership as an entity to the greatest extent possible and make an apportionment of the partners' total bases in accordance with the ratio which the fair market value of the assets contributed to the corporation bears to the fair market value of the total partnership assets. This would result in a reasonable allocation, but imposes a heavy burden upon the partners in requiring them to prove the fair market value of each partnership asset. On the other hand, applying the aggregate theory in an attempt to trace the bases of individual assets to each of the partners will often prove fruitless since the partnership may have acquired the assets by purchase or exchange from a nonpartner.

As an alternative to such artificial allocations, a court seeking to apply the aggregate theory to such a transfer of assets might attempt to discover a constructive transaction between partnership and partner. For example, if the court found that the assets had been distributed in kind to the partners by operation of law, each asset would then assume some

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[37] Sehtam Corp., 44 B.T.A. 258 (1941), *aff'd,* 125 F.2d 655 (2d Cir. 1942); Schmieg, Hungate & Katzian, Inc., 27 B.T.A. 337 (1932). This change of position by the Tax Court parallels that pointed out at note 26 *supra,* as to whether the partnership may be considered to be an entity capable of transferring the assets direct to the corporation.

portion of the basis of the individual partner for his interest in the partnership. It is not uncommon for a court to find such fictitious distributions and the Commissioner often argues that they have taken place.[38] Once the distribution is held to have occurred the assets will then be deemed to have been transferred to the corporation by the individual partners. In such cases, the assets will take the basis of the transferor in the hands of the corporation.[39]

Section 113(a)(13) and the regulations thereunder indicate that it was the intention of Congress that the partnership have a basis for its assets separate and apart from the basis of the partners for their interests in the partnership. On principle, therefore, in transactions which affect its basis, the partnership should be considered as an entity. To treat it otherwise is to disregard Congressional intent. The contribution of assets by the partnership to a corporation is clearly a transaction which requires the partnership to be treated as an entity in order to give effect to this intent.

(3.) *Basis of Stock in Hands of Partnership.* In addition to the determination of the basis of assets in the hands of the corporation, it may also become necessary to determine the basis of the stock in the hands of the partnership. If the partnership retains the stock, Section 113(a)(6) of the Code provides that where the exchange was non-taxable, the basis of the stock shall be the same as the basis of the assets transferred.[40] The usual procedure upon setting up the new corporation, however, is for its stock to be issued to the individual partners, either directly or through the partnership. Consequently, the basis of the stock in the hands of the partners must often be determined.

The position of the Bureau in such cases is that the partners have received a distribution in kind from the partnership, even though the stock may have been distributed directly to them as individuals.[41] Since the receipt of the stock is dependent upon the *transfer* of assets held by the partnership, it appears reasonable to hold that in substance the trans-

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38 S.M. 3748, IV-1 Cum. Bull. 17 (1925). See also notes 41 and 98 *infra*, and cases cited therein.

39 INT. REV. CODE § 113(a)(8).

40 INT. REV. CODE § 113(a)(6):

> If the property was acquired . . . upon an exchange described in section 112(b) . . . , the basis . . . shall be the same as in the case of property exchanged. . . .

41 G.C.M. 11,557, XII-1 Cum. Bull. 128,131 (1933):

> The fact that certificates for the shares were issued by the corporation directly to the individuals does not minimize the fact that ownership of the corporate shares was acquired, although perhaps only for a brief period, by the partnership, and that the shares were then owned and held by the several partners in their undivided proportions.
>
> . . . there occurred first a distribution in kind of the 6*x* shares, with the result that each partner received his relative and undivided interest in all the stock.

action represents an exchange of assets for stock and a subsequent distribution of the stock in kind.[42] Such a position would be consistent with Section 113(a)(6) which requires that the basis of property acquired in an exchange shall be the same as in the case of the *property exchanged.* Since it is the partnership assets which are exchanged, it seems correct to attribute to the stock the proper portion of the partnership basis before attempting to apply any other basis provisions of the Code.

A finding that the partners received the stock directly would be complicated by the fact that since the assets were transferred by the partnership, the partners receiving the stock would have no basis for the "property exchanged." Yet if the partnership basis of the assets exchanged is assigned directly to the stock in the hands of the partners, this amount may not equal their bases for their interests in the partnership. Thus, if the exchange involves all of the partnership assets, the partners may be left holding stock as their only asset, but with a portion of their bases for their interests in the partnership not assignable thereto. This portion of their bases would then presumably be extinguished without tax effect.

If all of the partnership assets are transferred and the stock is then distributed to the partners, the entire basis of each for his interest in partnership surplus on dissolution would then become the basis for the total shares of stock he receives. When only a portion of the assets is transferred, it is clear that only a part of the partners' bases should be allocated thereto. If the stock is distributed in kind, the general rules for allocation of basis would apply. However, if the stock is deemed to have been distributed directly to the partners, some other method of allocation would be required. The only reasonable method in such a case would be an allocation based upon the ratio of the fair market value of the assets transferred to the fair market value of the total partnership assets. Since both allocations will probably be founded upon the value of the partnership assets, the results under either method should be approximately equal, after allowing for variations due to the special problems created by a partial distribution in kind.[43] The former method

[42] *Accord,* S.M. 3748, IV-2 Cum. Bull. 17 (1925). The accounting entries in this case also tend to indicate that this is the substance of the transaction. The credit to asset accounts upon the transfer of all partnership assets can only be offset by a debit to the capital accounts of the partners. *Cf.* Raybestos-Manhattan Co. v. United States, 296 U.S. 60 (1935).

[43] Upon such partial distributions, there is a tendency in present Bureau practice to require that the distributee allot to the distributed assets a portion of his basis for his partnership interest which is equal in amount to the basis which the assets had in the hands of the partnership. Of course, this amount may have no relationship to the value of the assets at the date of distribution.

is clearly preferable, however, as more closely adhering to the legislative intent expressed in Section 113(a)(6).

(4.) *Holding Period of Assets and Stock.* The final problem created when partnership assets are transferred to a successor corporation is the determination of the holding period of assets and the stock exchanged therefor. Section 117(h)(2)[44] allows the corporation to include in its holding period for assets transferred to it in exchange for stock the length of time during which the partnership held those assets. In addition, if the assets were contributed to the partnership by a partner, the period of time in which the assets were held by the partner may also be included.[45]

In respect of the stock in the hands of the partnership, Section 117(h)(1)[46] allows the partnership to include in its holding period the period of time during which it held the assets given in exchange.[47] This is true even though the assets exchanged were not capital assets.[48] This principle immediately poses the difficult problem of attempting to match "stock received" with "assets transferred". One reasonable solution to the problem is as follows: Determine the fair market value of each asset transferred. Then group all assets having the same holding periods and determine the value of each group. The holding period of each such group should then be assigned to the number of shares of stock represented by the same percentage of total face value of the stock, which the percentage of value of the particular group of assets bears to the value of the total assets.

Each partner will own an undivided interest in each share of stock received. Upon the subsequent distribution of the stock in kind, each should be deemed to have received his pro rata share of each "holding period group" of stock. For example, if only a single asset has a holding period of seven months and represents 75 per cent. of the total assets,

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[44] INT. REV. CODE § 117(h)(2):

> 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.

[45] This is due to the fact that under INT. REV. CODE § 113(a)(13) the partnership is required to adopt the basis of the contributing partner for assets contributed to it.

[46] INT. REV. CODE § 117(h)(1):

> 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. . . .

[47] *Accord:* G. C. M. 11,557, XII-1 Cum. Bull. 128 (1933).

[48] G. C. M. 25,301, 1947-2 Cum. Bull. 83, and cases cited therein.

75 per cent. of the total face or actual value of the stock would be assigned such a holding period. Upon the subsequent distribution of the stock in kind, of the total shares received by a partner, 75 per cent. would be deemed to have been held for seven months. In the alternative, the stock itself may be held at least six months before any disposition thereof, thus eliminating the necessity of such burdensome computations.

The holding period of stock in the hands of individual partners is determined under the general principles governing the determination of such periods with respect to property distributed in kind.[49]

B. *Exchange by Partners of Partnership Interests for Stock*

(1.) *In General.* The partners may act in their capacities as copartners in transferring the partnership assets and business to the corporation, receiving the shares of stock directly from the corporation. Under such circumstances a serious problem is presented if either the Commissioner or the partners contend that there has been an exchange of partnership interests rather than an exchange of the partnership assets. Such a contention will normally be advanced because of differences in holding periods and bases between partnership assets and the interests of the partners in the partnership. Essentially, there has been a transfer to the corporation of the partnership assets. The question which remains is what additional factors must be present in such an exchange in order for a court to find that in substance the corporation acquired partnership interests rather than assets. Unless such a finding is contended for, there is little likelihood of any court's making it on its own initiative.[50]

The first case involving such a contention is *Kessler v. United States*.[51] There the stipulated facts merely stated that "the partners formed a corporation, to which they conveyed the partnership assets, taking shares in proportion to their respective shares in the partnership." Upon the taxpayer's suit for refund, the District Court found that the partners could not convey a mere undivided interest in assets, but could only convey that interest subject to the restrictions placed upon it by partnership law. It therefore followed that the subject matter of the transfer was necessarily the interests of the partners in the partnership. Upon appeal, the Court of Appeals for the Third Circuit reversed on the ground

49 See G. C. M. 20,251, 1938-2 Cum. Bull. 169 (1938); J. P. Jackson, *Partnership Distributions*, TAX INST. 65 (U. S. C. School of Law 1950).

50 Halliburton v. Comm'r., 78 F. 2d 265 (9th Cir. 1935); Betts v. United States, 1 USTC ¶ 161 (Ct. Cls. 1926). But even in this situation it may be possible to secure nonrecognition of gain under INT. REV. CODE § 112(b)(5).

51 41-1 USTC ¶ 9293 (E. D. Pa. 1941), *rev'd*, 124 F. 2d 152 (3d Cir. 1941).

that the District Court's determination was not supported by the meager evidence contained in the stipulation.

Two years later a similar problem was presented to the Tax Court and appealed to the Court of Appeals for the Third Circuit.[52] This time the partners had agreed that the partnership assets, business and good will should be transferred subject to partnership liabilities, but that undistributed profit balances in the capital accounts of the partners at the exchange date would not be transferred. Instead, these were loaned to the corporation at interest. The agreement also provided that stock would be issued to the partners "in full payment for their respective interests in said assets," and that the partnership would be terminated as of the day before the transfer.

The Tax Court ruled that under the terms of the exchange agreement the partners had merely exchanged their interests in partnership assets for stock of the corporation. This decision was founded upon two points: First, since the corporation did not receive the undistributed profits to the date of the exchange, it could not be said that the corporation took over the capital accounts of the partners. Therefore, all that the partners exchanged were their interests in the assets remaining after the loan by them of their undivided share of the profits to the corporation. Second, by the terms of the agreement, the partnership ended on the day before the transfer of assets, and, since the partnership had ended, it was a logical absurdity to contend that there was a conveyance of an interest in the partnership.[53]

Upon review, the Court of Appeals reversed the Tax Court, finding that in substance the transaction was an exchange of their interests in the partnership itself for corporate stock. The court stressed the form of the agreement under which the co-partners sold the "business" and all other assets of the partnership.

The Tax Court again decided this question in a more recent memorandum decision which was not reviewed by the full court.[54] As in the earlier case, the partners transferred their interests in "the business and the assets" to the corporation, but withheld all accumulated undivided profits. Although it is not clear that the partnership terminated at the

[52] George H. Thornley, 2 T.C. 220 (1943), Acq., 1949-1 Cum. Bull. 4, Non-Acq. 1944 Cum. Bull. 49 withdrawn, *rev'd*, 147 F.2d 416 (3d Cir. 1945).

[53] This decision was reviewed by the full Tax Court with one dissent. The court apparently did not have in mind the numerous cases involving the sale of partnership interests in which the sale itself was found to have terminated the partnership. For example, see Helen Davis, 9 CCH TC Mem. 263 (1950). As noted therein, the criterion in such cases is whether the going business formerly conducted by the partnership is continued.

[54] Frederick S. Pendleton, 5 CCH TC Mem. 571 (1946).

date of transfer, this is inferred; certainly it did no more business after that date. Without any reference to the previous decision or to the reversal thereof, the court found as a fact that the subject matter of the transfer was the interests of the partners in the partnership. The opinion then reviewed the legal effect of such transfers. There was no discussion of the issue nor is there any indication as to the contentions advanced by the Commissioner on this point. No subsequent cases have involved the issue.

From the foregoing, one may conclude that the Court of Appeals for the Third Circuit would hold that the subject matter of the exchange is the partnership interests of the partners in any case where the partners transfer the partnership assets, business and good will, and receive in exchange the corporate stock, providing the terms of the exchange agreement make it sufficiently clear that it is a transfer of the partnership business which is involved. On the other hand, there is some doubt as to the position of the Tax Court on this point. Although it may agree with the Court of Appeals, there is some risk that it will adhere to its earlier opinion on the point. In this connection, it is worth recalling that the earlier opinion found that interests in the partnership itself were not transferred because all of the partnership assets were not transferred and because the partnership terminated upon the transfer.

If the Tax Court continues to follow this rationale, the partners are faced with a dilemma. If they transfer all of the assets and receive the stock directly, the partnership will cease to exist for all practical purposes. Yet if the partnership is terminated, the court will find there is merely a transfer by the partners of their interests in the assets of the partnership, rather than of their interests in the partnership itself. The issue may at least be regarded as confused in the Tax Court. However, if the question of whether or not the partnership is terminated by the transfer were squarely presented to the Tax Court, this fact will probably be considered immaterial, in line with similar decisions which involve transfers of a single partnership interest.

On the other hand, by the specific terms of the agreement governing the transfer, the exchange actually may involve a transfer of partnership interests in exchange for stock. Since under the terms of such an agreement partnership interests and not interests in partnership assets are transferred, it is possible that the Tax Court, at least, might find that the subject matter of the exchange is the partnership interest of each partner. Such an agreement has recently been so construed by the Tax Court when the transaction involved a sale of such interests rather than an exchange.[55] The facts of that case do not indicate whether or not the transfer of interests terminated the partnership, nor does the opinion discuss the point. Under such an agreement the difficulty of identifying the subject matter of the exchange would be eliminated, thus leaving as the principal issue the problem of whether the partnership is such an entity that an interest therein is capable of being exchanged.[56]

By the overwhelming weight of authority, the partnership is such an entity that an interest therein is capable of being sold. The fact that the transaction involved an exchange rather than a sale should have little effect upon the attitude of the court concerning this issue. Certainly in view of its holding in the case of a transfer of the partnership business, the Court of Appeals for the Third Circuit should experience little difficulty in concluding that this type of transfer involved partnership interests.

(2.) *Recognition of Gain or Loss on Exchange.* If the partnership interests are found to be the subject matter of the exchange, such exchange will not result in the recognition of gain or loss under Section 112(b)(5).[57]

However, the problem of determining the proportionate interests of each partner in the totality of the interests transferred may prove troublesome under some circumstances.[58] The basis for the assets in the hands of the corporation will then be equal to the total bases of all the partners for their partnership interests.[59] On the other hand, the basis of the stock in the hands of each partner will be equal to his basis for his partnership interest.

