Edwin E. Berkeley, 40 B.T.A. 652 (1939)

A partner's holding period for a partnership interest, for capital gains purposes, is determined by how long the partner held the interest, not by how long the partnership held its assets; changes in partnership composition do not necessarily restart the holding period if the business continues without interruption.

Summary

Edwin E. Berkeley sold a portion of his partnership interest in Lehman Brothers and claimed long-term capital gains treatment. The IRS argued the holding period should be based on the partnership's assets or that a new partnership was formed after a partner's death, restarting the holding period. The Board of Tax Appeals held that the holding period was based on how long Berkeley held his partnership interest, and the partnership's continuation agreement prevented the death of a partner from creating a new partnership for tax purposes. Therefore, Berkeley was entitled to the long-term capital gains treatment.

Facts

Berkeley was a partner in Lehman Brothers. From December 31, 1925, to January 1, 1937, his partnership interest fluctuated but was never less than 13.425%. On January 1, 1937, he sold a 3.45% interest in the partnership, realizing a gain. Arthur Lehman, a partner, died in May 1936. The partnership agreement allowed the remaining partners to continue the business, which they did without interruption. The partnership executed new agreements to reflect changes in capital and profit interests after partners joined, died, or withdrew. The firm's books and records remained open, and existing contracts continued without alteration.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency, arguing the gain should be taxed at a higher rate based on a shorter holding period. Berkeley appealed to the Board of Tax Appeals, contesting the Commissioner's determination.

Issue(s)

1. Whether the holding period for a partner's sale of a partnership interest is determined by the length of time the partner held the partnership interest or by the holding period of the partnership's assets.
2. Whether the death of a partner and subsequent continuation of the partnership by the remaining partners, pursuant to a continuation agreement, creates a new partnership for the purpose of determining the holding period of a partnership interest.

Holding

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1. Yes, because a partner is selling an intangible interest in the partnership itself, not a direct interest in the partnership's underlying assets.
2. No, because the partnership agreement provided for the continuation of the partnership upon a partner's death, and the business continued without interruption.

Court's Reasoning

The court reasoned that a partnership interest is a capital asset separate from the partnership's underlying assets. Citing *Dudley T. Humphrey, 32 B.T.A. 280*, the court emphasized that a partner sells "an intangible consisting of his right to a share in the net value of the partnership after settlement of its affairs," not a share of the firm's specific assets. The holding period is thus determined by how long the partner held the partnership interest. The court also noted that under New York law, while the death of a partner technically dissolves the partnership, the partnership agreement allowed for its continuation, and the business continued without interruption. The court quoted *Robert E. Ford, 6 T. C. 499* stating, "Realistically speaking, the only change that has taken place is that the remaining partners have acquired a greater interest in the profits and surplus when final liquidation occurs." The court rejected the IRS's argument that a new partnership was created, stating, "These changes in the membership of the firm had no effect on the continuation of the firm's business or on the continuing nature of the petitioner's investment or interest therein."

Practical Implications

This case clarifies that the sale of a partnership interest is treated as the sale of a capital asset, distinct from the underlying assets of the partnership. It confirms that the holding period is determined by the partner's ownership of the partnership interest, not the partnership's assets. It also provides guidance on partnership continuation agreements, indicating that if a partnership agreement allows for continuation after a partner's death or withdrawal and the business continues without interruption, the holding period for the remaining partners' interests is not reset. This ruling provides certainty for partners in structuring their affairs and planning for the tax consequences of selling their partnership interests. Later cases have relied on this principle when determining capital gains treatments in similar partnership scenarios. It emphasizes the importance of well-drafted partnership agreements that address dissolution and continuation upon the occurrence of certain events.

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