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PARTNERSHIPS AND THE "USED SECTION 38 PROPERTY" INVESTMENT CREDIT: A WIDENING LOOPHOLE

DAVID BRIAN MURSTEN

President Carter, in his January 20, 1978, Tax Message to Congress, stated that "[t]he investment tax credit has proven to be one of the most potent tax incentives for capital formation."[1] To spur investment, the President proposed a liberalization of the investment tax credit, designed to "make the investment credit a stronger, more efficient, and more equitable incentive."[2] This note will examine the availability of the investment tax credit in transactions between a partnership and a partner.[3]

I. THE INTERNAL REVENUE CODE OF 1954—INVESTMENT CREDIT PROVISIONS

Section 38 of the Internal Revenue Code of 1954[4] allows the investment tax credit as provided by Code sections 46-50 and authorizes the Internal Revenue Service to promulgate legislative treasury regulations pursuant to section 38.[5] "Section 38 property," under sec-

1. Carter, *Tax Reform Proposals,* 36 CONG. Q. 222, 231 (1978).

2. *Id.* The President's investment credit proposal has been summarized as follows:

> The present 10 per cent investment tax credit, which was scheduled to drop to 7 per cent in 1981, would be continued permanently at 10 per cent. In addition, it would be liberalized so that it could be used to offset up to 90 per cent of a corporation's tax liability, as compared to the present 50 per cent ceiling. It also would be extended to investments in industrial and utility structures, in addition to applying to machinery and equipment. Carter also proposed allowing pollution control equipment to qualify for the full 10 per cent credit, even if it qualifies currently for five year amortization.
>
> Carter estimated that the changes would encourage new business investment by reducing taxes by $24.5 billion in 1979.

Conte, *Carter Proposes $24.5 Billion Tax Cut, Limited 'Reforms',* 36 CONG. Q. 164 (1978).

3. For detailed examinations of the investment credit in general, see 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 32A.01-.70 (1975); 3 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION §§ 45.11-.11B (1978); Bagley, *How to Maximize Investment Tax Credits; Planning Under the Cases and Rulings,* 43 J. TAX. 154 (1975); Jones, *Are Your Clients Getting the Most Out of the Investment Credit Provisions?,* 12 TAX. ACCOUNTANTS 196 (1974). For a discussion of the investment tax credit and partnerships, see 2 A. WILLIS, PARTNERSHIP TAXATION §§ 69.01-.07 (2d ed. 1976).

4. INTERNAL REVENUE CODE OF 1954, as amended [hereinafter cited as I.R.C.].

5. I.R.C. § 38 provides:

> SEC. 38. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.
>
> (a) GENERAL RULE.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.
>
> (b) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

tion 48(a), means "most tangible personal property and certain real property other than buildings or structural components."[6] The property must have a useful life of at least three years and qualify under the Code for depreciation or amortization.[7] Examples of section 38 property listed under the section 48 regulations include:

> production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment . . . .
>
> . . . [and] any other tangible property . . . used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or . . . a research or storage facility used in connection with any of the foregoing activities . . . .[8]

Other examples of section 38 property are law books,[9] income-producing citrus trees,[10] certain citrus-processing equipment,[11] certain farm improvements,[12] computers,[13] yachts,[14] and floating docks.[15] Section 38 property does not include most intangible personal property or realty.[16] For example, baseball and football player

6. Joseph L. Holloman, 1975 T.C.M. (P-H) ¶ 75,309, at 75—1325.

7. I.R.C. § 48(a)(1); *see* Treas. Reg. § 1.48-1 (1972).

8. Treas. Reg. § 1.48-1(c)-(d) (1972).

9. Steven M. Kipperman, 1977 T.C.M. (P-H) ¶ 77,032.

10. Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified by* Rev. Rul. 66-183, 1966-2 C.B. 47.

11. Central Citrus Co., 58 T.C. 365 (1972) ("sweet rooms"—used to ripen fruit, blowers, coolers, and related processing equipment—qualify).

12. Rev. Rul. 66-89, 1966-1 C.B. 7 (fences used in connection with raising livestock, drain tiles used to irrigate cultivated fields or improve pasture drainage, paved barnyards, water wells used in connection with raising poultry or livestock, and facilities used and designed solely for the storage of farm products qualify), *clarified by* Rev. Rul. 72-222, 1972-1 C.B. 17 (water wells).