(3.) *Holding Period of Assets and Stock.* There is some question as to whether the holding period of the corporation will include the period during which the partners were members of the partnership, or whether it will be determined by the period of time during which the partnership held the particular assets.[60] There are no decisions clarifying

55 Mignonette E. Luhrs, 9 CCH TC mem. 537 (1950).

56 See the discussion of sales of partnership interests in G. C. M. 26,327, 1950-1 Cum. Bull. 58.

57 Frederick S. Pendleton, 5 CCH TC Mem. 571 (1946). In George H. Thornley, 2 T. C. 220 (1943), Acq., 1949-1 Cum. Bull. 4, Non-Acq. 1944 Cum. Bull. 49 withdrawn, *rev'd* 147 F. 2d 416 (3d Cir. 1945), and Kessler v. United States, 124 F. 2d 152 (3d Cir. 1941), the Commissioner advanced no contention that the exchange was taxable.

58 Assume for example that the partners make capital contributions and share profits and losses, or all three, in different percentages. Compare Strouse, Adler & Co., 3 CCH TC Mem. 641 (1944), where the percentages differed but the sale was apparently treated as having been made by the partnership. See the discussion of this point by Specks, *The Tax Free Incorporation of Partnerships,* 45 ILL. L. REV. 483 (1950).

59 INT. REV. CODE § 113(a)(8).

60 Under INT. REV. CODE § 117(h)(2), quoted in note 44 *supra,* there is some question

this point. Although the former period would appear to be correct, in order to insure complete safety partners planning such an exchange should calculate these two periods and assume that the shorter is the correct holding period of the corporation. The holding period for the stock in the hands of the partner will include the period during which he has been a partner.[61]

C. Sale by Partnership of Its Assets for Cash

The partners may decide that instead of having the partnership exchange its assets for stock, the transaction should take the form of a sale to an existing corporation. The Tax Court has held that in such circumstances the partnership may be considered an entity capable of making such a sale.[62] However, a different question is presented when the partnership itself, or the partners individually organize the corporation. Under these circumstances a sale will be subjected to severe scrutiny.[63]

The problem becomes critical when the sale results in a loss. Section 24(b)(1)(B) prohibits the deduction of losses from either the direct or indirect sale of property by an individual to a corporation when that individual directly or indirectly owns more than fifty per cent. of the stock.[64] Despite the tax avoidance possibilities inherent in this situation, the Tax Court has recognized the partnership as an entity, holding that the loss is deductible since there has been no sale to the corporation by an *individual*.[65] Upon appeal the Court of Appeals for the Second Cir-

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as to whether the property acquired by the corporation is the same property "exchanged" by the partners. Thus, in Thornley v. Comm'r., 147 F.2d 416, 418 (3d Cir. 1945), the court quoted a portion of its earlier opinion in the *Kessler* case, in which it stated:

> '. . . the verb "exchange" is not restricted in meaning to the idea of an interchange but *includes as well the thought of merely giving up something in consideration of the receipt of something else. Thus the plaintiff might have given up his partnership interest in exchange for the stock even though that interest as such did not pass to the corporation.*'

61 INT. REV. CODE § 117(h)(2), quoted in note 44 *supra*; Thornley v. Comm'r., 147 F.2d 416 (3d Cir. 1945); Kessler v. United States, 41-1 USTC ¶ 9659 (E.D. Pa. 1941), *rev'd on other grounds*, 124 F. 2d 152 (3d Cir. 1941).

62 E. F. Simms, 28 B. T. A. 988 (1933); Henry F. McCreery, 4 B. T. A. 967 (1926), Acq. VI-1 Cum. Bull. 4 (1927).

63 However, this may not necessarily be true if some non-partners participate in the organization of the corporation and some partners do not. For example, in C. B. Shaffer, 29 B. T. A. 1315 (1934), the fact of sale was unquestioned by the Commissioner. The corporation had been organized by one partner and a non-partner, and the second partner apparently did not participate therein. The case should be viewed with caution, however, since this particular sale resulted in a gain rather than a loss.

64 An important exception to this principle, not applicable in this situation, is that such losses are allowed upon the receipt of distributions in liquidation of such corporation.

65 George Whitney, 8 T. C. 1019 (1947), Non-Acq., 1947-2 Cum. Bull. 7, *rev'd*, 169 F. 2d 562 (2d Cir. 1948).

cuit, after a full review of the legislative history surrounding the passage of this loophole-plugging measure, rejected this legalistic approach and concluded that in such cases the Congressional intent was to treat the partnership as a mere aggregation of individual partners. To hold otherwise, the court felt, would leave a loophole almost as large as the one Congress had set out to close. The court also pointed out that upon subsequent liquidation of the partnership, the loss is again disallowed. In theory, the loss reduces the partner's basis for his partnership interest, but this reduction is not recognized. Upon dissolution he therefore receives his share of cash and assets which is to be offset against his unreduced basis.[66]

In view of the legislative history of Section 24(b)(1)(B), the Court of Appeals' position seems sound. However, it is possible that the Tax Court will not allow this decision to affect its attitude on the issue. The question probably can be considered an open one at the present time in all jurisdictions except the Second Circuit.

In the event the partnership is found to have made the sale and the gain or loss therefrom is recognized, the basis of the partnership for the assets sold must be offset against the amount received.[67] Normally, the determination of partnership basis will present no major problems. When current partnership earnings are included as a part of the assets sold, however, the question arises as to whether the amounts thereof are includible in the basis of the partnership. The Tax Court has held that when the buyer acquires the right to earnings from operations to the

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66 Prior to the enactment of § 24(b)(1)(B) as a part of the Revenue Act of 1936, the courts faced this problem in a way which might have allowed the partner to secure recognition of the loss upon the subsequent liquidation of the partnership. In Labrot v. Burnet, 57 F. 2d 413 (D. C. Cir. 1932), the partnership organized a corporation and subsequently sold assets to it at a loss. The court held in substance there was an exchange of stock for assets and that no gain or loss was recognized upon that exchange under § 112(b)(5). In that case, the partnership continued to hold the stock throughout the taxable year. The court therefore did not consider the possibility of the loss being claimed upon liquidation of the partnership or as an operating loss at the close of the taxable year. However, under such a theory there is apparently no reason why the subsequent liquidation of the partnership would not have resulted in the loss then being realized. In fact, the purpose of § 112(b)(5) is to postpone the recognition of gain or loss only until there is a closed transaction. The liquidation of a partnership certainly would fall under that heading when the distribution was all in cash. Yet the *Labrot* decision was cited with approval in the non-partnership case of Snowden v. McCabe, 111 F. 2d 743 (6th Cir. 1940), involving a sale to a corporation prior to the passage of § 24(b)(1)(B).

67 This result must follow under Code § 113(a)(13) if the sale is made by the partnership without a distribution in kind to the partners. However, in E. F. Simms, 28 B. T. A. 988, 1025 (1933), the court found that the sale was made by the partnership but in the discussion of basis it nevertheless spoke of the cost to the partner of his interest in the partnership.

time of the sale, such earnings must be included in the cost of assets sold.[68]

Upon a sale of partnership assets, the holding period of such assets in the hands of the buyer will be computed under the provisions of Section 117(h).

(1.) *Capital Nature of Partnership Gain or Loss.* The capital nature of the gain or loss presents no particular difficulty when the subject matter of the sale consists of the assets of the partnership. The capital nature of the gain or loss upon the sale of each asset is determined by the capital nature of that particular asset. However, the solution is less clear when the partnership attempts to sell all of its assets and good will as a going business. It might then be argued that there has been a sale of a unitary business and that this business is a capital asset. The Tax Court in a very early case[69] concluded that the partnership may sell its business, specifically holding that where the entire business is sold, the sales price may not be allocated to specific assets. But the court did not indicate whether the gain or loss upon such a sale would be treated as capital or ordinary in nature.[70]

In the more recent decision of *Williams v. McGowan*,[71] a District Court in the Second Circuit reached a similar conclusion in a case involving the sale of the business of a sole proprietorship, and held that the gain or loss on such a sale was capital in nature. Upon appeal, the Court of Appeals for the Second Circuit reached a contrary conclusion, holding that upon sale of a going business, such business is to be comminuted into its fragments and each separate asset or group of similar assets tested separately against the definition of capital assets. Although the issue involved the sale of a sole proprietorship, the court framed its determination in general terms[72] and there appears to be little doubt but that this rationale would be applied to the present problem if it arose in that jurisdiction.

There is no indication of the effect which the *Williams* rationale might have upon the Tax Court when this question is again presented to it.

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68 Henry F. McCreery, 4 B. T. A. 967 (1926), Acq., VI-1 Cum. Bull. 4 (1927).

69 Henry F. McCreery, *supra* note 68.

70 The question did not arise under the peculiar facts of the case. Since the sales price was greater than cost but less than the fair market value on March 1, 1913, no gain or loss was realized upon the transaction.

71 152 F.2d 570 (2d Cir. 1945), *reversing*, 58 F. Supp. 692 (W.D. N.Y. 1944).

72 Williams v. McGowan, 152 F. 2d 570, 571 (2d Cir. 1945):

> We have to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in § 117(a)(1), or whether the whole business is to be treated as if it were a single piece of property.

In any event, the issue probably should not be regarded as settled in jurisdictions other than the Second Circuit.[73]

D. *Sale by Partners of Partnership Interests*

As noted above, the Tax Court recently held in the case of *Mignonette E. Luhrs*[74] that if by agreement all of the partners sold their partnership interests, such a sale would be treated in fact and in substance as a sale of such interests, and not as a sale of undivided interests in assets. In the *Luhrs* case, the sale was to a group of individual buyers. Nevertheless, the fact that in the problem under consideration the buyer would be a corporation should not change the result. In *Luhrs*, the buyers jointly and severally purchased the interests of the sellers, so that the transaction did not consist of separate but simultaneous sales of the various interests to several independent buyers. The buyers changed the partnership name and it is possible that these sales terminated the partnership although that point was not discussed. In other cases involving sales of single partnership interests, however, the termination of the partnership as a result of the sale has apparently been considered immaterial.[75]

There is then a strong possibility that the Tax Court would enforce an agreement for the sale by the partners of their interests in the partnership to a corporation in the event the corporation was not controlled by the partners. In addition, as noted at pages 479-480 above, the Court of Appeals for the Third Circuit recognizes the right of partners under certain circumstances to exchange their partnership interests for stock in a corporation. It may well be, therefore, that this court would likewise recognize the sale of such interests to a corporation for cash. In other jurisdictions, however, the question must be regarded as open.

If the buying corporation is controlled by the partners, a somewhat different problem is presented. In such cases, if the sales result in losses, such losses will clearly be disallowed under the provisions of Section 24(b)(1)(B).[76] But to the extent that the gain or loss from the sale of a partnership is recognized it will be considered capital in nature.[77] However, when all of the partnership interests are sold so that it may

[73] It should be noted, however, that in Violet Newton, 12 T. C. 204 (1949), there was a sale of a community property business. The Tax Court upheld the Commissioner's allocation of purchase price to individual assets upon the authority of *Williams v. McGowan*.

[74] 9 CCH TC Mem. 537 (1950).

[75] Helen Davis, 9 CCH TC Mem. 263 (1950).

[76] Since the sale is between the partner and the partnership, even the Tax Court would have no difficulty in disallowing the loss. Compare George Whitney, 8 T. C. 1019 (1947), where the sale was by the partnership to the corporation.

[77] Allen S. Lehman, 7 T. C. 1088 (1947), *aff'd* 165 F. 2d 383 (2d Cir. 1948); G. C. M. 26,379, 1950-1 Cum. Bull. 58.

be argued that in substance the transaction constitutes a sale of the partnership business, the question still remains as to the application of the fragmentation test in determining the capital nature of the gain or loss.[78]

Upon such a sale, the basis to the corporation of the property purchased will equal the purchase price thereof,[79] while the bases of the partners for computing gain or loss upon the sale will be the bases of their partnership interests.[80] The holding period of the corporation will commence upon the date of the purchase, while the holding period of the partner for his partnership interest will be the period of time during which he has been a partner.[81]

III. Admission of a New Partner.

A. The New Partner

When a new partner makes a cash contribution to the partnership, his income tax basis for the partnership interest will be the amount of that contribution[82] plus any incidental expenses incurred in making such contribution.[83] This is true even though a part of the total contribution of the new partner is not credited to his capital account, but is credited to the capital accounts of the remaining partners as a profit on the transaction.[84] On the other hand, if the new partner contributes property rather than cash, the basis of his partnership interest will be the cost to him of that property.[85]

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78 See the discussion of this point at page 485, *supra.*

79 Int. Rev. Code § 113(a).

80 Fundamentally, the basis of a partner for his interest in the partnership is its cost. Int. Rev. Code § 113 (a).

81 Thornley v. Comm'r., 147 F. 2d 416 (3d Cir. 1945).

82 Lehman v. Comm'r., 165 F. 2d 383 (2d Cir. 1948); T. B. Noble, 12 B. T. A. 1419 (1928). In this respect, the problems of the new partner are identical with those of partners making an initial contribution to a newly organized partnership.

83 The basis of the partner for his interest in the partnership is its cost. Int. Rev. Code § 113(a). Such an interest is a capital asset. G. C. M. 26,379, 1950-1 Cum. Bull. 58. Therefore, incidental costs incurred in securing such asset are properly capitalizable. U. S. Treas. Reg. 111, § 29.23(a)-15. For examples of this principle, see Missouri-Kansas Pipe Line Co., 3 CCH TC Mem. 15 (1944), *aff'd,* 148 F. 2d 460 (3d Cir. 1945); Bowers v. Lumpkin, 140 F. 2d 927 (4th Cir. 1944).

84 Hathaway Watson, CCH BTA Mem. Dec. 8919-E (1935), *aff'd* 82 F. 2d 345 (7th Cir. 1936). The court held that the new partner had paid the total amount for a share of the partnership profits and for the right to enjoy the intangibles of the partnership. It then stated that what the firm does with any part of this amount is immaterial. George V. Rotan, 17 B. T. A. 1192 (1929), *aff'd without discussion,* 56 F. 2d 153 (5th Cir. 1932). The amount in excess of that credited to his capital account is to be treated as a purchase of goodwill by the new partner whether goodwill is set up on the books of the partnership or not. George V. Rotan, *supra.*

85 Leonard M. Japp, 9 CCH TC Mem. 705 (1950). If the property was acquired by

It has long been the position of the Bureau of Internal Revenue that no gain or loss will be recognized upon the contribution of property to a partnership.[86] This position is founded upon a partial acceptance of the aggregate theory of partnerships. Under this theory, since the firm consists merely of its individual members, a contribution to the partnership is in a sense a contribution to oneself as a partner. Accordingly, recognition of gain or loss is denied on the premise that a partner cannot realize gain or loss by selling something to himself. The position of the Bureau upon this point is now firmly imbedded in its administration of the income tax law of partnerships, and there is virtually no risk of a change at the present time.[87]

Aside from the problems generally arising upon the admission of a new partner, the specific agreement under which he is admitted may create other problems. From the standpoint of the new partner, these problems will relate to his basis for his interest in the partnership and the amount of his distributable share of profits. Various types of specific agreements will be discussed in the two following subsections.

(1.) *Contribution of Notes.* Instead of contributing cash or property, the new partner may make his capital contribution in the form of personal notes which, it may be agreed, will be payable only out of his share of partnership profits. Such an agreement does not preclude taxation to him, *qua* profits, of any portion of his share of the profits which are so used.[88] In addition, the use of notes also raises a question

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him in a transaction other than a purchase, his basis therefor, determinable under the appropriate provisions of INT. REV. CODE § 113, will also be his basis for his interest in the partnership.

