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Income Tax-Partnerships — Distributive Share of Capital Gains — In What Respect is the Partnership Tax Return More Than an Information Return?

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Income Tax—Partnerships—Distributive Share of Capital Gains—In What Respect is the Partnership Tax Return More Than an Information Return?

A recent Tax Court decision presents an opportunity to review the function of the partnership in the income tax field. A partnership sold its assets under circumstances where it could have elected to treat the transaction as an installment sale under section 44(b) of the Internal Revenue Code.[1] However, on the partnership return, the capital gain from the sale was reported on the completed transaction basis. The partner on his return reported his share of the partnership capital gain on the installment basis. The tax court held that the partner must report the same distributive share of the gain as reported in the partnership return and could not elect to report his distributive share of the gain under the installment method.[2]

An understanding of the role of the partnership and partnership tax return in income tax laws is essential to the proper analysis of this case.[3] Many of the inconsistencies and areas of dispute in the present tax law stem from the fundamental difference in the conceptual nature of a partnership.[4] On the one hand the partnership may be regarded as an aggregate of the partners engaged in a joint enterprise (similar to a tenancy in common); on the other hand it may be regarded as a business entity separate and apart from its constituent members (similar to a corporation).[5]

Considerations For The Proposition That The Taxpayer Is Bound By The Election On The Partnership Return

(1) The partnership return is more than just an information return. It has consequences which go beyond the mere disclosure to the Commissioner of profits of the enterprise. For example, the partnership is either on the cash or accrual basis and such election is binding on the partner regardless of the fact that he personally is on a different basis. Similarly, even though the individual partner keeps his books and reports his income on the calendar year basis, he must nevertheless

[1] Int. Rev. Code § 44. "Installment Basis . . . (b) Sales of Realty and Casual Sales of Personalty—In the case (1) of a casual sale or other casual disposition of personal property . . . for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 3 per centum of the selling price . . . the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section."

[2] John G. Scherf, Jr., 20 T.C. 43 (1953).

[3] John G. Scherf, Jr., 20 T.C. 43 (1953).

[4] Model Code of Federal Income Tax 103 (Tent. Draft No. 7, 1952).

[5] Ibid.

include his share of his partnership's income for the full fiscal year ending within the calendar year, if the partnership has elected to keep books and file returns on a fiscal year basis. In the computation of net income, it is generally the partnership, not the individual partner, that exercises the various options open to taxpayers in computing net income under the Code.[6] Even in computing the total amount of the gain or loss on the sale of capital assets, the partnership determination is conclusive. In view of the above practices, perhaps the courts should adopt the view of the instant case and make the partnership determination not to report income on the installment basis binding on the individual partner. On the other hand, perhaps the answer to this conclusion is simply that "capital assets" are by their very nature fundamentally different.

(2) Generally speaking, in partnership law, the opinion of the majority of the partners is binding on all partners. The dissenting partner's only relief is to dissolve the partnership. The Commissioner has argued quite effectively, and the courts have agreed, that in the case of ordinary income, the decision of the majority of the partners as to whether a certain transaction is income or not is controlling in partnership affairs.[7] Should not this reasoning apply to the capital gains treatment by the partnership? On the other hand, query whether a court would accept the argument of the instant case if the present taxpayer had dissolved the partnership over the issue of how to treat the capital gain.

(3) The adoption of the entity concept of partnerships in the principal case is not new to the courts. For example, when a partner sells his partnership interest the same basic conflict is present. Under the entity theory, the sale is one of capital assets as a whole, while under the aggregate theory each particular asset of the partnership is examined to determine which part of the sale was ordinary income and which part capital gain. After some wavering, the courts have squarely adopted the entity concept in connection with this problem, and the Bureau has finally acquiesced in the result.[8] However, in a decision irreconcilable with the entity theory, the tax court has held that a partner who sells his partnership interest realizes ordinary income on his interest in installment obligations where ordinary income has been postponed under section 44(d).[9]

[6] John G. Scherf, Jr., 20 T.C. 43 (1953).

[7] I.T. 3713, 1945 Cum. Bull 178.

[8] 1 Rabkin and Johnson, Federal Income, Gift and Estate Taxation § 14.06(2) (1951).

[9] Rhett W. Woody, 19 T.C. 46 (1952). See 1 Rabkin and Johnson, Federal Income, Gift and Estate Taxation § 14.06(5) (1951).

Considerations For The Proposition That The Taxpayer Is Not Bound By The Election On The Partnership Return

(1) Section 182 of the Code[10] provides how the net income of a partner will be computed, and in subsections (a) and (b) states that his distributive share of the capital gains and losses will be included as part of his gains and losses from the sale or exchange of capital assets. Only subsection (c) states that the partner's distributive share of the ordinary income will be computed as by the partnership. Section 183[11] provides for the separation of capital gains from ordinary income. The capital gains do not become a part of the ordinary income to be taken up by the partners under section 182(c), but instead are listed in the partnership return for information purposes only. The dissenting opinion of Judge Arundell in the principal case stressed this point of statutory construction.

