Harris v. Commissioner, 61 T. C. 770, 1974 U. S. Tax Ct. LEXIS 140, 61 T. C. No. 83 (1974)

Partnership losses on asset sales may be allocated to a partner as ordinary losses if the allocation serves a business purpose and has substantial economic effect.

Summary

Leon A. Harris, Jr. , a partner in Artlah Realty, Ltd. , sought to liquidate his interest in a shopping center. In 1967, the partnership sold a 10% interest in the shopping center to trusts, allocating the resulting loss to Harris. In 1968, Harris withdrew from the partnership, receiving a 30% interest in the property, which he then sold to trusts. The Tax Court held that both transactions were arm's-length sales of section 1231 property, and the loss allocations to Harris were valid under section 704, as they had a business purpose and substantial economic effect.

Facts

Leon A. Harris, Jr. , owned a 40% interest in Artlah Realty, Ltd. , a partnership operating a shopping center in Dallas, Texas. In 1967, the partnership sold a 10% undivided interest in the shopping center real estate to trusts for $6,250, subject to existing debt. The proceeds were distributed to Harris, and the loss was allocated to him, reducing his capital account and share of future profits. In 1968, Harris withdrew from the partnership, receiving a 30% interest in the shopping center in liquidation of his partnership interest. He then sold this 30% interest to trusts for $7,000, also subject to existing debt.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Harris's 1967 and 1968 federal income taxes, disallowing the claimed ordinary losses. Harris petitioned the U. S. Tax Court for a redetermination. The Tax Court upheld the transactions as arm's-length sales and allowed the loss allocations to Harris under section 704.

Issue(s)

1. Whether the 1967 and 1968 transactions were arm's-length sales of section 1231 property.
2. Whether the losses realized on the 1967 and 1968 transactions were, in substance, from the sale of a partnership interest under section 741.
3. Whether the principal purpose of the amended partnership agreement allocating the 1967 loss to Harris was tax avoidance under section 704(b)(2).

Holding

1. Yes, because the transactions were negotiated at arm's length and the trusts

acquired only interests in the real estate, not partnership interests.
2. No, because the trusts did not acquire partnership interests, and the transactions were treated as sales of real estate.
3. No, because the allocation had a business purpose and substantial economic effect, as it was part of Harris's plan to liquidate his investment and reduced his capital account and share of future profits.

Court's Reasoning

The Tax Court applied the substance-over-form doctrine to determine that the 1967 and 1968 transactions were sales of section 1231 property, not sales of partnership interests. The court found no evidence that the trusts became partners or joint venturers with Artlah. The court upheld the loss allocations under section 704, noting that the allocations had a business purpose (liquidation of Harris's investment) and substantial economic effect (reducing Harris's capital account and share of future profits). The court cited section 1. 704-1(b)(2) of the Income Tax Regulations, which provides factors for determining whether tax avoidance is the principal purpose of an allocation. The court concluded that the principal purpose was not tax avoidance, given the business purpose and economic effect of the allocation.

Practical Implications

This decision clarifies that partnership losses from asset sales can be allocated to a partner as ordinary losses if the allocation has a business purpose and substantial economic effect. Practitioners should carefully structure such allocations to ensure they withstand IRS scrutiny. The decision also reinforces the importance of the substance-over-form doctrine in analyzing partnership transactions. Later cases, such as *Orrisch v. Commissioner*, have distinguished *Harris* based on the economic effect of the allocation. Businesses and partnerships should consider the tax implications of asset sales and the potential for allocating losses to partners seeking to liquidate their investments.