86 S. O. 42, 3 Cum. Bull. 61 (1920). This view of the Bureau was strongly reiterated in C. G. M. 10,092, XI-1 Cum. Bull. 114 (1932). *Accord,* Helvering v. Walbridge, 70 F. 2d 683 (2d Cir. 1934); Helvering v. Archbald, 70 F.2d 720 (2d Cir. 1934), *aff'g* 27 B.T.A. 837 (1933); United States v. Flannery, 25 F. Supp. 677 (D. Md. 1938), *aff'd per curiam,* 106 F. 2d 315 (4th Cir. 1939). G. C. M. 10,092 was recently revoked by G. C. M. 26,379, 1950-1 Cum. Bull. 58. However, this new ruling did not involve the point under consideration. It is believed that the revocation clearly was not intended to affect the Bureau's position upon this point.

87 INT. REV. CODE § 113(a)(13) provides that:

> 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....

Although the language of the statute implies that gain or loss may be realized upon such contributions to capital, U. S. Treas. Reg. 111, § 29.113(a)-13-1 indicates that the Commissioner does not so interpret the statute. The regulation merely states:

> The basis of property contributed in kind by a partner to partnership capital . . . is the cost or other basis thereof to the contributing partner.

88 This was the result reached by the Tax Court in a case involving the purchase of

as to the income tax basis in his hands of the new partner's interest in the partnership. That basis is the cost to him of his partnership interest. Since his liability on the notes is contingent upon the partnership making profits, there is serious doubt as to whether the face amount of such liability can be considered as the new partner's "cost" for his partnership interest. If the business loses money, the new partner is not required to make any payments in respect of his notes. If it fails completely, he may never have paid anything. Under such circumstances, the Commissioner would certainly oppose any attempt by the partner to deduct as a loss the face amount of the notes, or any other portion thereof not represented by actual payments made in discharge of the obligation which they represent.

(2.) *Graduated Profit Sharing Agreements.* Upon the admission of a new partner to the firm, the agreement may merely provide that he is to receive a designated percentage of the profits. He may or may not be required to make a contribution to capital. Under these circumstances, his right to share in profits is fixed under the terms of the agreement and he will be taxed upon his entire share thereof, whether actually received or not. In addition, the basis for his partnership interest will be the amount of his capital contribution, if any.

The agreement may provide, however, that after the new partner has been a member for some fixed period of time, his present percentage of interest in profits is to be increased to a higher fignre. At that time he may or may not be required to make an additional contribution to capital. In this situation, the new partner will not be deemed to have received any portion of the increased percentage of profits until they actually become payable under the terms of the agreement governing his admission.

A third type of agreement may give the new partner an opportunity to increase his percentage of interest in profits, but the measure of the period during which his original percentage is to continue may be stated in terms of partnership income. For example, if the new partner contributed to the partnership no notes, cash or property, it might be agreed that his share of partnership profits would be 5 per cent. until the remaining partners had received a cumulative total of $10,000 more profits than he, after which time his share would be 10 per cent.[89]

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a partnership interest. William B. Grise, 6 B. T. A. 743 (1927). On principle, the result should be indentical upon the notes being contributed to capital.

89 This type of agreement was suggested by the court in William B. Grise, 6 B. T. A. 743 (1927), as a method by which the partner who intended to contribute notes might escape tax upon the excess portions of partnership profits until a later date. However,

If this agreement is treated as being merely an agreement between the parties by which they will share partnership profits upon certain contingencies, the tax effect upon the new partner will be exactly the the same as in the case last mentioned above. The fact that the duration of the period during which he is to have a 5 per cent. interest in profits is to be measured by the amount of partnership income rather than the passage of time would then be immaterial.[90]

If it can be said, however, that because of the underlying facts in this type of case, the new partner is furnishing consideration to the old partners for this increased interest, the transaction may result in a purchase of such interest. The new partner may then be deemed, in the above example, to have received the $10,000 of profits as it is earned, and to have paid it to the old partners as the purchase price of the increased interest in profits.[91]

In the usual case, it will be difficult to find any consideration for such an alleged purchase. During the period prior to receiving the excess percentage of interest in profits, the new partner will be devoting a specified percentage of his time to the business. However, he presumably will be performing no extraordinary services for the benefit of only the original partners.

The Tax Court was recently presented with a similar agreement in *Walter J. Gresham*.[92] There the taxpayer had sold an interest in a partnership. One of the issues before the court was the basis of the interest being sold. By the terms of the partnership agreement, the taxpayer had promised to loan $10,000 to the partnership. He was to receive no percentage of profits and surplus until his loan had been repaid and until the remaining partner had received $10,000 in salary. After such time he was to receive a fifty per cent. interest in profits and surplus.

The Tax Court held that the taxpayer had a basis of zero for his partnership interest. There was no intimation that fifty per cent. of the profits during this period should be considered as having been received by the selling partner. In addition, in determining what was being sold,

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the court specifically refrained from expressing any opinion as to the effectiveness of the plan.

90 Note the implication by the court in William B. Grise, 6 B. T. A. 743 (1927), that such an agreement might be so interpreted.

91 The assignment of profits which belong to the partner will not relieve him from liability for income taxes in respect of such profits. George L. Hill, 10 B. T. A. 399 (1928); Lester G. Hathaway, 16 B. T. A. 1318 (1929); Helvering v. Smith, 90 F. 2d 590 (2d Cir. 1937).

92 8 CCH TC Mem. 77 (1949).

the court stated that under the terms of the agreement, although the loan had been repaid, all of the salary due the other partner had not yet been received by him. It therefore stated that the selling partner had no saleable interest in partnership income, that all he owned was a contingent interest in surplus. The court then held that there had been a sale of a partnership interest resulting in a capital gain.[93]

Despite the *Gresham* decision, there is some risk that the Commissioner would argue that there was consideration for the transfer of the increased percentage of interest in profits moving from the new to the old partners if the facts of the particular case were sufficiently favorable. Such a case might be presented if, for example, the old partners desired no longer actively to participate in a declining business, and turned over its entire management and operation to the new partner, leaving only their capital to be employed by him in building up the business.[94] There are no authoritative guideposts indicative of the treatment which the courts would accord such an argument.[95]

The facts might lend even more support to this argument in the case where a new partnership was organized in which one partner was to contribute services of a specialized character while the remaining partners contributed only capital.

B. *The Partnership*

Will the admission of a new partner cause a termination of the partnership? If it does, the basis of the partnership for the property it holds may be changed substantially.

The partnership is recognized as an entity capable of holding property and of having an income tax basis for such property which is distinct

93 The Commissioner was contending for a low basis for the partnership interest in order to show an increase in the amount of taxable gain and apparently offered his traditional argument that the subject matter of the sale was an undivided interest in partnership assets. Therefore, it is doubtful that the court fully considered the implications of its decision in relation to the problem under discussion.

94 In this case it is arguable that the new partner is coming into the partnership and rendering extraordinary services in building up the declining partnership business. Due to the profit sharing arrangement it can be argued that these services will be reflected in profits, to the extent they are as successful as anticipated, and that the primary beneficiaries of those services, to the extent of the designated total of profits, are the old partners.