This problem has been met by the American Law Institute in its "Model" Federal Income Tax Statute[12] in the following manner:

> Section 182 of I.R.C.[13]
> In computing the net income of each partner, he shall include, whether or not distribution is made to him—
> (a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months,
> (b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sale or exchange of capital assets held for more than 6 months.
> (c) His distributive share of the ordinary net income or the ordinary net loss of the partnership *as provided in section 183(b).*

> Section X750 of "Model" Code
> In computing his net income from the partnership, each partner should include the following, whether or not distribution is made to him:
> (a) As part of his ordinary net income or loss, his distributive share of the ordinary net income or loss of the partnership, *computed in accordance with section X728.*
> (b) As part of his capital gain and losses, his distributive share of the capital gains and losses of the partnership, *computed in accordance with Section X728.*

At first glance, one would conclude that the Model Code has destroyed the effectiveness of Judge Arundell's argument. However, the Model Code contains a new section[14] which provides that the income,

[10] Int. Rev. Code § 182.
[11] Int. Rev. Code § 183.
[12] Model Code of Federal Income Tax § X750 (Tent. Draft No. 7, 1952).
[13] Int. Rev. Code § 182.
[14] Model Code of Federal Income Tax § X750(c)(3) (Tent. Draft No. 7, 1952).

gain, or loss or credits of the partnership being brought from the partnership returns for tax purposes to the partners, shall be treated by the partner as if the item were realized or incurred directly by him from the source from which realized or incurred by the partnership, and in the same tansaction. Also, in the comments on this new section, it is specifically stated that the drafters did not intend to change the present law. Evidently their interpretation of the present law is different from Judge Arundell's and, perhaps, is inconsistent with their stated ideas concerning the nature of a partnership.

(2) The Model Code has expressly adopted the entity theory of the dissenting judges by the addition of another new section[15] concerning the nature of a partnership:

> Where the manner of application of a provision of this Chapter to a partnership or partner is not specified, then in the application of the provision a partnership shall be treated as the aggregate of the parties, each owning undivided interests in the partnership properties.

This general section should, if enacted, eliminate much of the confusion in taxation of partners and partnerships, although whether or not the manner of application of a provision is "specified" is always open to argument. The adoption of the aggregate theory should produce a more equitable allocation of taxes among the partners where they have not taken the tax into consideration in their negotiations with each other.

(3) The Revenue Act of 1938, section 182, was amended for the specific purpose of allowing the segregation of capital gains and losses in the partnership return, and the retention of such status for use by the partner in his individual return. The majority opinion stated that the sole argument advanced by petitioner to escape the consequences (of their reasoning) is based upon the fact that the assets sold by the partnership were "capital assets." In view of this statement, it is interesting to note that the house committee specifically stated that the proposed change in taxing of partnership capital gains and losses involved a departure from the general rules applicable to partnership income.[16]

[15] Model Code of Federal Income Tax § X701 (Tent. Draft No. 7, 1952).

[16] H.R. Rep. No. 1860, 75th Cong, 3d Sess. 42 (1938). "The method of treatment provided in these sections of the bill [182 and 183] is a logical corollary of the principle that only the partners as individuals, not the partnership as an entity, are taxable persons and is necessary to give the partners as individuals the benefit of the alternative tax in the case of net long-term capital gains provided in section 117(c), with respect to such gains realized upon the sale or exchange of partnership capital assets. It should be noted that this method involves a departure from the principle adopted in the Revenue Acts of 1934 and 1936 to the extent that it enables capital net losses of the partnership in the respective categories to be applied, on the basis of the partner's allocable shares thereof, to offset their individual capital net gains in the same cate-

(4) As a result of several recent court decisions,[17] the Commissioner adopted an entirely new approach to the taxation of compensation for services rendered over a period of thirty-six months or more.[18] Now a partner may allocate the income received from a partnership over the entire period of the time of the services even if it goes beyond the date of his entry into the partnership. Regardless of the correctness of the ruling, it seems inconsistent that a taxpaying partner can take advantage of this relief provision going back in time, and yet can not take advantage of a relief provision going forward in time.[19] Perhaps reconciliation is possible on the grounds that both the ruling and the principal case adopt the entity theory.

