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ARE PARTNERSHIPS AGGREGATES OR ENTITIES WHEN DETERMINING THE AVAILABILITY OF INVESTMENT CREDIT FOR USED PROPERTY?

The investment credit grants taxpayers who purchase certain properties substantial tax savings by setting off part of the property's purchase price directly against the purchaser's income tax.[1] The availability of the investment credit in instances when a partner acquires property previously used or owned by his partnership, or when a partnership acquires property previously used or owned by one of its partners, depends on which of two conflicting theories concerning the nature of partnerships[2] is adopted. One theory views the partnership as merely an aggregate of individuals, while the other views the partnership as a separate entity.[3] The Internal Revenue Code[4] (the Code) treats a partnership[5] as an aggregate for taxpayer obliga-

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[1] *See* I.R.C. § 38.

[2] The Uniform Partnership Act defines a partnership as ". . . an association of two or more persons to carry on as co-owners a business for profit." UNIFORM PARTNERSHIP ACT § 6(1).

[3] Under the aggregate theory, sometimes called the conduit theory, individual partners are viewed as co-owners of the enterprise. Under the entity theory, a partnership is considered a separate entity, entirely distinct from the partners. Thus, the entity theory accords partnerships a legal status similar to that given to corporations. A. ARONSOHN, PARTNERSHIP INCOME TAXATION 1-2 (6th ed. 1974) [hereinafter cited as ARONSOHN].

The conflict between the entity and aggregate theories is centuries old. *See generally* 1 A. WILLIS, PARTNERSHIP TAXATION, § 201 (2d ed. 1976) [hereinafter cited as WILLIS]. Although the English common law generally regarded partnerships as aggregates, the civil law treated partnerships as separate entities. ARONSOHN, *supra* at 2. In addition, merchantile law adopted the entity theory for partnerships. R. SUGARMAN, SUGARMAN ON PARTNERSHIPS § 4 (4th ed. 1966). The conflict between the two theories is evident in the Uniform Partnership Act. While Dean Ames, the original drafter of the Act, would have treated the partnership as an entity, Dean Lewis, who wrote the final drafts of the Act, favored the aggregate theory. Although the completed Uniform Partnership Act is based primarily on the common law aggregate theory, the Act encompasses a part of each theory. 1 BARRETT & SEAGO, PARTNERS AND PARTNERSHIPS: LAW AND TAXATION 154-55 (1956).

[4] As the laws governing federal taxation grew more complex, Congress decided to consolidate and organize the tax law into one code. The result was the Internal Revenue Code of 1939. By the early 1950's, the many tax law changes which had occurred since 1939 resulted in studies to reorganize the Code. These studies led to the Internal Revenue Code of 1954. The 1954 Code, as amended from time to time, is the fundamental tax law in effect today. The Code is incorporated in the United States Code as Title 26. *See* C. MCCARTHY, THE FEDERAL INCOME TAX: ITS SOURCES AND APPLICATION 4-5 (3d ed. 1974).

[5] The income tax concept of a partnership is broader than the common law concept and includes groups not commonly called partnerships. *See* Treas. Reg. § 1.761-1 (1956). The Internal Revenue Code includes within the term partnership ". . . a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on and which is not within the meaning of this title [subtitle], a corporation or a trust or estate." I.R.C. § 761(a).

Prior to the Internal Revenue Code of 1939, *see* note 4 *supra*, there were few statutory provisions dealing with partnerships. Therefore, courts often were required to determine on a case by case basis whether a partnership should receive aggregate or entity treatment. *See, e.g.*, Helvering v. Walbridge, 70 F.2d 683 (2d Cir.), *cert. denied*, 293 U.S. 594 (1934) (partnership holds stock contributed by partner as an entity); United States v. Coulby, 251 F. 982 (N.D. Ohio 1918), *aff'd* 258 F. 27 (6th Cir. 1919) (per curiam) (partnership an aggregate for

tions, but as an entity for most other purposes.[6] In some instances, however, the Code does not expressly state whether aggregate or entity treat-

receiving income from dividends on stock owned by partnership). While the skeletal partnership provisions found in the 1939 Code were an improvement, they did not cover many of the problems that frequently arose with respect to partnerships and partners. *See* 6 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION, § 35.01 (5th ed. 1975) [hereinafter cited as MERTENS]. Thus in many cases, courts still had to make a case by case analysis to ascertain whether the aggregate or entity theory was appropriate. This common law approach led to inconsistent results on similar issues tried before different courts. *Compare* Benjamin v. Hoey, 47 F. Supp. 158 (S.D.N.Y. 1942), *rev'd on other grounds,* 139 F.2d 945 (2d Cr. 1944) (partnership that is paid commission by partner treated as aggregate) *and* Swiren v. Comm'r, 183 F.2d 656 (7th Cir. 1950), *cert. denied,* 340 U.S. 912 (1951) (partner's share of legal fees owed partnership is held by partner; sale of partner's share is capital gain) *with* Harvey M. Toy, 11 B.T.A.M. (P-H) 42,451 (1942) (partnership that is paid commission by partner treated as entity) *and* Doyle v. Comm'r, 102 F.2d 86 (4th Cir. 1939) (partner's share of legal fees owed partnership is held by the partnership; sale of partner's share not capital gain).

[6] In United States v. Basye, 410 U.S. 441, 448 n.8 (1973), the Supreme Court noted that "[t]he legislative history indicates, and the commentators agree, that partnerships are entities for purposes of calculating and filing informational returns but that they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares." The individual Code provisions, however, indicate that the Supreme Court's statement is an oversimplification.