95 If the agreement is construed to provide for the sale of an interest in partnership profits, there appears to he little likelihood that the sale of such an interest by the original partners will constitute a mere assignment by them of partnership income. See the mention of this point, note 110 *infra*. However, if this were so, the new partner would then be deemed to have bought no interest in the partnership, but a mere right to receive partnership income after it is earned. In such case, he would merely be deemed to pay an amount equal to such profits in exchange for the profits themselves. Thus he would realize no gain or loss on the transaction and his basis for his partnership interest would not be affected.

from the basis of the partners for their interests in the partnership.[96] However, upon the termination of the partnership and the distribution of the property in kind to the partners, this basis is extinguished. Property distributed to each partner takes instead, as its basis in his hands, the amount of his income tax basis for his interest in the partnership. Obviously, the total bases of all the partners and the total basis of the partnership for all its property will not necessarily be equal. The distributed property may have a totally different basis in the hands of the partners—either greater or smaller—than it had in the hands of the old partnership. And when that property is subsequently contributed to a new partnership, since the statute requires that a partnership take as its basis the basis of the partner contributing the property[97], the basis of the property in the new partnership will reflect the change in basis which took place upon the distribution of the old partnership assets.[98]

(1.) *Effect of Application of Aggregate Theory.* The problem is made acute by the reasoning of the Court of Appeals for the Second Circuit in *Helvering v. Archbald.*[99] There it was held that the entrance of a new partner into the partnership with the consent of the old partners is not a cause of dissolution under the Partnership Law of New York. It is significant in this respect to note that the New York law is substantially identical with Section 31 of the Uniform Partnership Act.[100]

This determination in *Archbald* might easily and logically have been reached if the partnership had been considered an entity for this purpose. Instead, the court reached its result upon an application of the aggregate theory. Consequently, even after holding that the partnership was not terminated, the court could not reconcile its conclusion with the change in identity of the individual partners which had taken place. It therefore stated:

> Of course it is true that *de facto* a new firm is inevitably formed when a new partner is taken in, even though, as here, that event is provided for

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[96] INT. REV. CODE § 113(a)(13).

[97] *Ibid.*

[98] The fact that the assets have not been physically distributed in kind and recontributed to a new partnership may not be material. In such circumstances these acts may be found to have taken place by operation of law. Helvering v. Archbald, 70 F. 2d 720 (2d Cir. 1934); Waddell v. Comm'r., 102 F. 2d 503 (5th Cir. 1939); Planters Gin Co., 28 B. T. A. 22 (1933); John Whitney, 4 CCH TC Mem. 881 (1945); G. C. M. 10,092, XI-1 Cum. Bull. 114 (1932), *revoked by* G. C. M. 26,379, 1950-1 Cum. Bull. 58, dealing with a different problem; G. C. M. 11,557, XII-1 Cum. Bull. 128 (1933).

[99] 70 F. 2d 720 (2d Cir. 1934), citing N. Y. PARTNERSHIP LAW, § 62. *Cf.* Flannery v. United States, 25 F. Supp. 677 (D. Md. 1938), *aff'd per curiam*, 106 F. 2d 315 (4th Cir. 1939).

[100] N. Y. PARTNERSHIP LAW § 62.

> in the original articles and the agreement admitting him declares that the old articles shall continue in effect.[101]

Since a *de facto* new firm was created,[102] the court decided that the assets could have gotten into that firm only upon a distribution to the old partners in kind and their subsequent contribution to the new firm. The court pointed out, however, that the dissolution was purely formal and that the distributions received by the partners were uncertain in amount since they were as yet unliquidated. In addition, such amounts were bound to remain uncertain since they were received by the partners under a mutual agreement to contribute them to a new partnership in their unliquidated form. The court then held that the receipt by the partners of such amounts of property which would never be liquidated resulted in the receipt by them of nothing having a "fair market value", thus ruling out any possibility of gain or loss to the partners upon the distribution.

On the other hand, the basis problems inherent in the formation of a *de facto* new firm were not discussed by the court in the *Archbald* opinion. If such a new firm is created, the transfer to it of the assets of the old firm must have been accomplished by a distribution of the assets to the original partners, followed by their contribution to the new partnership. Upon such a distribution of assets to the old partners, each will constructively receive his undivided share thereof. As a result of that distribution, the basis of the old partnership for the assets will be extinguished and the entire basis of each distributee partner is then assigned to the assets distributed to him. Although the fair market value of the whole may not be determinable, this apparently is not necessary in order to assign a new basis for whole distributive shares thereof.[103]

The subsequent contribution of the allegedly unvalued mass of assets

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101 Helvering v. Archbald, 70 F. 2d 720 (2d Cir. 1934).

102 But even under the aggregate theory a *de facto* new firm might not always be created. For example, in Cavour Hartley, CCH BTA Mem. Dec. 11,278-D (1940), one member of an existing partnership was a minor. He owned outright a 5/66ths interest and the beneficial interest in another 5/66ths interest which was held in trust during his minority. In the middle of the taxable year of the partnership, he became of age and received legal as well as equitable title to the 5/66ths interest previously held in trust.

The Tax Court found that there had been no change in proportionate shares of partners, no change in partnership accounts and no new assets distributed or acquired. It therefore held that the transfer of bare legal title to the 5/66ths interest without a change in beneficial ownership did not result in a dissolution of the partnership. Although the Tax Court often recognizes the partnership as an entity for various purposes, this decision would be sound under either theory.

103 In such cases, the entire basis of the distributee would automatically attach to the entire property distributed. Since no allocation of basis is necessary, the value of the assets would be immaterial with respect to the basis problem.

to the new partnership would then cause the partnership to take as its basis for those assets the basis which the property had in the hands of the contributor. As noted above, the total bases of all the old partners for their partnership interests and the basis of the old partnership for its assets may be substantially different in amount. On this ground, the *Archbald* decision will allow the old partners to escape the immediate impact of the *de facto* termination of the partnership. However, upon the subsequent completion of a transaction involving partnership basis, the full effect of the decision will then affect old and new partners alike.

The attempt of the Court of Appeals in *Archbald* to prevent the imposition of tax upon the old partners indicates its awareness of the realities of the situation. It realized that in substance there had been no completed transaction resulting in the realization of gain or loss and that the economic position of the old partners was unchanged by the mere fact of the admission of a new partner. Possibly it might also have found a plausible answer to the basis problem had that been squarely presented. But the implications of the opinion will necessarily cause partners to pause when contemplating the admission of a new partner.

The application of the entity theory would immediately solve the problem, since changes in membership would have no effect upon the continuation of the firm. This approach automatically eliminates any partnership basis problems, since the firm has neither acquired nor sold any assets as a result of the transaction.[104]

The complete artificiality of any holding which changes the tax status of the partnership in this type of situation is highlighted by the fact that under the Uniform Partnership Act the admission of a new partner is not a cause of dissolution of the old firm.[105] The Act leaves the way open for a clear and simple solution to the problem by an application of the entity theory, allowing the partnership to be treated in contemplation of law as it is in fact—a mere continuation of an existing enterprise.

C. *The Original Partners*

(1.) *Contribution of Notes.* With respect to the original partners, the contribution of notes to the partnership by the incoming partner creates no problem if the entire amount thereof is credited to that partner's capital account.[106] Neither does the contribution affect their

104 In Robert E. Ford, 6 T. C. 499 (1946), the Tax Court reached a similar conclusion by an application of the entity theory to a case involving the withdrawal of a partner from a continuing partnership.

105 UNIFORM PARTNERSHIP ACT § 31.

106 For a discussion of the problems created when the entire amount contributed is not credited to the capital account of the new partner, see page 496, *infra*.

bases for their individual interests in the partnership.[107]

(2.) *Graduated Profit Sharing Agreements.* As noted in the above discussion with respect to the problems of a new partner, the agreement under which he is admitted may merely provide that he is to receive a fixed percentage of partnership profits. Although there is a shift in percentages of interests in firm profits among the various partners as a result of this agreement, it seems clear that there has been no sale or exchange thereof for tax purposes.[108]

The fact that the new partner makes a contribution to capital, all of which is credited to his own capital account, should not change the above result.

There likewise will clearly be no sale or exchange of partnership interests if a new partner is admitted to membership under an agreement by which at the end of a fixed term, his interest in profits shall be increased. On the other hand, as noted in the discussion of the problems of the new partner, the facts surrounding some graduated profit sharing agreements may suggest to the Commissioner the possibility that there has been such a sale or exchange. For example, if the new partner can be said to be rendering extraordinary services in consideration for the agreement to give him an increased percentage of interest in profits, the Commissioner may argue that there has been a sale to him of that interest.[109] No reported cases have considered such a contention, but

107 There is a change in the percentage of interest of each of the old partners in the assets, but the total assets have increased at the same time. Thus, there has been no exchange of partnership interests in the usual sense. See Comm'r v. Lehman, 165 F. 2d 383 (2d Cir. 1948), and discussion of that case at page 497 *infra*.