13. Rev. Rul. 71-177, 1971-1 C.B. 5.

14. J. Wade Harris, 1975 T.C.M. (P-H) ¶75,276. Nondepreciable yachts do not qualify for the credit. *See* Nicholls, North, Buse Co., 56 T.C. 1225 (1971), in which, upon failing to meet the business use substantiation requirements of I.R.C. § 274 relating to the disallowance of certain entertainment expenses, taxpayer's yacht was held nondepreciable and failed to qualify for the credit.

15. Rev. Rul. 75-178, 1975-1 C.B. 9, *revoking* Rev. Rul. 67-67, 1967-1 C.B. 6 *and* Rev. Rul. 69-14, 1969-1 C.B. 26 (relating to movable partitions). The pilings to which the floating docks are attached fail to qualify for the credit. Rev. Rul. 75-178 states that the determination of whether property is "personal" or "inherently permanent" will be based upon the manner in which the property is attached to the land or structure and "how permanently the property is designed to remain in place." *Id.*

16. *See* Treas. Reg. § 1.48-1 (1972).

contracts,[17] mobile homes rented mostly to nontransients,[18] and sports stadiums[19] fail to qualify.

"[B]ecause of the greater dependence of small business on used property, a limited credit [was] also made available for used property which is newly acquired."[20] Property qualifies as used section 38 property unless the person who uses the property after its acquisition is the same person or is related to the person who used the property prior to the acquisition.[21] For example, property acquired by a component member of a controlled group from another member of the same controlled group does not qualify as used section 38 property.[22]

Also excluded from the definition of used section 38 property is property acquired in transactions between family members; between shareholders and corporations; between personal holding

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17. Rev. Rul. 71-137, 1971-1 C.B. 104 (football player contracts); Rev. Rul. 67-379, 1967-2 C.B. 127 (baseball player contracts). Player contracts fail to qualify because they are intangible property.

18. Moore v. Commissioner, 489 F.2d 285 (5th Cir. 1973), *aff'g* 58 T.C. 1045 (1972). Under I.R.C. § 48(a), real property may qualify if it is rented mostly to transients. *See* Treas. Reg. § 1.48-1(h) (1972).

19. Rev. Rul. 69-170, 1969-1 C.B. 28. As real property, the stadium fails to qualify. But, the stadium's nonstructural components—the seats, field lights, flagpoles, batter's eyescreen, and foul line poles are qualifying " 'other tangible property' as defined in section 1.48-1(d) of the regulations." *Id.* at 29.

20. H.R. Rep. No. 1447, 87th Cong., 2d Sess. 7, 9 (1962), *reprinted in* 1962-3 C.B. 405, 413.

21. I.R.C. § 48(c) provides:

> (c) Used section 38 property.—
>
> (1) In general.—For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition (or by a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition).

I.R.C. § 179(d)(2) provides:

> (2) Purchase defined.— . . . [T]he term "purchase" means any acquisition of property, but only if—
>
> (A) the property is not acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b) (but, in applying section 267(b) and (c) for purposes of this section, paragraph (4) of section 267(c) shall be treated as providing that the family of an individual shall include only his spouse, ancestors, and lineal descendants),
>
> (B) the property is not acquired by one component member of a controlled group from another component member of the same controlled group . . . .

22. Treas. Reg. § 1.48-3(d)(4) (1972) defines "component member of a controlled group" (referring to related corporations) in terms of I.R.C. § 1563(a) and (b), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" each time it appears in I.R.C. § 1563(a)(1). (I.R.C. § 1563 provides definitions and special rules for controlled corporations filing under Code chapter 6 relating to consolidated returns.)

companies, trust fiduciaries, beneficiaries, and corporations related to the trust; and between certain charitable organizations.[23]

Property also fails to qualify if acquired in transactions between a partnership and a partner who owns more than fifty percent of the capital interest or the profits interest in the partnership or in transactions between "two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests."[24] Thus, a partnership will be treated as an *entity*, separate from a partner, if the partner is not, directly or indirectly, a more-than-fifty-percent partner. Similarly, separate partnerships will be treated as separate entities if they do not share partners who directly or indirectly own more than fifty percent of both partnerships.

But, under the section 1.48-3(a)(2)(ii) regulation, the Service sidetracks entity treatment and attributes to a partner the use of property by his partnership irrespective of the extent of his partnership interest. This regulation states that "property used by a partnership shall be considered as used by each partner" and treats a partnership as a collection of individuals or an *aggregate*—rather than as an entity identifiable separately from the partners.[25] Yet, as will be discussed in the remainder of this note, this regulation appears to be invalid.