The Code provisions that specifically deal with partnerships appear in Subchapter K, §§ 701 through 761. Section 701 provides that a partnership is not subject to income tax, and § 702 states that each partner must take into consideration his distributive share of partnership income in determining his personal income tax liability. I.R.C. §§ 701, 702. These two sections, which deal with a partnership's taxpaying obligations, clearly treat the partnership as an aggregate. The partnership serves merely as a conduit through which taxpaying obligations flow. S. REP. No. 1622, 83d Cong., 2d Sess., 89 (1954). Section 704, which sets out rules for determining a partner's distributive share, adds to the Code's aggregate approach toward partnership taxpaying obligations.

As the Supreme Court indicated, most of the other sections recognize the partnership as an entity for purposes of calculating and filing informational returns. Section 703, for example, provides that the taxable income of a partnership, with a few exceptions, shall be computed in the same manner as an individual's taxable income. In allowing partnerships to have a different taxable year than its partners, § 706 treats partnerships as entities. In addition, the Code adopts the entity concept for guaranteed annual payments to a partner for services or the use of capital. *See* I.R.C. §§ 706(a), 707(c); Jackson, Johnson, Surrey, Tenen & Warren, *The Internal Revenue Code of 1954: Partnerships,* 54 COLUM. L. REV. 1183, 1201-04 (1954) [hereinafter cited as COLUM. L. REV.]. In addition to the provisions in Subchapter K, § 7701(a)(1), applicable throughout the Code, defines the word "person" to include partnerships.

The Supreme Court's broad declaration that partnerships are entities for purposes of calculating and filing informational returns begins to break down with § 707 of the Code. The general rule of § 707, which treats transactions between a partnership and a partner acting in his individual capacity as transactions between the partnership and an outsider, follows the entity theory. This general rule, however, is subject to two modifications which treat the partnership as an aggregate to prevent tax avoidance. COLUM. L. REV., *supra* at 1200-01. Section 751, which converts part of a capital gain into ordinary income by ignoring the underlying assets of the partnership, is also arguably an application of the aggregate theory. Furthermore, the legislative history of the partnership sections of the 1954 Code indicates that no inference is to be drawn from the "entity" treatment of transactions between partners and partnerships for the purpose of applying other provisions of the internal revenue laws if the aggregate concept is more appropriate for those provisions. H. REP. No. 2543, 83d Cong., 2d

ment is appropriate. The Code's failure to state which partnership theory is appropriate becomes a problem in determining investment credit availability.

Under the investment credit provisions of the Code,[7] only a certain type of property is eligible for the investment credit. Such property, referred to as "section 38 property," must have a useful life of at least three years,[8] be depreciable or amortizable,[9] and must be either tangible personal property[10] or other tangible property that is closely connected with manufactur-

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Sess., 59 (1954). Therefore, while the Code generally treats partnerships as aggregates for taxpayer obligations and as entities for the purpose of calculating the filing informational returns, there are exceptions.

[7] Section 38 of the Code grants the taxpayer a credit against tax and authorizes the promulgation of regulations necessary to administer the credit. I.R.C. § 38. Code §§ 46-48 set out the rules for determining the amount of investment credit available to each taxpayer. I.R.C. §§ 46-48. To be eligible for investment credit, property must first qualify as "section 38 property." *See* text accompanying notes 9-12 *infra*. Of the taxpayer's "section 38 property," a percentage, which increases with the propertys useful life, becomes the taxpayer's "qualified investment." I.R.C. § 46(c). A taxpayer receives an investment credit equal to ten percent of his "qualified investment" in property acquired and placed in service after January 21, 1975 and before January 1, 1981. I.R.C. § 46(a)(2)(A). Additional credit is available to corporations that elect to contribute a sum equal to one percent of their qualified investment for the year to a qualifying employee stock ownership plan. I.R.C. § 46(a)(2)(B). The investment credit rate for property placed into service before January 22, 1975 is seven percent of the taxpayer's "qualified investment." I.R.C. § 47(a)(2)(C). While the credit generally is taken in the year the property is placed into service, it may be taken earlier for property with a normal construction period of more than two years, an expected useful life of more than seven years, and on which progress payments are made. I.R.C. § 46(d).

While the Code allows a taxpayer to offset completely his first $25,000 of tax liability with investment credit, only fifty percent of any tax liability exceeding $25,000 may be offset by the credit. I.R.C. § 46(a)(3). Credit not usable in a current year because of this limitation may be carried back to the three preceding years or carried forward to the next seven years. I.R.C. § 46(b). If a taxpayer takes investment credit on property and later disposes of the property before the end of its useful life, the Code requires that the taxpayer's tax for the year of the early disposition be increased by the amount that the credit would have been decreased had the original credit been computed on the period of actual use instead of estimated use. *See* I.R.C. § 47.

[8] Prior to 1971, the Code required a useful life of four years for property to qualify as "section 38 property." The taxpayer has the burden of establishing the useful life of property for which he intends to take investment credit. Spartenburg Terminal Co. v. Comm'r, 66 T.C. 916 (1976) (taxpayer failed to carry burden of establishing useful life for grading and tunnel base; no depreciation or investment credit allowed).

[9] *See, e.g.,* Coca-Cola Bottling Co. v. United States, 487 F.2d 528 (Ct. Cl. 1973) (investment credit denied where bottles and cases were expensed currently rather than depreciated); Rev. Rul. 75-491, 1975-2 C.B. 19 (molten tin used in float process manufacturing of flat glass is not depreciable).

