BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
J. W. RADIL)

Appearances:

For Appellant: J. W. Radil, in pro. per.

For Respondent: Wilbur F. Lavelle, Assistant Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of J.W. Radil against a proposed assessment of additional personal income tax in the amount of $61.55 for the year 1952.

In 1945 Appellant entered into a limited partnership agreement with one L. L. Brandenburg. L. L. Brandenburg was then engaged in the business of selling and installing intercommunicating equipment under the name of Brandenburg & Company in San Francisco. The agreemtnt contained the following terms which we deem pertinent to the discussion hereafter:

> 1. The said limited partnership shall continue until dissolved by mutual consent, or by operation of law, or in accordance with this agreement.
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> * * *
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> 6. The sole management and control of said business shall be in first party, [Brandenburg] as general partner, and said first party agrees to devote his entire time to t e business of said partnership.
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> 8. CAPITAL: The capital of the partnership shall be owned by the partners in accordance with their respective pecuniary contributions . . . . Second party [Appellant] agrees to contribute thereto the sum of Fifteen Thousand Dollars ($15,000.00) in cash . . . . Each month there shall be deducted from each partner's share of such net

profits five percent. (5%) of the total net profits, which said sum shall be credited to a "Reserve Fund", which shall be considered a part of the capital of the partnership. Neither party shall, under any circumstances, withdraw any part of the capital of the partnership. If either party shall withdraw any such capital, either directly or by overdrawing his share of the net profits, his share of such net profits (but not his share of any losses which shall be incurred) from the time of such withdrawal until the overdraft shall have been restored, shall be reduced by the percentage which such overdraft bears to his capital contribution at the time of such overdraft, and the share of the net profits of the other partner shall be proportionately increased.

9. SALARY OF FIRST PARTY: Before determining the net profits of the partnership ..., first party shall first be paid a salary as Manager of the business, of Seventy-two Hundred Dollars ($7,200.00) per year, provided ... such salary shall ... have actually been earned by the business.

10. NET PROFITS AND WITHDRAWALS: The net profits of the partnership shall be determined by deducting from the gross income all expenses of the business . . . . including the salary paid or due to the first party, ... Such net profits shall be divided as follows: Seventy-five percent. (75%) to first party, and twenty-five percent. (25%) to second party.

In spite of the prohibition against withdrawal of partnership capital, the record shows that as of December 31, 1950, L. L. Brandenburg had overdrawn his account to the extent of $7,747.43. A statement of the net worth accounts of the partnership for the period January 1, 1951, to March 31, 1952, shows:

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	L. L. Brandenburg Capital	J. W. Radil Capital	J. W. Radil Withdrawal Acct.	Reserve Fund	Total Net Worth
Bal.12/31/50	($7,747.43)*	$15,000.00	$1,582.58	$761.88	$ 9,597.03
Add: Net Profit for year 1951	7,200.00		3,863.52		11,063.52
	($ 547.43)	$15,000.00	$5,446.10	$761	$20,660.55
Less: Drawings by L.L. Brandenburg	7,250.91				7,250.91
Bal.12/31/51	($7,798.34)	$15,000.00	$5,446.10	$761.88	$13,409.64
Add: Net profit for the three months ended 3/31/52	1,800.00		3,759.47		5,559.47
	($5,998.34)	$15,000.00	$9,205.57	$761.88	$18,969.11
Less: Drawings by L.L. Brandenburg	-1,800.00				1,800.00
Bal. 3/31/52	($7,798.34)	$15,000.00	$9,205.57	$761.88	$17,169.11

* () Indicates capital overdraft.

The entire net profit of the partnership in excess of the manager's salary during this period was credited to Appellant's withdrawal account because of L. L. Brandenburg's Overdraft.