108 See the discussion of shifts in percentages of partnership interests in Lehman v. Comm'r., 165 F. 2d 383 (2d Cir. 1948).

109 If such an argument is successful, a reasonable method of determining what each partner has sold would be to hold that each partner is disposing of a portion of his individual interest in the partnership profits which is equal to the percentage of interest in profits being acquired by the new partner. For example, assume that *A, B* and *C* have 10, 40 and 50 per cent. interests respectively in partnership profits. If *D* acquires a 10 per cent. interest in the profits, *A* would be considered as having transferred to him 10 per cent. of his 10 per cent. interest in profits, or one per cent. of the total interests in partnership profits. Similarly, *B* and *C* would be considered to have transferred 4 per cent. and 5 per cent. interests respectively in the total profits.

Partner *A* in this example would then probably be permitted to allocate 10 per cent. of his income tax basis for his partnership interest to the interest in profits transferred. If, however, Partner *A* has one percentage of interest in profits and another percentage of interest in the surplus of assets remaining after dissolution and liquidation of the partnership, a difficult problem of allocating basis between the two percentages is presented.

Since payments of purchase price are contingent upon profits, it would apear that *A* could be considered as having sold at each payment only that portion of his interest in profits which the payment represents of the total purchase price. Total basis for the interest being sold would be similarly allocated.

there is some doubt that the Commissioner would succeed on the point.[110]

(3.) *Effect of Original Partners Realizing Profit or Loss Upon Admission of New Partners.* If the original members of the partnership can be found to have realized a gain or suffered a loss upon the admission of a new member, that gain or loss will be recognized for income tax purposes. Aside from the questions presented by the graduated profit sharing agreements discussed above, gain or loss upon the admission of a new partner will normally be recognized only in case the capital accounts of the original partners are changed as a result of his entry into the firm.[111] It is submitted that only by such a change in capital accounts can the benefit realized or the detriment suffered by the original partners be measured with sufficient definiteness for the transaction to be considered taxable.

If the firm is a personal service partnership, the new partner will often be required to make a capital contribution. If a part of that contribution is credited to the capital accounts of the original partners, then, it is believed, they will have realized a taxable gain from the transaction. On the other hand, if some portion of the capital accounts of the original partners are transferred to the account of the new partner, or are written down without a corresponding withdrawal of cash from the firm by the original partners, then, it seems, recognizable loss results. The same principles also should apply to a partnership dealing in tangible assets rather than personal services.

Assume, for example, that *A, B* and *C* are equal partners, each having

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110 If it is assumed that the agreement with the new partner involves the purchase and sale of an interest in profits, such a purchase will be ineffectual if it constitutes a mere assignment of income. As a general rule, one who earns or creates income cannot escape tax by anticipatory assignments of it. Lucas v. Earle, 281 U. S. 111 (1930). But, if the taxpayer transfers the corpus from which the income is derived, such a transfer will be effective in transfering the income derived from such corpus.

The receipt by a new partner of an interest in partnership profits with no corresponding interest in surplus remaining after dissolution and liquidation will not prevent his being treated as a partner. Mosbacher v. United States, 30 F. Supp. 703 (Ct. Cls. 1940), *rev'd on other grounds*, 311 U. S. 619 (1940); Daniel B. McDaniel, 3 CCH TC Mem. 826 (1942). The Bureau of Internal Revenue apparently agrees. I. T. 1849, II-2 Cum. Bull. 6 (1923) (by implication).

In a number of cases and rulings new partners had received interests in profits without making either capital contributions or payments to capital partners. Since, however, the transfer of an interest in profits is sufficient to prevent the taxation to the original partners of the profits received by a new partner, there should be no different result when such a transfer is accompanied by the passage of consideration to the original partners.

111 This statement assumes, of course, that each of the original partners continues in the partnership, and that the only change is the admission of a new partner. He may or may not make a contribution to capital, but will receive an interest in partnership profits.

invested $10 in the partnership. Upon the admission of *D* to the partnership, it is agreed that all four partners will have a 25 per cent. interest in profits and will bear 25 per cent. of the losses. If *D* contributes $10 to the partnership, he will have contributed an amount equal to 25 per cent. of the total capital. Since the value of the interest in capital which he receives is equal to the amount of capital he contributes, the original partners realize no gain or loss and there cannot be a sale or exchange of partnership interests as a result of the transaction.

Under these circumstances, the interests in the partnership of *A*, *B* and *C* have decreased from 33 1/3 per cent. to 25 per cent., while that of *D* has increased from zero to 25 per cent. To this extent, there has been a transfer of 8 1/3 per cent. of the interest of each of the original partners to the new partner. However, it should be pointed out that at the time this change in percentages is taking place there is also an increase in partnership assets and capital accounts. For instance, although *A* previously had a 33 1/3 per cent. interest, worth $10, in assets worth $30, he now has a 25 per cent. interest, worth $10, in assets worth $40. Therefore, while the percentages of interests have changed, *A*'s position remains unaltered in economic fact. He has transferred nothing to the new partner except a bare percentage figure.

The Court of Appeals for the Second Circuit faced a somewhat analogous question in the case of *Commissioner v. Lehman*.[112] One partner had died. His capital account had been cancelled and the amount thereof set up on the books as an account payable. This naturally increased the percentages of interest in the partnership held by the remaining partners. However, assets were reduced by a comparable amount when the account was paid, so that the economic percentages of each partner's interest in assets were actually unchanged. The Commissioner argued that there had been an accretion in the interest of the surviving partners as a result of an exchange with the estate. The court rejected this argument, observing that:

> [i]t is true that the percentages of the survivors were increased; but percentages are not property but only mathematical symbols; and although they did share the firm assets in new proportions, the firm assets were not the same assets as before. The survivors' shares: i.e. their claims upon profits and in the surplus, were precisely what they had been before Arthur Lehman died; there had been no accretion of anything but a factor of computation.[113]

In the foregoing example, the new partner, *D*, had to contribute $10 in order for his contribution to equal 25 per cent. of the total capital.

112 165 F. 2d 383 (2d Cir. 1948).

113 *Id.* at 387.

It was in exchange for this contribution that he was to receive a 25 per cent. interest in partnership profits. Assume, however, that instead of contributing $10, he actually contributes $15. Upon the completion of this payment, the partnership books may show a debit to cash of $15, a credit to *D*'s capital account of $10, and credits to the accounts of *A*, *B* and *C* of $1.66 each.[114] In this example, the original partners are receiving a premium from the incoming partner for his admission to the partnership since the amount contributed is in excess of that required to make *D*'s contribution equal to 25 per cent. of the total capital. The premium results in a profit to the remaining partners which probably will be recognized for tax purposes. Similarly, when *D* contributes only $9 and the capital accounts of the original partners are written down correspondingly, the transaction results in a loss to the original partners which should also be recognized for tax purposes.[115] The problem is one of determining whether or not the expenditure is made to purchase a capital asset. In the light of the cases discussed above with respect to the withdrawal of a partner, one might argue with force that this transaction results in the sale of a partnership interest, so that the gain or loss will be treated as capital in nature.[116]

There is a strong possibility that the *Lehman* rationale will not apply to the situation in which *D* contributes $15 cash and the excess over $10 is credited to the capital accounts of the original partners. Before the transfer, *A*, for example, had a 33 1/3 per cent. interest in the partnership. The value of this interest was worth $10. After the transfer, he had a 25 per cent. interest in the partnership. This interest was also worth $10, but in addition, *A* has received $1.66 cash from *D*, in the form of a credit to his capital account. Under such circumstances, the *Lehman* case is distinguishable, and it may be strongly argued that *A* has sold a portion of his partnership interest to *D*, realizing a capital gain or loss thereon.