[10] Frequently, the courts have been called on to determine whether a specific item is tangible personal property. *See, e.g.,* Texas Instruments, Inc. v. United States, 551 F.2d 599 (5th Cir. 1977) (seismic data tapes are tangible personal property); Kramertown Co. v. Comm'r, 488 F.2d 728 (5th Cir. 1974) (rooftop airconditioning and heating units are not tangible personal property); Walt Disney Prod. v. United States, 480 F.2d 66 (9th Cir. 1973), *cert. denied,* 415 U.S. 934 (1974) (motion picture negatives are tangible personal property); Weirick v. Comm'r, 62 T.C. 446 (1974) (ski resort line towers and wooden ramps are tangible personal property, earth ramps are not). In deciding whether an item is tangible personal

ing, production, or one of several other specified activities.[11] If the property has been in service before the taxpayer purchases it, the property also must qualify as "used section 38 property" in order to be eligible for the credit.[12] Section 48(c)(1) of the Code states that property is not "used section 38 property" if "after its acquisition by the taxpayer, it is used by a person who used such property before such acquisition. . . ."[13] That section goes on to exclude from "used section 38 property" all property purchased by a person who is related in any one of several ways to a person who used the property before the acquisition.[14]

In effect, section 48(c)(1) conditions the availability of investment credit for "section 38 property," the use of which is transferred between a partner and his partnership, on whether the partnership is viewed as an aggregate or an entity in its use of partnership property. If the partnership is viewed as an aggregate, property used by the partnership would be considered to have been used by the individual partners. Thus, when the use of "section 38 property" is transferred between a partner and his partnership, the partner would be deemed to have used the property both before and after the transaction. Since the property would have been used

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property the courts often look for guidance to the regulations that interpret § 48 of the Code, the section that defines "section 38 property" as including certain tangible property. One such regulation, Treasury Regulation § 1.48-1(c), defines tangible personal property as "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures. . . ." The Regulation also states that local law is not controlling for purposes of determining whether property is tangible personal property and that all property in the nature of machinery shall be considered tangible personal property. Treas. Reg. § 1.48-1(c) (1964). In at least one case, however, a court has found the applicable regulation invalid because it was contrary to the intent of § 48 of the Code. Walt Disney Prod. v. United States, 480 F.2d 66 (9th Cir. 1973) (Regulation § 1.48-1(f) invalid as contrary to the intent of § 48 of Code insofar as it relates to this case).

[11] I.R.C. § 48(a). To qualify as "section 38 property," tangible property that is not personal property must function as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services. If used in connection with one of the above activities, property which constitutes a research facility or facility for the bulk storage of fungible commodities also qualifies. I.R.C. § 48(a)(1)(B). Several cases concerning whether certain types of property satisfy these requirements have been decided. *See, e.g.*, Yellow Freight System, Inc. v. United States, 538 F.2d 790 (8th Cir. 1976) (docks, dock additions, and inspection lanes do not qualify under Code § 48(a)(1)(B)); Thirup v. Comm'r, 508 F.2d 915 (9th Cir. 1974) (greenhouses used to produce flowers are eligible for investment credit); Brown & Williamson Tobacco Corp. v. United States, 369 F. Supp. 1283 (W.D. Ken. 1973), *aff'd per curiam*, 491 F.2d 1258 (6th Cir. 1974) (structures used for storing tobacco are eligible for investment credit). In addition, elevators and escalators constructed or acquired after June 30, 1963 are considered "section 38 property." I.R.C. § 48(a)(1)(C).

[12] I.R.C. § 48(b) & (c).

[13] I.R.C. § 48(c)(1).

[14] *Id.* The relevant portion of § 48(c)(1) states that "[p]roperty 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)." For an explanation of exactly what relationships are excluded from "used section 38 property" by § 48(c)(1), see note 37 *infra*.

by the same person both before and after the transaction, it would not qualify as "used section 38 property" and would not be eligible for investment credit. If, on the other hand, the partnership is viewed as an entity, property used by the partnership would be deemed to have been used by the partnership entity, not the individual partners. Accordingly, a purchaser could take an investment credit on his investment in the property since it would not be deemed to have been used by the partner both before and after the transaction.

Treasury Regulation § 1.48-3(a)(2)(ii)[15] addresses the question of whether a partnership uses its property as an aggregate or an entity. This regulation regards property that has been used by a partnership as having been used by each partner for the purpose of determining whether the property qualifies as "used section 38 property."[16] By treating partnerships as aggregates, the regulation would eliminate the possibility of investment credit for transactions involving a partner and his partnership.[17] Recent cases, however, have held that Regulation § 1.48-3(a)(2)(ii) is contrary to

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[15] Treas. Reg. § 1.48-3(a)(2)(ii) (1964).

[16] While Treas. Reg. § 1.48-3(a)(2)(ii) treats partnerships as aggregates, another part of the same regulation applies the entity theory. Regulation § 1.48-3(c)(3), which explains Code §§ 48(c)(2)(A) & (B), treats the partnership as an entity for purposes of the Code's limit on the amount of "used section 38 property" which can be counted toward investment credit in any one taxable year. According to the regulation, the partnership entity can count its "used section 38 property" only up to the Code's limit for the taxable year, recently increased from $50,000 to $100,000. Each partner is also limited to $100,000 of "used section 38 property" by Code § 48(c)(2)(D). In addition, the partner must include his proportionate share of the partnership's "used section 38 property" in reaching his $100,000 limit. If partnerships were considered aggregates for the purpose of the limitation on the amount of "used section 38 property" available per year, the limit would only apply to the individual partners.