(5) In some respects it can not be denied that the partnership return is an information return. For example, the partnership is not permitted to deduct contributions as an expense, but rather each partner takes his distributive share of the contribution in his individual return.[20] This provision was enacted to put partners on equal footing with other taxpayers who were limited in the amount of their contributions or who perhaps received no direct tax benefit from their contribution since they took the standard deduction. Whether the taxpaying partner will get to deduct any contributions will depend on each partner's particular tax situation, thus adopting the aggregate approach. But the principal case refused to allow the taxpaying partner the benefit of the installment provisions of the Code under the theory that the partnership is the "tax computing" entity. An attempt to treat taxpaying partners the same as other taxpayers should give them the advantages held by other taxpayers as well as take away the advantages they formerly held over the other taxpayers.

(6) There has been considerable controversy over the extent to which partners may utilize gains or losses from partnership transactions in offsetting gains and losses incurred in their individual enter-

gories. The allocation of the short-term and long-term capital gains and losses as such among the individual partners will, of course, affect the computation of the amount, if any, of the short-term capital net loss and the long-term capital net loss in any taxable year which the partners as individuals may be entitled to carry over to the succeeding taxable year, under other provisions of the bills."

[17] Commissioner v. Eversen, 187 F.2d 233 (9th Cir. 1951); Commissioner v. Nielson, 187 F.2d 233 (9th Cir. 1951); Commissioner v. Marshall, 185 F.2d 674 (3d Cir. 1950).

[18] G.C.M. 26993, 1951-2 Cum. Bull. 54. "Income received by a partner as his share of compensation for services rendered by the partnership over a period of 36 months or more is subject to allocation over the entire period under section 107 of the Internal Revenue Code, amended, notwithstanding the fact that part of the services was rendered prior to the partner's admission to the partnership."

[19] Supra note 1.

[20] Int. Rev. Code §§ 183(a), 183(c).

prises.[21] The Supreme Court has held that the stock loss limitations sections were to be construed so as to permit a partner to treat gains and losses from both partnership and non-partnership sources in the same fashion as similar gains and losses realized by a taxpayer not a member of a partnership.[22] If the partnership has gambling gains, these gains will retain their character when included in the partner's distributive share of partnership income and the partners may set off against them individual gambling losses.[23] These holdings are consistent with the traditional common law concept of a partnership as essentially a tenancy in common by the partners in specific properties,[24] and since the income tax has refused in these instances to employ the entity conception of a partnership, there would seem to be no reason, in principle, for denying the taxpayer in the principal case the right to refute the entity concept.

Conclusion

To the tax practitioner who is presented with a problem similar to the one in the instant case, it is suggested that the holding of the court is not a conclusive determination requiring absolute adherrence. In the first place, the Bureau might not even contest the treatment by the partner if it came up again under similar circumstances. This would be in line with the new Bureau policy[25] placing less empasis on the depreciation deduction unless clearly erroneous. The Commissoner reasoned that although the efforts of the revenue agents concerning the depreciation deduction sometimes produced more immediate revenue, in the long run there was no noticeable change in total taxes received by the Government. In the second place, an appellate court would be relatively free to decide the case either way; the tax court experts disagreed by a vote of ten to six and there are authorities for either conclusion.[26]

[21] 6 Mertens, Law of Federal Income Taxation § 35.13 (Rev. ed. 1949).

[22] Neuberger v. Commissioner, 311 U.S. 83 (1940).

[23] Jennings v. Commissioner, 110 F.2d 945 (5th Cir.), cert. denied, 311 U.S. 704 (1940).

[24] 1 Rabkin and Johnson, Federal Income, Gift and Estate Taxation § 14.01(2) (1951).

[25] See 5 CCH Fed. Tax Rep. ¶ 8625 (1951).

[26] Monett, Tax Atlas ¶ 12.85 (1952-53). "The partnership's net short-term capital gain or loss as reported in Form 1065—Schedule K 'Partner's Shares of Income and Credits' for each partner is entered on the partner's Schedule D—Form 1040—Line 2." 1 Rabkin and Johnson, Federal Income, Gift and Estate Taxation § 14.02(2) (1951) ("The partner reports as ordinary income . . . his distributive share of the partnership ordinary net income."); § 14.02(9) ("The partner includes in his . . . capital gain . . . his distributive share of the .... capital gain of the partnership."). Contra: 6 Mertens, Law of Federal Income Taxation § 35.16 (Rev. ed. 1949) (". . . capital gains and losses, as such, do not enter into computation of partnership net income, the partnership return

Whether the partnership is treated as an aggregate of the partners engaged in a joint enterprise or as a business entity is a matter to be determined by legislative enactments rather than court determinations. It is submitted that serious thought should be given in the drafting of future tax statutes concerning partnerships to the view of providing the courts with expressed adoption of one theory or the other. Perhaps the only equitable solution would be to adopt a part of both concepts, but in such case an effort should be made to gain some consistency in the field as far as each particular phase of partnership tax law is concerned. The A.L.I.'s Model Code is a step in the right direction.

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with respect to them merely serving as an instrument of segregating them for treatment on returns of the partners in the same fashion as similar gains and losses realized through non partnership transactions.").