II. Cases and Rulings

A. Edward A. Moradian

In 1944, Edward Moradian and one Hagopian bought land as tenants in common.[26] Shortly thereafter they entered into a farming partnership which grew and sold grapes. The partners divided profits and losses equally. The partnership never owned the farm land, and apparently the partners allowed their partnership to use the land without a formal agreement.[27] In May, 1964, the partnership

23. *See* I.R.C. § 267(b)-(c).

24. *Id.* § 707(b). A partner will be treated as owning, indirectly, the partnership interest of certain related individuals. *See id.* §§ 267(c), 707(b)(3).

25. Treas. Reg. § 1.48-3(a)(2)(ii) (1972).

26. Edward A. Moradian, 53 T.C. 207 (1969), *appeal dismissed*, [1978] 2 Fed. Taxes (P-H) ¶ 5982(35) (9th Cir. 1970), *nonacq.* 1973-1 C.B. 2; 1973-2 C.B. 4.

27. 53 T.C. at 214 (Scott, J., dissenting).

Because land is owned by partners and used by their partnership, it does *not* automatically become partnership property owned by the partners as tenants in partnership:

> Real estate owned by a partner, or by the partners as cotenants, before formation of the firm may be occupied and used by the firm without any agreement that it shall become partnership property. It remains separate property, hence subject to the prior rights of separate creditors of the owning partner in the event of a distribu-

dissolved. Immediately thereafter, Hagopian conveyed his undivided one-half interest in the land and grapevines to Moradian's wife, Georgia.[28] For her purchase of the grapevines, Georgia took a used section 38 property investment credit.

The Service disallowed the credit, relying on its use attribution regulation, which provides that "property used by a partnership shall be considered as used by each partner."[29] The Service asserted that Georgia's purchase would have qualified but for Edward's use of the grapevines before and after the acquisition.

The Tax Court held that the two partnerships were neither the same person nor related persons. The court examined the definition of the term "person" and found that "person" means partnership, "unless otherwise distinctly expressed or manifestly incompatible with the intent of a particular section."[30] Because two different partnerships used the grapevines, the same person did not use the grapevines before and after the acquisition. Thus, the acquisition qualified as a purchase. In applying the related person test, the court employed the adopted-by-reference Code section relating to partnerships, section 707(b).[31] Again, it found that the acquisition qualified as a purchase since no partner owned more than fifty percent of the capital interest or the profits interest in the two partnerships.[32]

Contemplating the validity of the Service's use attribution regulation, the court examined the legislative history of the investment credit.[33] It determined from the expressed purpose of the credit—to

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> tion of insolvent estates. Thus, mere use or occupancy by the partnership does little or nothing to show that land or other fixed assets have become partnership property, whether at the start of the firm or later on.

J. CRANE & A. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP § 37(b), at 204-05 (1968) (footnotes omitted). But, property "subsequently acquired by purchase or otherwise, on account of the partnership, is partnership property . . . unless the contrary intention appears . . . ." UNIFORM PARTNERSHIP ACT § 8(1)-(2); *see* J. CRANE & A. BROMBERG, *supra* at 202-13.

28. It is unclear how Hagopian came to own the grapevines, which, as property acquired subsequent to formation of the partnership, were most likely Moradian-Hagopian partnership property. *See* note 27 *supra* and text accompanying note 43 *infra*.

29. Treas. Reg. § 1.48-3(a)(2)(ii) (1972).

30. 53 T.C. at 211; *see* I.R.C. § 7701(a)(1).

31. *See* I.R.C. § 48(c)(1), which incorporates I.R.C. § 179(d)(2)(A) (quoted at note 21 *supra*), which incorporates I.R.C. § 707(b).

32. Regarding the more-than-50% test, see J.T. McKay, 1968 T.C.M. (P-H) ¶ 68,275, a case in which a partner (owning 100% of the capital interest in a partnership), upon acquiring used § 38 property from the partnership, unsuccessfully sought the investment credit.