In Bryant v. Comm'r, 46 T.C. 848 (1966), a partnership elected under Code § 761(a) not to be treated as a partnership for Subchapter K purposes. When the partners computed the amount of investment credit they could take on their individual returns, they ignored the limit on the amount of "used section 38 property" a partnership could claim in a year. The Tax Court, however, held that since the investment credit provisions are not included in Subchapter K, the limitation on the amount of "used section 38 property" for each year still applied to the partnership and that the partners could take only their proportionate share of the $50,000 of the "used section 38 property" allowed the partnership for the taxable year. The Fifth Circuit affirmed the Tax Court's decision. Bryant v. Comm'r, 399 F.2d 800 (5th Cir. 1968). Treating the partnership as an entity for purposes of the limit on the amount of "used section 38 property" allowable per year was crucial in this case. If the partnership had been considered an aggregate for the purposes of this limit, the individual partners would have been allowed to count as much of their proportionate share of the partnership's "used section 38 property" as the limitation on the amount of "used section 38 property" they could take as individuals would allow, regardless of whether they had elected not to be considered as a partnership.

A similar limit is found in Code § 46(a)(3). Instead of limiting the amount of "used section 38 property" allowable per year, § 46(a)(3) limits the amount of investment credit that can be used to offset tax liability in a given year. *See* note 7 *supra*. Here, however, the Code treats the partnership as an aggregate. Since the partnership itself does not pay income tax, I.R.C. § 701, the limit on the amount of investment credit allowable per year applies only to the partners as individuals. [1978] 2 FED. TAXES (P-H) ¶ 5937 at 5974-F. *See also* Treas. Reg. § 1.48-3(f) (1964).

[17] *See* text accompanying notes 12-14 *supra*.

the intent of Congress and invalid.[18] The Tax Court's decisions in *Edward A. Moradian,*[19] *Holloman v. Commissioner,*[20] and *Kipperman v. Commissioner,*[21] and the Fifth Circuit's affirmation in *Holloman,*[22] have held uniformly that property used by a partnership should be treated as having been used by the partnership as an entity, not by the individual partners.

Moradian, a 1969 decision, was the first case to require the Tax Court to determine whether a partnership uses property as an aggregate or an entity.[23] Edward Moradian and Nick Hagopian were equal general partners[24] in a farming partnership.[25] The two purchased land used in the farming operation as tenants in common shortly before forming their partnership.[26] The land contained grapevines which became a substantial part of the assets used by the partnership in the production of grapes.[27] After the dissolution of the Moradian-Hagopian partnership, Hagopian sold his undivided one-half interest in the land used by the partnership to Moradian's wife, Georgia.[28] The Moradians continued the grape growing business as a partnership under the name of Gem Farms. On their joint federal

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[18] Kipperman v. Comm'r, 36 T.C.M. (CCH) 146, 148 (1977); Holloman v. Comm'r, 34 T.C.M. (CCH) 1354, 1356 (1975), *aff'd,* 551 F.2d 987, 990 (5th Cir. 1977); Edward A. Moradian, 53 T.C. 207, 210-11 (1969). While Regulation § 1.48-3(a)(2)(ii) has been held invalid, the Tax Court has applied Regulation § 1.48-3(a)(2)(i) in at least one case. In Ocrant v. Comm'r, 65 T.C. 1156 (1976), the Tax Court, relying on Regulation § 1.48-3(a)(2)(i), disallowed an investment credit because the taxpayer failed to show that the property had not been used by the same person both before and after its acquisition as the I.R.S. had claimed.

[19] 53 T.C. 207 (1969).

[20] 34 T.C.M. (CCH) 1354 (1975).

[21] 36 T.C.M. (CCH) 146 (1977).

[22] 551 F.2d 987 (5th Cir. 1977).

[23] 53 T.C. 207 (1969). James T. McKay, 27 T.C.M. (CCH) 1478 (1968), a previous Tax Court decision, raised the question of whether a partnership uses property as an aggregate or an entity. The court, however, decided *McKay,* without reaching this question. In *McKay,* a taxpayer/partner claimed an investment credit for some office equipment he had purchased from his partnership. *Id.* at 1483. The IRS disallowed the credit. The Tax Court then determined that the taxpayer/partner owned more than a fifty percent interest in his partnership. Section 48(c)(1) excludes from "used section 38 property" all property that is used after its acquisition by someone "related" in one of several ways to the person who used it before its acquisition. *See* text accompanying note 14 *supra.* Since § 707(b) of the Code, as it applies to section 48(c)(1), includes a partnership and a partner who owns more than fifty percent of the partnership as being "related", the Tax Court held that the office equipment was not "used section 38 property" and that the taxpayer/partner was not entitled to an investment credit for its purchase. *See* note 37 *infra.*

[24] 53 T.C. at 209. As equal partners, Moradian and Hagopian split the profits and losses from their farming partnership. *Id.* at 208. The fact that the partners divided the profits equally is important for investment credit purposes since Regulation § 1.46-3(f)(2) provides that a partner's share of the partnership's investment credit is determined in accordance with the ratio used to divide the partnership profits. Treas. Reg. § 1.46-3(f)(2) (1964).

[25] 53 T.C. at 207-08.

[26] *Id.* at 208.

[27] The grapevines were apparently attached to the land purchased by Moradian and Hagopian. *Id.* at 214 (Scott, J., dissenting).

[28] *Id.* at 208.

income tax return, the Moradians claimed an investment credit attributable to Georgia's acquisition of the grapevines. The IRS disallowed the credit, creating a deficiency for the taxable year, and the Moradians petitioned the Tax Court for a redetermination of the deficiency.[29]

The IRS claimed that since Regulation § 1.48-3(a)(2)(ii) treats property used by a partnership as being used by each partner, Edward Moradian had used the grapevines both before and after the purchase by his wife.[30] Therefore, the IRS argued, section 48(c)(1) of the Code would prohibit Georgia Moradian from receiving investment credit for the purchase of the grapevines.[31] The Tax Court, however, refused to base its decision on the regulation. Instead, the court relied on the Code provisions and congressional committee reports dealing with investment credit to find that the regulation was invalid as applied by the IRS to the facts in *Moradian.* The court held that property used by a partnership should be considered as having been used by the partnership as an entity.[32] After so finding, the court had little trouble in holding that Georgia Moradian was entitled to investment credit for her purchase of the grapevines.[33]

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[29] *Id.* A taxpayer desiring to challenge a deficiency determination by the IRS has several courses of action available. He can, as the taxpayer did in *Moradian,* file a petition with the Tax Court for a redetermination of deficiency. The action resulting from such a petition is commonly called a deficiency suit. *See* I.R.C. §§ 6211-15. Alternatively, the taxpayer can pay the deficiency and file a claim for a refund. If the claim is not granted, the taxpayer may file a suit for refund in either the Court of Claims, 28 U.S.C. § 1491 (1970), or a federal district court, 28 U.S.C. § 1340 (1970). Finally, the taxpayer may ignore the deficiency altogether. If the taxpayer does not pay the deficiency, the government can resort to the lien on the taxpayer's property that attaches at the time of the assessment. I.R.C. § 6321. The government may start a civil action in a district court to enforce the lien up to the amount of the deficiency. *See* I.R.C. § 7403.

In choosing which course of action to follow, the taxpayer should consider several factors. One such factor is that while payment of the deficiency is a prerequisite in refund suits, the taxpayer does not have to pay the deficiency before bringing a deficiency suit. The taxpayer also should consider the fact that an adverse decision in a deficiency suit requires not only the payment of the deficiency but also the payment of an interest charge. Additional factors which may be important to a taxpayer include: lack of an appeal right to a circuit court of appeals from the Court of Claims; the availability of jury trials only in district courts; the availability of small claims procedures in the Tax Court, and the differences in the technical competency of the judges of the various courts in tax related matters. *See* J. CHOMMIE, FEDERAL INCOME TAXATION § 297 (2d Ed. 1973).

[30] 53 T.C. at 209.

[31] If Regulation § 1.48-3(a)(2)(ii) were followed, the grapevines would not qualify as "used section 38 property" and therefore would not be eligible for investment credit. *See* text accompanying note 12 *supra.* To qualify as "used section 38 property" the grapevines must first quality as "section 38 property." *See* text accompanying notes 7-11 *supra.* The grapevines must be "tangible personal property" or "other tangible property" within the meaning of § 48(a)(1) to qualify as "section 38 property." While the grapevines would not appear tó qualify as tangible personal property, Regulation § 1.48-1(d)(2), which lists orchards, gardens, and nurseries as examples of "other tangible property," indicates that grapevines are in fact "section 38 property." *See also* Powers v. United States, 285 F. Supp. 72 (C.D. Cal. 1968).

[32] 53 T.C. at 212.

[33] *Id.* at 214.

In deciding that a partnership should be considered as using property as an entity, the court reasoned that the failure of the IRS to treat a partnership as a "person" for purposes of section 48(c)(1) was inconsistent with the definition of the term "person" in section 7701(a)(1) of the Code.[34] Section 7701(a)(1) defines "person" as including partnerships unless otherwise expressed or unless incompatible with the intent of a particular section.[35] This definition, which treats partnerships as entities, is not expressly precluded by section 48 and does not appear to be incompatible with the intent of the investment credit provisions.[36] Since section 48(c)(1) excludes from "used section 38 property" all property used by the same "person" before and after its acquisition and since the Code includes partnerships as "persons," the language of the Code itself strongly indicates that the use of property by a partnership should be attributed to the partnership entity.

The court also noted that to consider the individual partners as having used the grapevines would in certain situations nullify that portion of section 48(c)(1) that excludes from "used section 38 property" all property used by a person related to someone who had used the property before its purchase.[37] For the purposes of section 48(c)(1), section 707(b) deems such

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[34] *Id.* at 211.

[35] I.R.C. § 7701(a)(1).

[36] *See* text accompanying notes 41-44 *infra.*

[37] 53 T.C. at 211. *See* text accompanying note 14 *supra.* Section 48(c)(1) incorporates from other sections of the Code the types of relationships between pre-transfer property users and post-transfer users that will exclude property from being "used § 38 property." Section 48(c)(1) excludes from "used section 38 property" all property that is used after its purchase by a person who bears a relationship described in § 179(d)(2)(A) or (B) to a person who used the property before the acquisition. For the exact text of this limitation see note 15 *supra.* The main purpose of § 179 is to grant an additional first-year depreciation allowance for small business owning qualifying property. As it relates to § 38(c)(1), however, § 179(d)(2)(B) excludes from "used section 38 property" any property that is acquired by one component member of a controlled group from another component member of the same controlled group. The term controlled group as defined in § 1563 includes chains of corporations connected through stock ownership with a parent corporation, two or more corporations in which less than six people own most of the stock, and certain insurance companies. For the purposes of § 48(c)(1), the percentage of ownership needed by a parent corporation for a chain of corporations to qualify as a controlled group is reduced from "at least 80 percent" to "more than 50 percent." I.R.C. § 48(c)(3)(C).

Section 179(d)(1)(A) excludes from property eligible for the additional first-year depreciation allowance and therefore from "used section 38 property," those relationships that would result in the disallowance of losses under § 267 and § 707(b) of the Code. Section 267 disallows losses for nine different relationships listed in § 267(d), the most important of which for the purposes of § 38(c)(1) seems to be members of a family. Thus, for example, when a taxpayer purchases farm equipment from his father for use on a farm rented to him by his father, no investment credit will be allowed for the purchase of the farm equipment since it does not qualify as "used section 38 property." Schelling v. United States, (D.C. Iowa, 1976), 38 A.F.T.R.2d 76-5903. Section 707(b) disallows losses on sales or exchanges of property between a partnership and a partner owning more than a fifty percent interest in the partnership and between two partnerships in which the same person owns more than a fifty percent interest. Therefore, property involved in these types of transactions will not qualify as "used section 38 property" and will not be eligible for investment credit.

a relationship to exist between a partnership and a partner owning more than fifty percent of the partnership as well as between two partnerships in which the same individual owns more than fifty percent.[38] Therefore, property involved in transactions between a partnership and a partner owning more than fifty percent of the partnership or between two partnerships in which the same individual owns more than a fifty percent interest will not qualify as "used section 38 property." If partnerships are treated as aggregates, however, this limitation becomes meaningless. Under the aggregate theory, property involved in a transaction between a partner and his partnership could never qualify as 'used section 38 property" since the partner is deemed to have used the property both before and after the transaction.[39] Thus, the Tax Court concluded that the only way to give full meaning to the restriction on transactions between "related" persons is to treat partnerships as entities.[40]

The *Moradian* court found additional support for its holding in the legislative history of the investment credit. Noting that Congress first enacted the investment credit provisions[41] to "stimulate investment" and "increase the competitiveness of American exports in world markets," the court reasoned that Congress intended the statute to be interpreted liberally.[42] The court decided that section 48(c)(1) was intended to prevent the taking of investment credit only in situations where the goals of the investment credit were not met.[43] Applying this reasoning to the *Moradian* facts, the court concluded that Georgia Moradian's purchase furthered the goals of the investment credit, and accordingly, was not one of the abuses section 48(c)(1) was intended to prevent.[44]

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[38] *See* note 37 *supra*.

[39] *See* text accompanying notes 12-13 *supra*.

[40] 53 T.C. at 211-12.

[41] Congress first established the investment credit in the Revenue Act of 1962. Revenue Act of 1962, Pub. L. No. 87-834, § 2, 76 Stat. 960 (1962). In 1966, Congress suspended the investment credit for the period between October 10, 1966 and December 31, 1967 as part of a plan to curb inflation. Act of Nov. 25, 1966, Pub. L. No. 89-800, 80 Stat. 1508 (1966). When the economy became sluggish in 1967, Congress acted to limit the suspension period to March 9, 1967 instead of December 31, 1967. Act of June 13, 1967, Pub. L. No. 90-26, 81 Stat. 57 (1967). When the country faced another period of high inflation in 1969, Congress added § 49 to the Code and thus, with a few exceptions, terminated the investment credit. Tax Reform Act of 1969, Pub. L. No. 91-172, § 703(a), 83 Stat. 487 (1966). Another lag in the economy prompted the reinstatement of the investment credit by the addition of § 50 in 1971. Revenue Act of 1971, Pub. L. No. 92-178 § 101, 85 Stat. 497 (1971). The investment credit provisions have been in effect since 1971. *See* MERTENS, *supra* note 5 at § 32A.57.

[42] *Id.* at 212.

[43] *Id.* at 213. The court felt that the goal of the investment credit, to stimulate the economy by encouraging businesses to invest in additional capital assets, is not furthered when the asset acquired continues to be used by the same person who used it before its acquisition. *Id.*

[44] Specifically, the court noted that Mrs. Moradian's personal business activities were increased by virtue of her acquisition of the grapevines. Thus, her purchase of the grapevines would stimulate the economy because of the increase in her personal business activities and because the economy is strengthened by a ready turnover of business assets. *Id.*

The IRS has made its disagreement with the *Moradian* court's decision quite clear.[45] In 1973, the IRS nonacquiesced to the *Moradian* decision.[46] Then in Revenue Ruling 74-64,[47] the IRS stated that it would continue to apply Regulation § 1.48-3(a)(2)(ii) despite the Tax Court's holding in *Moradian.*

Notwithstanding these actions by the IRS, in *Holloman v. Commissioner,*[48] the Tax Court again held that a partnership should be treated as an entity for purposes of section 48(c)(1). Holloman, the taxpayer in that case, formed a partnership with a fellow dentist, Dr. Blankenship, to practice dentistry.[49] Blankenship leased to the partnership dental equipment he had owned prior to the formation of the partnership. When the partnership was terminated, Holloman purchased the dental equipment from Blankenship and claimed an investment credit for the purchase. The IRS disallowed the investment credit and Holloman brought a deficiency suit before the Tax Court.[50] Relying on Regulation § 1.48-3(a)(ii), the IRS claimed that Holloman had used the dental equipment as a member of the dental partnership before purchasing the equipment for his own practice.[51] The Tax Court, however, relied on the same reasoning it used in *Moradian* and held that Holloman was entitled to investment credit for his purchase of the dental equipment.[52]

The IRS appealed and the Fifth Circuit affirmed the Tax Court's decision.[53] The Fifth Circuit held that the reference in section 48(c)(1) to use by a "person" does not refer to the individual who physically used the property, but rather to the legal entity which used it.[54] The court reasoned

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[45] The IRS appealed the *Moradian* decision, but withdrew the appeal before the case was heard. *See* Pusey, *The Partnership as an "Entity:" Implications of* Basye, 54 TAXES 143, 158 n.57 (1976).

