16 T.C. 126 (1951)

A purported sale of a partnership interest will be treated as an assignment of future income when the partnership is in a state of liquidation, and the primary motive of the transaction is tax avoidance.

Summary

Frank and Dehn formed a partnership to supervise construction projects. Frank later "sold" his partnership interest to third parties procured by Dehn. The Tax Court determined that the partnership was essentially in liquidation at the time of the alleged sale, and the transaction was designed to convert ordinary income into capital gains. Therefore, the court held that the gain from the assignment was taxable as ordinary income, not as a capital gain, because Frank was merely assigning his right to receive income for services previously rendered.

Facts

Frank and Dehn formed a partnership (Housing Construction Company) in 1943, each contributing $500 for equal shares. The partnership supervised defense housing projects. By early 1945, the partners sought to terminate their relationship. Frank offered to sell his interest to Dehn, but upon advice from tax counsel suggesting sale to a third party would be treated more clearly as capital gains, Dehn refused the offer. Elinor, William, and Elizabeth were then procured to be the "third party" assignees. The partnership's assets mainly consisted of accounts receivable ($274,000) with minimal capital assets ($1,000) and no liabilities. Frank assigned his interest for $112,500 and claimed capital gains treatment on the $112,000 gain.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against Frank, arguing the gain should be taxed as ordinary income. Frank petitioned the Tax Court for a redetermination. The Tax Court reviewed the case and upheld the Commissioner's determination.

Issue(s)

Whether the gain derived by the petitioner upon the purported assignment of his interest in a partnership should be taxed as a capital gain or as ordinary income, given that the partnership was nearing completion of its contracts and the assignment occurred primarily for tax avoidance purposes.

Holding

No, because the partnership was in a state of liquidation at the time of the assignment, and the assignment was merely a way for Frank to receive his distributive share of income due for personal services previously rendered;

therefore, it is treated as ordinary income.

Court’s Reasoning

The court emphasized that while taxpayers are generally entitled to minimize their taxes through legitimate means, transactions primarily motivated by tax avoidance are subject to close scrutiny. Citing *Gregory v. Helvering*, 293 U.S. 465 (1935), the court stated that “substance will prevail over form.” The court found that the Housing Construction Company was essentially in liquidation when Frank assigned his interest. The assignees had no intention of continuing the business. Frank’s assignment was merely a transfer of his right to receive income for services already rendered. The court distinguished this case from *Swiren v. Commissioner*, 183 F.2d 656 (1950), where a partnership interest was sold in a going concern. The court also noted, “Nobody would suggest that the sale of a declared dividend payable in the future turns the cash received into capital.” The cash payment of $35,500 was merely a collection in advance of the money that petitioner had previously earned as ordinary income. Paying $50,000 directly to petitioner by the firm in a manner similar to that which would have been employed had no assignment been executed also shows a state of liquidation. The court concluded that taxing the gain as ordinary income aligns with the principle that income is taxed to those who earn it, citing *Lucas v. Earl*, 281 U.S. 111 (1930).

Practical Implications

Frank v. Commissioner illustrates the importance of examining the substance of a transaction over its form, especially in the context of partnership interest transfers. Courts will scrutinize transactions motivated primarily by tax avoidance, particularly when a partnership is nearing liquidation. Legal professionals should advise clients that attempts to convert ordinary income into capital gains through artificial arrangements are unlikely to succeed. This case highlights the ongoing tension between legitimate tax planning and impermissible tax avoidance, and serves as a reminder to lawyers and accountants that a sale of a partnership interest nearing liquidation can be recharacterized as assignment of income. Subsequent cases will continue to analyze partnership interest sales considering the business’s operational status and intent of the involved parties to ensure that the transactions reflect genuine economic activity rather than mere tax avoidance schemes.