33. Upon the recommendation of President Kennedy, the investment credit was enacted in 1962. Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960 (current version at I.R.C. §§ 38, 46-48). It was designed to "stimulate the domestic economy and make it more effective in competition with foreign products by modernizing and expanding both plant and equipment . . . ." 5 J. MERTENS, *supra* note 3, at § 32A.01; *see* H.R. REP. No. 1447, *supra* note

20, at 7, *reprinted in* 1962-3 C.B. 405, 411; S. REP. No. 1881, 87th Cong., 2d Sess. 1-2, 10-12 (1962), *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3297, 3304-05, 3313-14 *and in* 1962-3 C.B. 707, 707-08, 716-18. By encouraging capital expenditures, the credit spurred employment—the need for additional workers to construct and operate the credit encouraged capital investments. The credit was touted to "both aid in providing the longrun [*sic*] growth needed by our domestic economy and be of major assistance in our more immediate problem of economic recovery." S. REP. No. 1881, *supra* at 2, *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3297, 3304 *and in* 1962-3 C.B. 707, 708. Although the credit as originally proposed was expected to cost about $900 million, H.R. REP. No. 1447, *supra* at 6, *reprinted in* 1962-3 C.B. 405, 410, it was pointed out that "the stimulus it provides to new investments will have favorable effects on the level of economic activity . . . and that this will in turn add to federal revenues." *Id.* at 7, *reprinted in* 1962-3 C.B. 405, 411.

The credit was suspended from October 10, 1966, until March 9, 1967, in order to "moderate the pace of the economy to a more sustainable level of economic growth." S. REP. No. 1724, 89th Cong., 2d Sess. 1 (1966), *reprinted in* [1966] U.S. CODE CONG. & AD. NEWS 4327, 4328 *and in* 1966-2 C.B. 925; *see* I.R.C. § 48(j): "[T]he term 'suspension period' means the period beginning October 10, 1966, and ending March 9, 1967." *See also* Zeitlin, *Suspension of Investment Credit and Accelerated Depreciation—Application to Related Taxpayers,* in 25 NEW YORK UNIVERSITY TWENTY-FIFTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1331-32 (H. Sellin ed. 1967).

Effective April 18, 1969, the credit was again terminated with the enactment of the Tax Reform Act of 1969. Pub. L. No. 91-172, § 703, 83 Stat. 487. Section 703 of the Tax Reform Act of 1969 enacted I.R.C. § 49, then titled "Termination of Credit." Congress terminated the credit upon finding that "present defects in the tax structure impede the proper functioning of the economic system." S. REP. No. 552, 91st Cong., 1st Sess. 14 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2041 *and in* 1969-3 C.B. 423, 431.

> Because of the double economic effect of suspension of the investment credit [misplaced reliance upon the future availability of the credit, and the distortion of the timing of investments] and because of the administrative problems involved in turning the credit off and on, your committee [the House Committee on Ways and Means] has concluded that it is better to repeal the investment credit than to suspend it.

H.R. REP. No. 413 (pt. 1), 91st Cong., 1st Sess. 180 (1969), *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1645, 1833 *and in* 1969-3 C.B. 200, 312. These defects were found to "encourage legal and technical efforts to minimize taxes [and] encourage transactions for tax purposes rather than for economic reasons." S. REP. No. 552, *supra* at 14, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2041 *and in* 1969-3 C.B. 423, 431. The House Committee on Ways and Means' report stated that the defects

> result in a misallocation of resources and may misdirect investment into those areas [in which] special tax benefits are provided. . . . This is true, for example, in the case of the investment credit which was adopted in 1962 as a method of attracting investment in plant and equipment but which in the last 2 years appears to have been an important factor in overheating the capital goods industry.

Id. The repeal of the credit saved the treasury approximately $2.5 billion in 1970. *See id.* at 6, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2032 *and in* 1969-3 C.B. 423, 432-33.

Congress restored the investment credit upon enacting the Revenue Act of 1971. Pub. L. No. 92-178, § 101, 85 Stat. 497. Section 101 of the Revenue Act of 1971 enacted I.R.C. § 50, "Restoration of Credit," and amended and retitled I.R.C. § 49 "Termination for Period Beginning April 19, 1969, and Ending During 1971." The committee reports accompanying the act pointed out that among other things, it was designed to again put the "lagging economy on the high growth path . . . , increase the number of jobs and diminish the high unemployment rate . . . [and] provide a rational system of tax incentives to aid in the modernization of our productive facilities." H.R. REP. No. 533, 92d Cong., 1st Sess. 1 (1971), *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1825 *and in* 1972-1 C.B. 498; S. REP. No. 437, 92d Cong., 1st Sess. 1 (1971), *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1918 *and in* 1972-1 C.B. 559. The reports made particular note that capital goods expenditures had

stimulate the growth and expansion of the American economy by encouraging capital investment—that Congress intended a liberal reading of the statute.

Regarding the abuses Congress sought to prevent in enacting the statutory "use" tests, the court was unable to find any reference to partnerships in the committee reports. But it inferred from the reports that "the abuse envisioned by Congress was the possibility that an investment credit [would] be procured by an individual under circumstances in which the purposes of the investment credit are not served."[34] More directly stated, the envisioned abuse was that property would be acquired but the user of the property would remain the same or would be closely related to the pre-acquisition user. Thus, new investment would not be stimulated.

Having determined that the two partnerships were neither the same person nor related, the court found that the envisioned abuse had not occurred. Therefore, it refused to apply the Service's attribution regulation and held it invalid as applied. The court stated that to apply the regulation would be contrary to the legislative intent expressed in the statute and the committee reports.[35]

Six judges dissented in two opinions. In one dissent, Judge Tannenwald asserted that even if partnerships are treated as entities under the Code's partnership provisions, the entity theory of partnerships "clearly need not be applied beyond those provisions."[36] This is apparent from the conference committee report accompanying the 1954 Code:

> Both the House provisions and the Senate Amendment provide for the use of the "entity" approach in the treatment of the transactions between a partner and a partnership which are described above [sections 701-708]. No inference is intended, however, that a partnership is to be treated as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.[37]

"hardly grown at all." H.R. REP. No. 533, *supra* at 3, *reprinted in* [1971] U.S. CODE CONG. & AD. NEWS 1825, 1827 *and in* 1972-1 C.B. 498, 499; S. REP. No. 437, *supra* at 6, *reprinted in* [1971] U.S. CODE CONG. & AD NEWS 1918, 1922 *and in* 1972-1 C.B. 559, 562.

34. 53 T.C. at 213.

35. "In our view, under the particular facts of this case the [Service's] position and regulations cited to the extent they support [its] position are contrary to the intent of Congress as expressed in the statute and in the committee reports and are to that extent invalid." *Id.* at 210-11.

36. *Id.* at 215.

37. *Id.* (quoting H.R. REP. No. 2543, 83d Cong., 2d Sess. 59 (1954)).

Judge Tannenwald stated that because section 38(b) conferred upon the Service the power to promulgate legislative regulations, that is, "specific statutory authority to 'prescribe such regulations as may be necessary to carry out the purposes of' those provisions," the regulations "should not be declared invalid unless clearly contrary to the legislative mandate."[38] In view of the conference committee report, the dissent would have held the regulation valid since it is not clearly contrary to the legislative mandate. Thus, the dissent would have applied the Service's attribution regulation and treated a partnership as an aggregate for purposes of the used section 38 property investment credit.

"To what extent courts or legislators have treated or should treat partnerships as entities has been a matter of considerable dispute."[39] The Uniform Partnership Act, adopted by forty-eight states,[40] treats a partnership as an entity for some purposes and as an aggregate for others.[41] These opposing theories are likewise embodied in the Internal Revenue Code:

38. *Id.* at 216 (citing Commissioner v. South Tex. Co., 333 U.S. 496 (1948); Lucas v. American Code Co., 280 U.S. 445 (1930)).

The Service promulgates two types of regulations: interpretative and legislative. Interpretative regulations are promulgated under I.R.C. § 7805, which authorizes "all needful rules and regulations for the enforcement of" the Code. These regulations state the position of the Service and are given great weight by the courts. Legislative regulations are promulgated under particular Code sections, like I.R.C. § 38(b), in which Congress delegated to the Secretary of the Treasury specific authority to write detailed rules. A legislative regulation is accorded greater weight than an interpretative regulation and is "given the force and effect of law unless the Regulation exceeds the scope of the delegated power [M.E. Blatt Co. v. United States, 305 U.S. 267 (1938)], is contrary to the statute [Joseph Weidenhoff, Inc., 32 T.C. 1222, *acq.* 1960-2 C.B. 7], or is unreasonable [Miller v. Commissioner, 333 F.2d 400 (8th Cir. 1964); McCord v. Granger, 201 F.2d 103 (3d Cir. 1952)]. Having the effect of law, these Regulations bind both the Commissioner and the taxpayer." Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity,* 43 TAXES 756, 759 (1965) (footnotes indicated in brackets).

39. J. CRANE & A. BROMBERG, *supra* note 27, at 18 (citing Crane, *The Uniform Partnership Act—A Criticism,* 28 HARV. L. REV. 762 (1915); Crane, *The Uniform Partnership Act and Legal Persons,* 29 HARV. L. REV. 838 (1916); Drake, *Partnership Entity and Tenancy in Partnership,* 15 MICH. L. REV. 609 (1917); Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism,* 29 HARV. L. REV. 158, 291 (1916); Wright, *Opposition of the Law to Business Usages,* 26 COLUM. L. REV. 917, 927 (1926); and other authorities); *see* J. CRANE, HANDBOOK ON THE LAW OF PARTNERSHIPS AND OTHER UNINCORPORATED ASSOCIATIONS 9-21 (2d ed. 1952); J. CRANE & A. BROMBERG, *supra* note 27, at 16-18.