[46] 1973-2 C.B.4 . In nonacquiescing to a decision, the IRS is, in effect, saying that it will continue to contest the issue decided in that case as it arises in future cases.

[47] Rev. Rul. 74-64, 1974-1 C.B. 12, 13. Revenue Ruling 74-64 states the position of the IRS on the availability of investment credit for a taxpayer who has purchased a 25 percent working interest in an oil and gas lease joint venture from an individual who owned 50 percent of the oil and gas joint venture. The Ruling states that the joint venture would be treated as a partnership for the purpose of determining the availability of investment credit. *See* Rev. Rul. 65-118, 1965-1 C.B. 30. *See also* note 5 *supra.* The Ruling then states that the IRS will continue to apply Regulation § 1.48-3(a)(2)(ii) which requires that property used by a partnership be considered as having been used by each partner. Thus, those persons who retained an interest in the oil and gas lease both before and after the taxpayer purchased a 25 percent share of it were deemed to have used the oil and gas lease both before and after its purchase by the taxpayer. Since § 48(c)(1) of the Code excludes from "used section 38 property" any property used by the same person both before and after its acquisition by the taxpayer, the purchaser's interest in the oil and gas lease would not be "used section 38 property" and would not be eligible for investment credit.

[48] 34 T.C.M. (CCH) 1354 (1975).

[49] *Id.* at 1355.

[50] *Id.*; *see* note 29 *supra.*

[51] 34 T.C.M. (CCH) at 1356.

[52] *Id.* at 1356-57.

[53] 551 F.2d 987 (5th Cir. 1977).

[54] *Id.* at 989. The Fifth Circuit pointed out that if the reference in § 48(c)(1) to use by a

that since the Code treats the partnership as a separate "person," the use of equipment by a partnership should not be charged to individual partners unless the partner owned more than fifty percent of the partnership.[55]

Despite *Moradian* and *Holloman,* the IRS has refused to admit defeat. *Kipperman v. Commissioner*[56] is the latest case to grow out of the insistence of the IRS that the partnership should be considered an aggregate in determining whether investment credit is available for used property. Instead of the partner purchasing property used by the partnership as in the two previous cases, *Kipperman* involved a partnership that purchased property from one of its partners. Kipperman, an attorney, owned as a tenant in common property necessary for the practice of law.[57] Kipperman then formed a partnership with several other attorneys. The partnership purchased Kipperman's undivided one-half interest in the property he owned as a tenant in common as well as some additional personal property owned by Kipperman.[58] Kipperman then claimed investment credit for his share of the property purchased by the partnership.[59]

The IRS asserted that since the property had been used by Kipperman both before and after its purchase by the partnership, it was not "used section 38 property" and therefore, did not qualify for investment credit purposes.[60] As in *Moradian* and *Holloman,* Regulation § 1.48-3(a)(2)(ii) was the basis for this argument.[61] The IRS attempted to distinguish *Kipperman* from *Moradian* and *Holloman* by pointing out that the petitioner in *Kipperman* had both the use and the ownership of the concerned property before and after its acquisition.[62] The IRS claimed that by comparison the taxpayer in *Moradian* had neither the use nor ownership of the concerned property before its purchase, and that in *Holloman* the taxpayer did not have the ownership of the involved property prior to its purchase.[63] The Tax Court, citing its two previous decisions, again disapproved of the

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person means the individual person who physically uses the property, many situations would arise for which an investment credit would be denied even though common sense would dictate otherwise. For example, if a taxpayer starts a new business and purchases equipment from an unrelated taxpayer and then hires the same person who had operated the equipment for the former owner to operate it for him, there would be no investment credit allowed for the purchase of the equipment. The Fifth Circuit could see no purpose for such an interpretation of the statute. *Id.*

[55] *Id.* at 989. The exception for a partner who owns more than 50 percent of a partnership recognizes the provisions of § 707(b) which are incorporated into § 48(c)(1). *See* note 37 *supra.*

[56] 36 T.C.M. (CCH) 146 (1977).

[57] The property Kipperman owned as a tenant in common with the other attorney consisted mainly of law books and office furniture. *Id.* at 146.

[58] *Id.* at 146-47. After buying Kipperman's interest in the property, the partnership sold its interest in the office furniture to the attorney who owned the other one-half interest and divided up the law books with him. *Id.*

[59] *Id.* at 147.

[60] *Id.*

[61] *Id.*

[62] *Id.* at 148.

[63] *Id.*

regulation.[64] In granting Kipperman a summary judgment on his claim for his share of the investment credit resulting from the partnership's purchase of the property,[65] the Tax Court dismissed the argument of the IRS by stating that the crux of its two earlier decisions, that a partnership should be considered an entity for purposes of section 48(c)(1), was still applicable in *Kipperman.*[66]

Any attempt to analyze the decisions of the Tax Court and the Fifth Circuit in the *Moradian, Holloman,* and *Kipperman* cases must take into account the fact that such a holding requires the invalidation of Regulation § 1.48-3(a)(2)(ii). Since Code section 7805[67] and Regulation § 301.7805-1[68] authorize the Commissioner of the IRS, with the approval of the Secretary of the Treasury, to prescribe all rules and regulations needed for the enforcement of the Code, such regulations are accorded considerable weight.[69] In addition, Code section 38(b) confers upon the Commissioner, as delegate of the Secretary, specific statutory authority to prescribe regulations for carrying out the provisions of the investment credit.[70] Courts have long held that such statutory grants of authority furnish powerful support for regulations and that regulations promulgated under these statutory provisions should not be declared invalid unless clearly contrary to the legislative mandate.[71]