Appellant entered into an agreement on April 15, 1952, under which he assigned to one C. N. Nelson, as his agent, all his "right , title and interest in said partnership and ... all claims against L. L. Brandenburg arising out of said partnership ...." Nelson agreed to "either liquidate or dissolve and liquidate" the partnership or in the alternative, to sell Appellant's "interest in said partnership or sell the entire business and assets of said partnership....!' In consideration for this service, Nelson was to keep 25 percent of all money or property obtained from the disposition of the interests assigned to him.

Pursuant to this assignment, Nelson filed suit in San Franchise Superior Court for dissolution of the partnership. While this matter was pending, however, Nelson sold all his right, title and interest in Brandenburg & Company, including all claims against L. L. Brandenburg individually, to one T. J. Northen for the sum of $17,000. The Northen agreement, dated May 28, 1952, stated as a preliminary fact that Nelson and L. L. Brandenburg had agreed to a dissolution of the partnership and each had "agreed to sell . . . his respective interest in said partnership to Northen." The sale was made effective as of March 31, 1952, and all interest Nelson had in the operation of the business

subsequent to that date passed to Northen. Paragraph 4 of their agreement stated:

> It is agreed that Northen may enter into possession of said business and carry on its operations and complete the performance of all its contracts upon obtaining from L. L. Brandenburg an assignment of his interest in said partnership or entering into an agreement with L. L. Brandenburg for the purchase of the latter's interest in said business.

According to his understanding with Nelson, Appellant received $12,750 of the sale price. Appellant's investment in the partnership on March 31, 1952, totaled $24,586.51, which included: original investment - $15,000, one-half of the reserve fund - $380.94, accumulated profits in withdrawal account - $5,446.10, and current net profits - $3,759.47. The partnership assets on that date consisted of $421.38 in cash, $3,911.26 in accounts receivable, $14,190.16 in inventories, $2,600.86 in furniture, fixtures and automotive equipment and $205 in advance commissions.

Appellant's personal income tax return for the year 1952 treated the sale transaction as resulting in a capital loss. Schedule D showed total cost of $20,827.04, net sale price of $12,750 and a capital loss of $8,077.04. Appellant deducted $2,000 which was the maximum capital loss allowable under Revenue and Taxation Code, Section 17717 (now Section 18152). Appellant did not report as income any of the $3,769.47 earned by the partnership during the period January 1, 1952, to March 31, 1952, although all of it was allocable to him under the terms of the partnership agreement. The Franchise Tax Board assessed Appellant on the theory that this amount was taxable to him as ordinary income. That assessment led to this appeal.

Appellant makes several contentions in support of his position. He first argues that he did not sell a partnership interest; rather, that the partnership was dissolved prior to the sale and he merely sold his interest in the partnership assets. Citing Section 15040 of the Corporations Code (Uniform Partnership Act) for the proposition that upon dissolution of a partnership a partner is first entitled to a return of his capital and then to his share of the profits, Appellant reasons that since he received less than his original capital investment, he never received any of the partnership profits and cannot be taxed thereon. Appellant also reasons that since he sold his interest in individual assets, most of which were other than capital assets, his loss was an ordinary, fully deductible loss.

We are of the opinion that what Appellant sold to Northen, via his agent Nelson, was his partnership interest and not an interest in the partnership assets. Careful consideration of the record leads us to the conclusion that the partnership was not dissolved prior to the sale of Appellant's interest to Northen. The partnership agreement provided for dissolution only by mutual consent or by operation of law. The only evidence in the record which could support a conclusion that the partnership had been dissolved prior to the sale is the agreement with Northen, executed in May of 1952.

Examination of that instrument, however, leads us to a contrary interpretation. The plain import of the language used is that the parties intended to dissolve the partnership by each partner conveying his interest therein to Northen, not that a prior dissolution was intended, to be followed by a sale of the assets. This is made abundantly clear by the recognition, in paragraph 4, of L. L. Brandenburg's continuing partnership interest,

Next Appellant argues that even if the transaction was a sale of a partnership interest, the applicable rule of law is: when a partner sells his partnership interest, including his share of the current, untaxed partnership profits, these profits are no longer taxable as ordinary income but become part of his cost basis from which capital gain or loss is determined. In effect, this rule would convert ordinary income into Capital gain through the sale of the partnership interest.