40. The Act has also been adopted by the District of Columbia, Guam, and the Virgin Islands. Georgia and Louisiana have not adopted the Uniform Partnership Act. 6 UNIFORM LAWS ANN. 7 (Supp. 1978).

41. For example, a partnership is treated as an entity by Uniform Partnership Act §§ 2, 8, 9, 10, 12, 13, 14, 15, 18, 19, 21, 24, 25, 26, 27, 28, 30, 35(1)(b), and 40(a)II(h) and (i). Jensen, *Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?,* 16 VAND. L. REV. 377, 379 n.11 (1963). A partnership is viewed as an aggregate of individuals by Uniform Partnership Act §§ 15, 29, 31, and 34. A. ARONSOHN, PARTNERSHIP INCOME TAXES 2 n.9 (6th ed. 1974).

> Although the partnership is not a separate taxpaying entity, it is a separate entity for the purpose of computing, reporting, and allocating the consequences of partnership activities. The partnership has its own taxable year and it, rather than the individual partners, makes the basic decisions with respect to the computation of partnership income. It determines for example, the method of computing depreciation of partnership property, whether to use a cash or accrual method of accounting, and whether to elect to report income under the installment method.[42]

Furthermore, according to the *Moradian* majority, a partnership is an entity for purposes of the used section 38 property investment credit.

The other *Moradian* dissenting opinion, by Judge Scott, reflected the confusion about property and partnerships. Scott stated that "certainly the persons who owned the land owned the vines attached thereto absent any agreement to the contrary."[43] The presumption in this assertion is reversed. Property acquired subsequent to the formation of a partnership is partnership property unless a contrary intention appears.[44] And, although tangible personalty may be owned by a partner and seemingly loaned to the partnership, the conduct of the partners may indicate an intention that the property "shall pass to the firm. A strong presumption to this effect should arise when the property is of a kind sold in the ordinary course of business (inventory) or consumed in its operation (supplies)."[45] Under these circumstances the partners would own the property as tenants in partnership.[46]

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42. Weidner, Pratt *and Deductions for Payments to Partners,* 12 REAL PROP., PROB. & TR. J. 811 (1977) (citations omitted) (includes a thorough examination of the availability of a tax deduction for payments made by a partnership to a partner and a review of the tension between the entity and aggregate theories embodied within the Code); *see* I.R.C. §§ 167, 446(c), 453, 701, 703, 706; Treas. Reg. § 1.703-1(b) (1974); A. ARONSOHN, *supra* note 41, at 1-3; 1 A. WILLIS, *supra* note 3, at §§ 2.01-.04.

This schizophrenia is also embodied in Treas. Reg. § 1.267(b)-1(b) (1960). This regulation affirms that transactions between a member of a partnership and the partnership "are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners." But, regarding transactions between the partnership and a nonpartner, the regulation treats the partnership as an aggregate, that is, a collection of individuals: "Any transaction . . . between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately."

43. 53 T.C. at 214.

44. *See* note 27 *supra.*

45. J. CRANE & A. BROMBERG, *supra* note 27, at 206 (footnote omitted).

46. *See* UNIFORM PARTNERSHIP ACT § 25(1). This doctrine is important, for example, in protecting a partner's interest in partnership property from the separate creditors of another partner. Absent tenancy in partnership, separate creditors could jeopardize the partnership as a going concern by attaching partnership property. Under the Uniform Partnership Act, a

The Ninth Circuit dismissed the Service's appeal of *Moradian,* but the Service nonacquiesced in the decision,[47] indicating its intention to relitigate the issue should it arise again.[48] Indeed, subsequent to its nonacquiescence, the Service stated in Revenue Ruling 74-64 that it would "continue to apply section 1.48-3(a)(2)(ii) of the regulations and treat partnership property as being used by each partner notwithstanding the decision of the United States Tax Court in *Edward A. Moradian* . . . ."[49]

B. Subsequent Rulings and Litigation

Revenue Ruling 74-64 applied the section 1.48-3(a)(2)(ii) regulation. *A* and *B* entered into a joint venture as equal partners. They purchased an oil lease and drilling equipment and took a "new section 38 property" investment credit. After wells had been drilled, *A* sold one-half of his fifty percent interest to *C*. The drilling equipment used by joint venture *AB* continued in use by joint venture *ABC*. Although the *AB* joint venture had not elected to be treated as a partnership for subchapter K purposes, under Revenue Ruling 65-118 it was a partnership for section 38 purposes.[50]

C unsuccessfully sought an investment credit for the acquisition of used section 38 property. Applying the section 1.48-3(a)(2)(ii) regulation, the Service attributed "partnership" *AB*'s use to *A* and *B* and attributed "partnership" *ABC*'s use to *A, B,* and *C*. Because *A* and *B* used the property before and after the acquisition, the Service determined that *C*'s purchase failed to qualify for the investment credit.[51] Moreover, due to his disposition of the property prior to the expiration of its useful life, *A*'s investment credit was recaptured under section 47(a).[52]

Joseph L. Holloman returned this issue of partnership use attri-

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creditor instead may subject a debtor-partner's interest to a charging order. *See id.* §§ 25(c)(2), 28.

47. 1973-1 C.B. 2; 1973-2 C.B. 4.

48. For an examination of the Service's nonacquiescence policy, see Martin, *The Commissioner's Nonacquiescence,* 40 S. CAL. L. REV. 550 (1967); Uretz, *The Chief Counsel's Policy Regarding Acquiescence and Nonacquiescence in Tax Court Cases,* 44 IND. L.J. 206 (1969); Comment, *Treasury Department's Practice of Nonacquiescence to Court Decisions,* 28 ALB. L. REV. 274 (1964).

49. Rev. Rul. 74-64, 1974-1 C.B. 12, 13 (citation omitted).

50. Rev. Rul. 65-118, 1965-1 C.B. 30.

51. Example five of Treas. Reg. § 1.48-3(a) (1972) provides: "[I]f *F* buys *C*'s [one-third] interest in partnership *CDE,* such acquisition would not result in the acquisition of used section 38 property by *F* . . . because the partnership property is used by the same persons (partners *D* and *E*) who used the property before the acquisition."

52. *See* Treas. Reg. §§ 1.47-1 to 3 (1972); Treas. Reg. §§ 1.47-4 to 6 (1967); 2 A. WILLIS, *supra* note 3, at §§ 69.06-.07.

bution to the Tax Court.[53] Holloman, a dentist, became an employee of a sole practitioner dentist in October, 1970. On January 1, 1971, he purchased one-half of his employer's accounts receivable, and the two became fifty percent partners. Holloman's partner retained ownership of all dental equipment and leased it to the partnership. On August 31, 1971, the partnership terminated. Holloman bought his partner's fifty percent interest. He also bought the dental equipment. For the acquisition of the dental equipment, Holloman took a "used section 38 property" investment credit.

The Service disallowed the credit, asserting that the same person, Holloman, had used the property both before and after the acquisition. Again the Service relied on the section 1.48-3(a)(2)(ii) regulation providing that "property used by a partnership shall be considered as used by each partner" and asserted that the partnership should be treated as an aggregate of individuals rather than as an entity.

The Tax Court allowed that "Congress . . . felt that no credit should be allowed where no change in ownership took place"[54] but found that "the abuse which Congress sought to prevent [had] not occurred."[55] Relying on *Moradian,* the court held that the partnership was the "person" using the property after the acquisition. The court suggested that congressional intent had "at least indirectly" been fulfilled. Although Holloman had purchased the assets of a preexisting business, if his former partner wanted to "continue in business as a dentist, he [would] have to go out and purchase new or used dental equipment to replace the equipment he sold to [Holloman]."[56]

The Service unsuccessfully appealed. The Fifth Circuit held that the section 48(c)(1) reference to "used by a person" "does not mean the individual person who actually physically used the equipment, but refers to the legal entity which was using the equipment."[57] Thus, the court held the attribution regulation invalid except to the extent that it applies to a partner owning more than fifty percent of the capital or the profits interest in a partnership. That is, a partnership is recognized as a separate entity unless a partner is a "more-than-fifty-percent" partner.

Reductio ad absurdum, the court suggested that if the use test was based upon physical use, the credit would be disallowed "if a

53. 1975 T.C.M. (P-H) ¶ 75,309, *aff'd,* 551 F.2d 987 (5th Cir. 1977).
54. *Id.* at 75—1325.
55. *Id.* at 75—1327.
56. *Id.*
57. 551 F.2d 987, 989 (5th Cir. 1977).

taxpayer started a new business and purchased equipment from another wholly unrelated taxpayer and then hired to operate the equipment the same person who had operated it for the former owner."[58] Unfortunately for the government, the court appeared to be unwilling to distinguish between productive use for trade or business and mere operation.

Prior to the Fifth Circuit's *Holloman* opinion, the Tax Court rejected another attempt by the Service to apply the section 1.48-3(a)(2)(ii) regulation in *Steven M. Kipperman.*[59] Kipperman and one Silber shared a law office from January, 1971, to June, 1973. The two lawyers practiced independently. But they were tenants in common, and each owned an undivided one-half interest in the office's furnishings and books. In June, 1973, Kipperman formed a law partnership with two otherwise unrelated individuals, with each partner owning a one-third interest. The partnership bought Kipperman's undivided one-half interest in the furnishings and books and, shortly thereafter, bought Silber's undivided one-half interest in the furnishings. The parties then exchanged their undivided interests in certain books in return for the undivided interest of the other party in the remainder of the books.

On his 1973 tax return, Kipperman reported the recapture of the investment credit originally taken on the purchase of the assets he sold to his partnership. Kipperman also took his share of the partnership's investment credit for its acquisition of the furnishings and the books: used section 38 property. The Service disallowed the credit, asserting that the acquisition failed to qualify because the same person, Kipperman, used the property before and after the acquisition. Again it attributed the partnership's use to Kipperman, although he owned only a one-third interest in the partnership.

The Service tried "desperately to distinguish the facts of this case from *Moradian* and *Holloman.*"[60] It asserted that Kipperman "had both the use and the ownership of the concerned property before and after the pertinent acquisition whereas . . . [Georgia] Moradian had neither the use nor ownership of the property before the acquisition, and [Holloman] had the use but not the ownership prior to the acquisition."[61] Unpersuaded, the Tax Court followed *Moradian* and *Holloman,* finding that the property "was owned and used by the partnership, a different entity than the person, petitioner indi-

58. *Id.*
59. 1977 T.C.M. (P-H) ¶ 77,032.
60. *Id.* at 77—147.
61. *Id.*

vidually [Kipperman] who in part owned and used the property before the acquisition by the partnership."[62]

III. CONCLUSION

Moradian, Holloman, and *Kipperman* indicate that so long as no partner owns more than fifty percent of a partnership, the used section 38 property investment credit will be available. It is surprising that the Tax Court has adopted this liberal position, and its opinions in these cases seem weak.

For example, contrary to the Tax Court's assertion that Holloman's former partner would have to purchase new equipment in order to remain in the dental business, Holloman could hire his former partner as an employee.[63] No new investment would be spurred. *Kipperman* suggests another possible abuse: upon becoming attorneys, two or more recent graduates could form an equal law partnership. Each could sell his old casebooks and hornbooks to the firm and obtain a used section 38 property investment credit—without "spurring new investment."[64] Additionally, the books would generate depreciation deductions.

The *Moradian* dissent discredits the majority's opinion, but, amazingly, the two *Holloman* opinions and *Kipperman* blandly follow *Moradian.* The 1954 legislative history espousing the aggregate theory over entity treatment should have been sufficient to uphold the voided regulation. But the *Kipperman* court again expressly rejected the Service's assertion, although it indicated that the issue might be revisited.[65]

The Service might acquiesce on this matter because the investment tax credit expires soon—on January 1, 1981. Or the Service might encourage Congress to address the issue, which could prove to be particularly important in view of the government's recent interest in providing more tax incentives to aid business. A contin-

62. *Id.* Kipperman prevailed when the Tax Court granted his motion for summary judgment.

63. The infirmity of this example is that Holloman's partner personally owned and used the property prior to formation of the partnership. Holloman's acquisition probably would not qualify as a purchase because the same person—Holloman's partner—would be using the property before and after the acquisition, although another person, the partnership, interposed the uses. But, given a situation in which the use of the property originated with a partnership, one partner could purchase the property from the partnership, obtain the investment credit, and hire his former partner.

64. The tax credit would inure to the partnership, but because a partnership is considered an aggregate for the purposes of allocating the economic consequences of partnership activities, and because under I.R.C. § 702(a)(7) tax credits are among the items constituting a partner's distributive share, the partners would obtain the credit.

65. 1977 T.C.M. (P-H) ¶ 77,032, at 77—147.

ued and increased investment credit for used section 38 property might be enacted to allow small business to share in the incentives. Then the importance of tightening the rules for obtaining this credit would be heightened.