Thus, for the decisions of the Tax Court and the Fifth Circuit in *Moradian, Holloman,* and *Kipperman* to be justified, Regulation § 1.48-3(a)(2)(ii) must be clearly contrary to Congress' intent in enacting the investment credit provisions. The investment credit was added to the Code in order to stimulate the economy by encouraging investment in capital equipment that would make the investor's business more competitive and increase its productive capacity.[72] To prevent abuses, Congress limited credit for used property to instances where the same person does not use the property both before and after the transaction.[73] The purchase of "used

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[64] *Id.*

[65] In allowing Kipperman to take his share of the investment credit resulting from the partnership's purchase of the property, the court was following Regulation § 1.46-3(f), which states that each partner shall be treated as the taxpayer for his share of the partnership's "section 38 property." Treas. Reg. 1.46-3(f) (1964). *See* note 24 *supra.* By dividing up the investment credit due to a partnership among its partners, this regulation treats partnerships as aggregates.

[66] 36 T.C.M. (CCH) at 148.

[67] I.R.C. § 7805.

[68] Treas. Reg. § 301.7805-1 (1960).

[69] United States v. Cartwright, 411 U.S. 546, 550 (1973), Lykes v. United States, 343 U.S. 118, 127 (1952); Morrissey v. Comm'r, 296 U.S. 344, 354-55 (1935). *See* MERTENS, *supra* note 5, at § 3.20.

[70] I.R.C. § 38(b).

[71] Comm'r v. South Texas Co., 333 U.S. 496, 503 (1948); Lucas v. American Code Co., 280 U.S. 445 (1930).

[72] *See* S. REP. No. 1881, 87 Cong., 2d Sess. 10-12 (1962), *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3297, 3313-16.

[73] S. REP. No. 1881, 87 Cong., 2d Sess. 13 (1962), *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3297, 3317.

section 38 property" and its immediate lease back to the original owner with the purchaser claiming investment credit is an example of the type of situation the limitation in Section 48(c)(1) is intended to prevent.[74]

Regulation § 1.48-3(a)(2)(ii) was promulgated in connection with this limitation. But if partnership property is considered as being used by each partner as the regulation requires, investment credit will be denied for some transactions that would further the goals Congress had in mind when it established the credit. For example, the regulation would deny a partner with a one percent interest in his partnership from taking investment credit on property he purchased from his partnership even if he had never physically used the property. Credit would not be granted despite the fact that following the transaction the purchaser would have at his disposal property that he did not have prior to the transaction which he could use to increase his business' productive capacity and to improve its competitiveness.[75]

In addition to the fact that Regulation § 1.48-3(a)(2)(ii) would deny an investment credit in situations where the credit should be permitted, there are other strong indications that the regulation is contrary to congressional intent. As the Tax Court pointed out, the use of the word "person"[76] and the fact that the part of section 48(c)(1) that deals with related parties would be rendered surplusage by that regulation[77] weigh against the regulation's validity. Taken together these factors reveal that Regulation § 1.48-3(a)(2)(ii) is not consistent with the Code's investment credit provisions.

These same factors strongly support treating partnerships as entities for the purpose of determining whether used property is eligible for investment credit. Thus, although the IRS may continue to relitigate the issue, the decisions by the *Moradian, Holloman,* and *Kipperman* courts holding

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[74] The sale and leaseback agreement is mentioned specifically by Congress as one of the abuses the limitation against property used by the same person both before and after the agreement was intended to prevent. S. REP. No. 1881, 87th Cong., 2nd Sess. 158-59 (1962). Other examples of abuses this limitation is intended to prevent are the purchase by a taxpayer of property he had been leasing and the sale of property by a lessor subject to a lease. *Id.* The *Moradian* court inferred from the examples listed in this committee report that the abuse envisioned by Congress was the possibility that an investment credit might be procured by an individual when the purposes of the investment credit are not met. 53 T.C. at 213. For the purpose of investment credit, see the text accompanying note 72 *supra.*

[75] The *Moradian, Holloman,* and *Kipperman* cases also involve situations in which Regulation § 1.483(a)(2)(ii) would deny an investment credit when the purposes of the investment credit would be further served by granting credit. In *Moradian,* the purchase of the property by Mrs. Moradian put at her disposal property which increased her business activities. *See* text accompanying notes 23-44 *supra.* In *Holloman,* the petitioner's purchase of dental equipment at least indirectly stimulated investment since the party who sold the equipment would have had to purchase other equipment if he wished to continue his practice of dentistry. *See* text accompanying notes 48-55 *supra.* In *Kipperman,* the purchase of the law books by the partnership improved the partnership's ability to serve its clients. *See* text accompanying notes 56-66 *supra.*

[76] *See* text accompanying notes 34-36 *supra.*

[77] *See* text accompanying notes 37-40 *supra.*

that partnerships use property as entities seem to be well founded.[78] Such a conclusion indicates that a partner should be able to purchase property used previously by one of its partners without losing an otherwise available investment credit.

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[78] In addition, the decisions of the *Moradian, Holloman,* and *Kipperman* courts are consistent with the Code's general treatment of partnerships as entities for most purposes other than the actual payment of taxes. *See* text accompanying notes 4-6 *supra.*