It is possible also to contend that *A* has sold the portion of his partnership interest represented by the difference between 33 1/3 per cent. and 25 per cent. Since 33 1/3 per cent. represents his total interest, he has disposed of one quarter thereof as a result of this sale. A portion of his total basis for his partnership interest would accordingly be allocated to the portion of the interest sold. Thus, if *A* has a basis for his interest of $10, the portion allocable to the interest sold would be $2.50. Since *A* received only $1.66 for this interest, he sustains a loss on the sale of $0.84.

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114 GRAHAM and KATZ, ACCOUNTING IN LAW PRACTICE 111 (2d Ed. 1938).

115 *Id.* at 112.

116 G. C. M. 26,379, 1950-1 Cum. Bull. 58 and cases cited therein.

When basis and capital account are equal, the economic and tax consequences of such sale should coincide. Economically, it appears that *A* has realized a gain on this sale, not a loss. The result clearly indicates the unrealistic nature of an allocation of basis made in this manner. The analysis of the *Lehman* case further indicates the fundamental artificiality of these percentage-of-interest figures in relation to the changes in capital account which give rise to the tax consequences in the transaction.[117]

Inasmuch as it is the change in capital accounts which creates the taxable transaction, it is believed that the more reasonable approach would be to measure the amount of partnership interest sold by the amount of the change in a partner's capital account. Thus in the above example, the value of *A*'s interest in excess of $10 which he sold to *D* can be assumed to be the amount *D* paid therefor, or $1.66. The total value of *A*'s interest before the sale would then be $11.66. Upon the sale of a part of that interest, *A* would allocate some part of his total basis for his partnership interest to the portion sold. Based upon the relative value of the interest sold and the total interest, this allocation fraction would be 1.66/11.66. If *A*'s basis for his partnership interest is $10, his basis for the portion sold would then be $1.42. He would therefore realize a $0.24 gain upon the admission of *D* to the partnership.

(4.) *Termination of Partnership by Admission of New Partner.* A further problem involving recognition of gain or loss to the original partners arises upon the issue of whether or not the partnership is terminated by the admission of the new partner. As noted at pages 492-493, *supra,* the Court of Appeals for the Second Circuit adopted the aggregate theory of partnerships in the case of *Helvering v. Archbald,*[118] holding that in substance the admission of a new partner created a *de facto* new firm. This holding required the court to find that there had been a distribution of all the assets to the original partners, followed immediately by the contribution of those assets to a new partnership. The court found, however, that by agreement the assets were received by the original partners in an unliquidated form subject to a mutual agreement to contribute them in that form to the new partnership. Accordingly, the receipt of such amounts, which under the terms of the agreement would never be liquidated by the partners, gave them nothing having a

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117 This lack of relationship between percentage of interests and the subject matter of the sale is further illustrated by the admission of a new partner when there is no change in capital accounts of the two original equal partners. Assume the new partner is given a 10 per cent. interest, but makes no contribution to capital. It is submitted that there has been no taxable transaction in this situation. Yet the percentage of interest of each of the two original partners has decreased from 50 to 45 per cent.

118 70 F. 2d 720 (2d Cir. 1934).

"fair market value", and no recognizable gain or loss resulted. The Fourth Circuit has reached a similar conclusion.[119]

The result of this rather tenuous line of reasoning is that no gain or loss of the original partners will be recognized in the Second and Fourth Circuits. It is possible that other jurisdictions will also apply the aggregate theory in arriving at a solution to this problem. But this would not foreclose a holding that an undivided interest in specific assets subject to liabilities is quite capable of valuation in the hands of an individual partner, despite the fact that all of such assets, subject to liabilities, must immediately be contributed to a new partnership. Therefore, if the assets distributed consist of cash and property, as will usually be the case in a going business, the gain or loss of the original partners may be recognized.[120] Yet this transaction is quite clearly not closed. There has been no change in economic position, and in the sense in which that term is normally used, the original partners can have realized no gain or loss.

An application of the entity theory by the courts in the analysis of this problem will result in a conclusion which is not only logical, but which is in accord with both the economic realities and the legal principles governing partnership termination. Under Section 31 of the Uniform Partnership Act, the partnership is not dissolved or terminated by the admission of a new partner. The entity theory would allow an identical result to be reached under the tax laws, thus eliminating the problem.

As noted in the discussion in Section III B, at pages 491-492, *supra*, termination of the partnership may result in a change in partnership basis, but despite this fact the bases of the original partners will remain intact. Upon such termination, the partnership assets will be deemed distributed to the original partners in kind.[121]

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119 United States v. Flannery, 106 F. 2d 315 (4th Cir. 1939), *affirming per curiam*, 25 F. Supp. 677 (D. Md. 1938). The District Court opinion cited and relied upon the *Archbald* decision.

120 This would apparently be the view of the Court of Appeals for the Second Circuit if the distributed property had a fair market value. Helvering v. Walbridge, 70 F. 2d 683 (2d Cir. 1934). *Accord,* C. K. Boettcher, CCH BTA Mem. Dec. 10,794-A (1939). If any of the original partners are limited partners, such gain or loss may be recognized even upon the receipt of a distribution of assets solely in kind, although they are immediately contributed to a new partnership. Annie Stevens Woodruff, 38 B.T.A. 739 (1938), Non-Acq., 1939-1 Cum. Bull. 69.

121 The share of assets distributed to each partner then takes as its basis in the hands of the distributee the amount of his total basis for his interest in the partnership. Upon their contribution to the new firm, that entity takes as its basis therefor, an amount equal to the basis of the contributor. INT. REV. CODE § 113(a)(13).

IV. Conclusions

In a partnership reorganization in which assets are sold to a successor partnership, the courts have generally treated the two firms as separate entities and have recognized the sale. However, losses from such sales have been disallowed when there has been no substantial change in the character of the firm.

Upon the exchange of its assets by the partnership for stock of a successor corporation, the firm is recognized as an entity for the purpose of the transfer. No gain or loss will be recognized if the requirements of Section 112(b)(5) are met. The firm has also been recognized as an entity for the purpose of making sales of its assets to the successor corporation for cash. However, when the sale results in a loss, at least some courts may be expected to disregard the partnership as an entity and disallow the loss under Section 24(b)(1)(B). If gain or loss is recognized, there is some risk that the transaction will not be treated as the sale of a unitary business. The nature of the gain or loss would thus be determined by the nature of each individual asset sold.

There is authority for the proposition that the partners may exchange their interests in the partnership for stock in a successor corporation if this result is required by the terms of the particular agreement. In the light of the cases upholding sales of such interests upon an application of the entity theory this result seems sound. No gain or loss will be recognized upon the exchange if the provisions of Section 112(b)(5) are complied with. There is also a good possibility that the Tax Court, at least, would recognize a sale by all members of their partnership interests to a successor corporation. Any loss resulting from a sale to a controlled corporation would be disallowed under Section 24(b)(1)(B). It is possible that any gain would be treated as beng capital in nature. However, this transaction in substance would constitute the sale of an entire business, and there may be some risk that the nature of the gain or loss must be determined by the nature of the particular assets of the business itself.

With respect to the problems arising upon the admission of a new partner, the primary concern of the partnership and the original partners is whether or not the venture is terminated. There is authority indicating that there may be such a termination under the aggregate theory. On the other hand, the entity theory allows the admission of the new partner without a termination of the firm, thus producing the more reasonable result under the circumstances. It is submitted that the remaining partners realize no recognizable gain or loss upon the admission of a new partner merely as a result of a shift in profit-sharing percentages. Only when a part of the contribution of the new partner is credited to the capital accounts of the remaining partners should gain or loss be recognized. Indeed, the confusion caused by the failure on the part of the courts to adhere consistently to either the aggregate or the entity theory leaves the taxpayer and the tax practitioner in a considerable and unnecessary dilemma.