Such a rule was followed by the United States Court of Appeals for the Seventh Circuit in Meyer v. United States, 213 F. 2d 278. The rule appears to have been applied also in the Sixth and Eighth Circuits. (See Berry v. United States, 267 F. 2d 298; and, United States v. Donoho, 275 F. 2d 489.) A contrary view, however, has been adopted by the Second, Third, Fourth, Fifth and Tenth Circuits, as well as by the Tax Court. (See Leff v. Commissioner, 235 F. 2d 439; Tunnell v. United States, 259 F. 2d 916; Doyle v. Commissioner, 102 F. 2d 86; Sherlock v. Commissioner, 294 F. 2d 863, cert. denied, 369 U. S. 802 [7 L. Ed. 2d 549]; United States v. Snow, 223 F. 2d 103, cert. denied, 350 U. S. 831 [100 L. Ed. 741]; and, Chris J. Sherlock, 34 T.C. 522.) These courts have consistently held that the mere sale of a partnership interest does not convert a partner's share of untaxed earnings into a capital item or relieve him from the necessity of paying a tax thereon as ordinary income.

This latter view is predicated on the fundamental principle that while a partnership interest is a capital asset, any ordinary income derived from an income-producing capital asset is still ordinary income. Gain or loss from the sale of a partnership

interest is not to be confused with the proper reporting of the income earned from the operation of the partnership. We conclude that the majority rule, supported as it is with such analogous leading cases as Helvering v. Horst, 311 U. S. 112 [85 L. Ed. 751; Hort v. Commissioner, 313 u. S. 28 [85 L. Ed. 1168]; and Lucas v. Earl, 281 U. S. 111 [74 L. Ed. 731], should be followed here. (For a thorough review of the conflicting rules see Sherlock v. Commissioner, supra, 294 F. 2d 863, cert. denied, 369 U. S. 802 . .d 2d 549].)

Appellant contends that, in any event, he cannot be taxed on the partnership net profit for the first quarter in 1952 because he suffered an offsetting loss. He argues that he never received his share of the accumulated partnership profits, and thus suffered an ordinary loss.

Appellant's answer is to be found in Frank J. Johnson, T.C. Memo. , Dkt. No.17694, March 29, 1950. In that case, the taxpayer sold his interest in a limited partnership to the general partner for a price less than his capital investment plus his share of the undistributed profits. He argued that any amount on which he might be held taxable as his share of the partnership profits earned in the year of sale, should be allowed as an offsetting ordinary loss for the same year. Faced with essentially the same issue as that presented here, the Tax Court held that while the taxpayer did suffer a loss, that loss resulted from the sale of the partnership interest, a capital transaction. Thus, the court concluded that the entire loss was capital in nature, subject to the usual limitations on the deduction of such losses, and could not be used to wholly offset the tax liability arising from the taxpayer's share of the partnership profits, which was ordinary income. The reasoning of the court is equally applicable to Appellant's case.

Appellant's last argument, that he also suffered an offsetting loss when he gave up any and all claims he might have had against L. L. Brandenburg individually, stands on no firmer ground than did its predecessors. As shown by the agreement of May 28, 1952, the claim resulting from Brandenburg's overdraft was sold to Northen together with Appellant's partnership interest. The loss due to the overdraft was reflected in the sale of the partnership interest, since the capital withdrawn was included in Appellant's basis for the interest. Even if the sale of the claim were treated separately, any loss on the sale would be a capital loss because the claim was a capital asset. (Rev. & Tax. Code, § 17711, now 18161. See also Harry L. Booker, 27 T.C. 932.) Thus the deduction for the year in question could not exceed the sum of $2,000 which Appellant has already been allowed.

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O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of J. W. Radil against a proposed assessment of additional personal income tax in the amount of $61.55 for the year 1952, be and the same is hereby sustained.'

Done at Sacramento, California, this 19th day of March, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary