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of insurance may rise in the near future, ultimately the industry will develop new methods of cost control in its operation. Both sound business practice and a desire to stem consumer dissatisfaction will dictate this result.

III. Conclusion

In *Group Life & Health* the Supreme Court was presented with the task of interpeting the phrase "business of insurance" for purposes of the McCarran-Ferguson Act antitrust exemption. At issue specifically were Pharmacy Agreements between Blue Shield and participating pharmacies designed to provide policyholder benefits under a drug insurance plan. The Court construed the business of insurance narrowly, and thereby further limited the McCarran-Ferguson Act antitrust exemption. The Pharmacy Agreements, as well as all provider agreements, were declared by the Court to be outside the scope of the business of insurance because they are merely contractual arrangements for the purchase of goods and services by an insurance company and do not involve the underwriting and spreading of risks. This decision parallels the growing sentiment to abolish or severely limit statutory antitrust exemptions and profoundly affects every insurance company obligation that had relied on a provider agreement for its performance.

Maureen A. Murry

Gulfstream Land & Development Corp. v. Commissioner: Section 1031(a) Applied to the Exchange of General Partnership Interests

Gulfstream Republic Properties, Inc. and Gulfstream University, Inc. were wholly owned subsidiaries of petitioner, Gulfstream Land and Development Corporation. In June 1971 Gulfstream Republic Properties entered into a joint venture[1] with an unrelated corporation. In 1972 Gulfstream University entered into another joint venture with All Seasons Development Corporation; also an unrelated corporation. Both joint ventures were formed to develop and improve real estate. On July 18, 1974, Gulfstream Republic Properties exchanged its joint venture interest for the joint venture interest owned by All Seasons Development Corporation; Gulfstream Republic Properties and Gulfstream University thus became equal interest coventurers in the same joint venture. The parent, Gulfstream Land and Development Corporation, did not report any of the gain it realized from the exchange on its consolidated tax return for the taxable

1. For federal income tax purposes the terms "joint venture" and "partnership" are synonymous. *See* I.R.C. §§ 761(a) & 7701(a)(2); Treas. Reg. § 1.761-1, T.D. 7208, 1972-2 C.B. 396.

year ending September 30, 1974, treating the transaction as a tax-free exchange pursuant to section 1031(a) of the Internal Revenue Code.[2] The Commissioner of the Internal Revenue Service assessed a deficiency against the parent corporation, claiming that the parenthetical language of section 1031(a) prevents an exchange of general partnership interests from qualifying for nonrecognition of gain treatment. In the alternative, the Commissioner argued that the transaction was a constructive exchange of the underlying partnership assets, which the Commissioner classified as stock in trade held primarily for sale.[3] Gulfstream filed suit in the Tax Court to dispute the deficiency and moved for partial summary judgment.[4] *Held, motion for partial summary judgment denied*: An exchange of general partnership interests will qualify for section 1031(a) nonrecognition treatment unless scrutiny of the underlying partnership assets reveals that the substance of the transaction is an exchange of property that would not otherwise qualify for nonrecognition under section 1031(a). *Gulfstream Land & Development Corp. v. Commissioner*, 71 T.C. 587 (1979).

I. I.R.C. SECTION 1031

A. *The History and Mechanics of Section 1031*

Internal Revenue Code section 1031(a) contains two basic components.[5] The operative component provides mandatory nonrecognition of any gain or loss realized when property held for investment or for productive use in trade or business is exchanged for property of a like kind.[6] The second component parenthetically excludes "stock in trade or other property held primarily for sale, [and] stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest"[7] from qualifying for nonrecognition treatment.

The predecessor of the present section 1031(a) originated in the Revenue

2. I.R.C. § 1031(a) provides:

> No gain or loss shall be recognized if property held for productive use in trade or business or for investment (*not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest*) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

(Emphasis added.)

3. Stock in trade held primarily for sale, *i.e.*, inventory, is a type of property expressly excluded from nonrecognition treatment by the parenthetical clause of § 1031(a). *Id.*

4. Gulfstream originally filed a motion for judgment on the pleadings pursuant to rule 120 of the Tax Court Rules of Practice and Procedure. The Commissioner objected and moved to convert Gulfstream's motion to a motion for partial summary judgment pursuant to rule 121 of the Tax Court Rules of Practice and Procedure. The Tax Court granted the Commissioner's motion and thus the case was before the court on Gulfstream's motion for partial summary judgment. *See* Gulfstream Land & Dev. Corp. v. Commissioner, 71 T.C. 587, 588 n.1 (1979).

5. *See generally* [1975] 61-3d TAX MNGM'T (BNA) for the requirements of § 1031(a).

6. The nonrecognition provision of I.R.C. § 1031(a) is nonelective and cannot be voluntarily waived. *See* United States v. Vardine, 305 F.2d 60, 66 (2d Cir. 1962). *Compare* I.R.C. § 1031 *with id.* § 1033.

7. I.R.C. § 1031(a).

Act of 1921.[8] After several amendments, the section was enacted in its present form in 1928.[9] The congressional policy behind the provision is to permit a "paper" gain to escape taxation temporarily when a taxpayer's original investment remains unliquidated.[10] The predecessor of section 1031(a) parenthetically excluded from nonrecognition treatment stock in trade or other property similarly held for sale.[11] The provisions of the 1921 Act, however, were applied liberally to allow tax-free exchanges of all types of like-kind property, including the tax-free exchange of appreciated stock for other stock and bonds.[12] Many taxpayers abused this liberal construction by trading in appreciated securities without incurring tax liabil-

8. Revenue Act of 1921, Pub. L. No. 98, ch. 136, § 202(c)(1), 42 Stat. 230 (codified following amendment at I.R.C. § 1031(a)). Even before the Revenue Act of 1921 was enacted by Congress, a treasury regulation issued under the Revenue Act of 1918 excepted certain exchanges from the general rule requiring recognition of gain or loss. The regulation provided that no gain or loss from the exchange of property would be recognized unless there was (a) a change in the substance of the property and not merely the form and (b) a change of the property into the equivalent of cash. Treas. Reg. 45, art. 1563, T.D. 2971, 2 C.B. 38 (1920). For a discussion of the legislative history of § 1031, see Comment, *Section 1031: Like Kind Exchanges of Partnership Interests*, 29 U. FLA. L. REV. 168, 169 (1976). *See generally* 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 20.21, at 79 (rev. ed. 1972).

9. Revenue Act of 1928, Pub. L. No. 562, ch. 852, § 112(b)(1), 45 Stat. 816 (now codified at I.R.C. § 1031(a)).

10. The report of the Senate Committee on Finance relating to this portion of the Revenue Act of 1921 stated: "Section 202 (subdivision c) provides new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit." S. REP. No. 275, 67th Cong., 1st Sess. 11 (1921). *See also* H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934), in which the House Committee on Ways and Means reported on the Revenue Act of 1934. In the section of the report concerned with the tax-free exchange provision the Committee stated:

> [I]f the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.

Id. One court has suggested that the legislative purpose behind the section was to reduce the administrative complications of valuing property received in an exchange. *See* Century Elec. Co. v. Commissioner, 192 F.2d 155, 159 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), in which the court stated that reduction of administrative complications was the reason for § 1031's enactment. This explanation, however, has been rejected as having no support in legislative history. *See* Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959). The court in *Jordan Marsh*, addressing the interpretation of the legislative history in *Century Electric*, stated:

> Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. . . . These considerations, rather than concern for the difficulty of the administrative task of making the valuations . . . were at the root of the Congressional purpose in enacting [§ 1031(a)].

Id. at 456 (footnote omitted).

11. *See* Revenue Act of 1921, Pub. L. No. 98, ch. 136, § 202(c)(1), 42 Stat. 230. *See also* Comment, *supra* note 8, at 170.

12. *See* Girard Trust Co. v. Commissioner, 16 B.T.A. 308 (1929) (decided under the 1921 Act allowing the tax-free exchange of stock for bonds and stock); Greene v. Commissioner, 15 B.T.A. 401 (1929), *aff'd*, 42 F.2d 852 (2d Cir. 1930) (allowing the tax-free exchange of stock for railway bonds under the 1921 Act).

ity.[13] This loophole was closed by an amendment in 1923 that added "stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest" to the parenthetical clause of the 1921 provision.[14] The legislative history of the 1923 amendment and subsequent exchange provisions clearly indicate that Congress intended only to close this specific tax loophole and not to eliminate a larger class of property from the tax-free exchange provision.[15]

B. *Prior Resolution of Section 1031 as Applied to Exchanges of Partnership Interests*

Both the courts and the Internal Revenue Service recently have addressed the question of whether an exchange of general partnership interests qualifies for nonrecognition treatment pursuant to section 1031(a).[16] Cases dealing with such exchanges have focused on two major issues. One issue is the potential inclusion of a general partnership interest within the scope of the parenthetical clause of section 1031. The Service consistently has argued that the parenthetical clause precludes the tax-free exchange of general partnership interests.[17] The second issue is the extent to which an exchange of partnership interests satisfies the like-kind requirement of section 1031(a). The regulations state that "the words 'like kind' have reference to the nature or character of the property and not to its grade or

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13. In a letter dated Jan. 13, 1923, to the Chairman of the House Ways and Means Committee, the Secretary of the Treasury stated: "This provision of the act is being widely abused. Many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain." H.R. REP. No. 1432, 67th Cong., 4th Sess. 1 (1923).

14. Act of March 4, 1923, Pub. L. No. 545, ch. 294, 42 Stat. 1560.

15. The original bill for the 1923 amendment introduced in the House of Representatives and recommended by the House Ways and Means Committee would have eliminated all property held for investment from the tax-free exchange provision. But when the bill reached the floor for debate, the House amended it to restore the whole class of investment property to the provision and added only the language describing securities and similar type property to the parenthetical exclusion clause. *See* 64 CONG. REC. 2854 (1923).

A House Ways and Means Committee report on the reenactment of the tax-free exchange provision in the Revenue Act of 1934 described the section as follows:

> The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments . . . but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money . . . .

H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934).

16. *See* Estate of Meyer v. Commissioner, 58 T.C. 311 (1972), *nonacq.*, 1975-1 C.B. 3, *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974); Miller v. United States, 63-2 U.S. Tax Cas. ¶ 9606 (S.D. Ind. June 14, 1963); Rev. Rul. 78-135, 1978-1 C.B. 256.

17. The parenthetical clause of § 1031(a) contains several terms that describe a broad range of property interests. The IRS arguably could classify a partnership interest as any one of the several property interests described in the parenthetical clause. It is unlikely, however, that the Service could classify partnership interests as stocks, bonds, notes, certificates of trust of beneficial interest, or evidences of indebtedness. The terms "choses in action," "securities," and "evidences of interest" are more vague and provide the Service with greater opportunity to argue that they encompass a partnership interest. For a discussion of the potential of classifying a partnership interest as a chose in action or security, see Boyd & Heller, *Like-Kind Exchanges of Partnership Interests: A Comprehensive Analysis*, 3 REV. TAX. INDIVIDUALS 87, 89-95 (1979). *See also* Comment, *supra* note 8, at 175-77.

quality."[18]

In *Miller v. United States*,[19] a United States district court decision, the taxpayer exchanged his fifty percent interest in a tavern partnership for a twenty-five percent partnership interest in a home and auto supply store. The court held, without discussion, that the exchange of partnership interests was an exchange of like-kind property qualifying for nonrecognition under section 1031(a).[20] The court reasoned that the plaintiff's investment in the partnership interest received was a continuation of the old investment still unliquidated. Also without discussion, the court further stated that the partnership interests transferred were not property interests included in the parenthetical clause of section 1031(a).[21]

The *Miller* court apparently did not examine the nature of the underlying partnership assets. Examining the transaction solely at the partnership interest level, only the partnership interests actually exchanged were required to pass the tests of section 1031(a). Both partnerships held notes and inventory, which are types of property ineligible for nonrecognition treatment.[22] Thus, if the court had viewed the transaction as a constructive exchange of partnership assets, the exchange would not have been completely tax-free.[23]

The Tax Court also permitted a tax-free exchange of general partnership interests in *Estate of Meyer v. Commissioner*.[24] In *Meyer* father and son each held a one-half interest in a California general partnership. In the same transaction, both partners exchanged a portion of their general partnership interest for a part interest in a limited partnership. Meyer, Sr. received a fifteen percent limited partner interest, while Meyer, Jr. received a

18. Treas. Reg. § 1.1031(a)-1(b), T.D. 6935, 1967-2 C.B. 272. To qualify for nonrecognition of gain under § 1031(a), the exchange must involve like-kind properties. Recent cases suggest that any exchange of realty for realty or personalty for personalty will meet the like-kind test. State law determines whether the property is realty or personalty. *See, e.g.*, Helis v. Usry, 464 F.2d 330 (5th Cir. 1972) (property held for productive use in overseas oil exploration exchanged for productive property in the same business); Fleming v. Commissioner, 241 F.2d 78 (5th Cir. 1957) (limited overriding royalty or oil payment interests exchanged for a ranch and urban business property); Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941) (undivided interest in minerals in unimproved country land exchanged for undivided interest in improved city land). *But see* Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (an exchange of realty for realty was not allowed, but the decision was based on precluding the anticipatory assignment of income). Both the Uniform Partnership Act and the Uniform Limited Partnership Act regard partnership interests as personalty. UNIFORM PARTNERSHIP ACT § 26; UNIFORM LIMITED PARTNERSHIP ACT § 18. This suggests that partnership interests could be like-kind property. *See also* Comment, *supra* note 8, at 177-78.

19. 63-2 U.S. Tax Cas. ¶ 9606 (S.D. Ind. June 14, 1963).

20. *Id.* at 89,453.

21. *Id.*

22. *Id.* at 89,452.

23. The *Miller* case has been criticized for its failure to consider the underlying partnership assets. One commentator noted that the court permitted the completely tax-free exchange of the partnership interests even though the underlying assets contained some boot property. *See* Huskins, *Section 1031 Like-Kind Property Exchanges: Possibilities and Pitfalls*, 30 S. CAL. TAX. INST. 459, 500 (1978).

24. 58 T.C. 311 (1972), *nonacq.*, 1975-1 C.B. 3, *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

twenty percent general partner interest in the limited partnership. Both partnerships involved in the transaction owned and operated rental apartments. The Commissioner insisted that both exchanges were ineligible for nonrecognition treatment because the partnership interests were choses in action, a type of property specifically excluded from section 1031(a) by the parenthetical clause.[25] The Tax Court, focusing broadly on the legislative history of the section, rejected the Commissioner's argument and concluded that Congress only intended to eliminate "investment securities or similar intangibles" from the nonrecognition provision by its 1923 amendment expanding the parenthetical clause.[26] The court thus determined that a partnership interest is not included within the scope of the parenthetical clause of section 1031(a) as a chose in action or under any of the other parenthetical terms.[27]

The Commissioner was successful, however, in his argument that Meyer, Sr.'s exchange of a general partnership interest for a limited partnership interest was not an exchange of like-kind property.[28] The court noted several differences in the undertakings of a general and a limited partner and concluded that the variations were "substantial enough to warrant invocation of the principle calling for strict construction of the exceptions to the rule that where gain is involved it will be recognized and taxed when it is realized."[29] The court also held that Meyer, Jr.'s exchange of one general partnership interest for another was a like-kind exchange,

25. 58 T.C. at 313. The Commissioner relied on two cases, Blodgett v. Silberman, 277 U.S. 1 (1928), and McClennen v. Commissioner, 131 F.2d 165 (1st Cir. 1942), claiming that these decisions classified a partnership interest as a chose in action. The Tax Court, however, pointed out that these cases merely characterized the rights of a deceased partner's personal representative to an accounting and cash liquidation as a chose in action. Nevertheless, some cases appear to classify a partnership interest as a chose in action. *See* Commissioner v. Smith, 173 F.2d 470 (5th Cir.), *cert. denied*, 338 U.S. 818 (1949) (sale of a partnership interest described as a sale of an intangible asset or chose in action); Humphrey v. Commissioner, 32 B.T.A. 280, 283 (1935). One commentator has also acknowledged that a general partnership interest may be a chose in action. 1 A. WILLIS, PARTNERSHIP TAXATION § 26.07, at 339 (2d ed. 1976).

26. 58 T.C. at 313. The court reasoned: "We are not dealing with trading in investment securities or similar intangibles. The transactions . . . were exchanges of proprietary (partnership) interests in one small business solely for proprietary (partnership) interests in a second small business . . . ." *Id.*; *see* notes 11-15 *supra* and accompanying text.

27. The court stated: "In our view, however, the clause excluding exchanges of stock, bonds, etc., is not called into play by the facts of this case . . . ." 58 T.C. at 313. *See also* 2 W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 15.04[2], at 15-29 (1977); Boyd & Heller, *supra* note 17, at 89-95.

28. 58 T.C. at 314. The holding that limited and general partnership interests are not like-kind property rejects the rationale of recent cases suggesting that any exchange of personalty for personalty is a like-kind exchange. *See* note 18 *supra*.

29. 58 T.C. at 314. Since § 1031(a) is an exception to the general rule requiring tax recognition of gain or loss realized on an exchange of property, it must be strictly construed. *See* Black v. Commissioner, 35 T.C. 90, 94 (1960); Midfield Oil Co. v. Commissioner, 39 B.T.A. 1154, 1157 (1939), *acq.*, 1939-2 C.B. 25; Treas. Reg. § 1.1002-1 (1960). The court noted that limited partner interests and general partner interests differ in the personal liability of the partner, priority in liquidation, and dissolution upon the death of a partner. 58 T.C. at 314. The Tax Court's holding that limited and general partnership interests are not like-kind property was the only issue appealed to the Ninth Circuit. The Ninth Circuit affirmed per curiam. Estate of Meyer v. Commissioner, 503 F.2d 556 (9th Cir. 1974). Compare this holding with I.R.C. § 1036.

citing *Miller* with approval.[30]

The Tax Court's approval of *Miller* indicates that the nature of the underlying partnership assets was not a factor in the decision and that the court viewed the transaction solely at the partnership interest level. The court's examination of the different characteristics of a general and limited partnership also suggests that the like-kind determination was made at the partnership interest level.[31] In the last paragraph of its opinion, however, the court limited its holding to a "situation where both partnerships owned the same type of underlying assets—in this case, rental real estate."[32] Thus, it appears that the nature of the underlying partnership assets was at least a consideration in the court's decision.[33] It remained an open question, however, as to what extent the court in the future would look beyond the partnership interest level to the underlying assets.[34]

The Internal Revenue Service has declared its nonacquiescence to the *Meyer* decision, maintaining its opposition to the tax-free exchange of general partnership interests.[35] In 1978 the Service issued Revenue Ruling 78-135[36] expressing its present position on the subject.[37] Instead of classifying a general partnership interest as a chose in action as was done in *Meyer*, the Service now asserts that a partnership interest is incorporated into the parenthetical language as an "evidence of. . . . interest."[38] As further support for its position, the Service states that section 741[39] requires,

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30. 58 T.C. at 314. This point was not contested by the Commissioner.
31. *See* Boyd & Heller, *supra* note 17, at 96 & 97.
32. 58 T.C. at 314. Judge Dawson, dissenting, argued that since the underlying assets of the partnerships were of "crucial importance" to the majority in determining whether the general partnership interests were of like kind, the exchange of Meyer, Sr. should also have been found to be a like-kind exchange. To be consistent, the examination of the Meyer, Sr. exchange also should have focused on the underlying partnership assets and not the difference in the nature of the partnership interests exchanged. Because the underlying assets were the same, the exchange of a limited partnership interest for general partnership interest should also be found to be a like-kind exchange. Judge Dawson rejected this approach, however, and viewed the exchange of a general partnership interest for a limited partnership interest as an exchange of like-kind property of different "quality, grade, or value." *Id.* at 315-16.
33. Three commentators have stated that the caveat suggests that the like-kind test must be satisfied at both the partnership interest and partnership asset levels. 2 W. McKEE, W. NELSON & R. WHITMIRE, *supra* note 27, ¶ 15.04[3][a].
34. For a discussion of the implications of the *Meyer* and *Miller* decisions with regard to I.R.C. § 741 and partnership liabilities, see Comment, *supra* note 8, at 178-82.
35. 1975-1 C.B. 3.
36. 1978-1 C.B. 256.
37. Revenue Ruling 78-135 has been criticized by many commentators who agree that the Service has no support for the ruling's arguments and that it ignores the holdings in both *Meyer* and *Miller*. *See* 1 A. WILLIS, *supra* note 25, § 26.07 (Supp. 1979); Boyd & Heller, *supra* note 17, at 93; Burton & Pennell, *Shop Talk*, 49 J. TAX. 63 (1978).
38. 1978-1 C.B. at 257. The ruling states:

> The language in the parenthetical clause of section 1031(a) of the Code in part encompasses all types of equity interests in financial enterprises other than by direct ownership of the underlying property. Because a partnership interest represents such an equity interest, it comes within the ambit of the parenthetical clause of section 1031(a).

39. I.R.C. § 741 provides:

> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be consid-

without exception to section 1031(a), the recognition of gain or loss on an exchange of partnership interests.[40]

II. GULFSTREAM LAND & DEVELOPMENT CORP. V. COMMISSIONER

In *Gulfstream* a subsidiary of the taxpayer exchanged its joint venture interest in a real estate development for an interest in a similar joint venture owned by an unrelated corporation. Both joint ventures were operated as general partnerships and owned the same type of underlying assets. The Tax Court was presented with the issue of whether an exchange of general partnership interests qualifies for nonrecognition treatment pursuant to section 1031(a).

The taxpayer, citing *Estate of Meyer v. Commissioner*,[41] argued that the transaction qualified for nonrecognition treatment. The Commissioner countered with three arguments claiming that the transaction was a taxable event. The first two arguments reiterated the Service's position in Revenue Ruling 78-135.[42] The Commissioner first contended that general partnership interests are a type of equity interest described in the parenthetical clause of section 1031(a). The Commissioner also argued that section 741 overrides section 1031 and thus requires gain to be recognized upon the sale or exchange of any partnership interest. In addition, the Commissioner insisted that this transaction was a constructive exchange of stock in trade.

Emphasizing its opinion in *Meyer*, the Tax Court rejected the Commissioner's argument that the scope of the parenthetical clause includes a general partnership interest.[43] The court stated that its "opinion in *Meyer* [was] not based solely on a rejection of [the Commissioner's] chose in action argument, but rather [was] founded on a broad analysis of the legislative history of section 1031(a)."[44] Thus, the court declined to hold that general partnership interests are "evidences of interest" as that language is used in the parenthetical clause of section 1031(a).[45] The court did not reach the Commissioner's argument that section 741 requires, without exception to section 1031(a), that gain be recognized upon the sale or ex-

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ered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

40. The Commissioner argues that the word "shall" in the first sentence of § 741 requires the recognition of gain to the transferor. The Commissioner bases this interpretation on the holding of the Tax Court in Pollack v. Commissioner, 69 T.C. 142 (1977). In *Pollack* the Tax Court held that the word "shall" in the second sentence of § 741 required mandatory capital asset treatment. By analogy the Commissioner argued that the word "shall" in the first sentence should be interpreted to require mandatory tax recognition. *See* Memorandum in Opposition to Petitioners' Motion for Partial Summary Judgment at 13-15, Gulfstream Land & Dev. Corp. v. Commissioner, 71 T.C. 587 (1979).

41. 58 T.C. 311 (1976), *nonacq.*, 1975-1 C.B. 3, *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

42. 1978-1 C.B. 256; *see* text accompanying notes 38-40 *supra*.

43. 71 T.C. at 593.

44. *Id.; see* notes 11-15 *supra* and accompanying text.

45. 71 T.C. at 594.

change of a partnership interest. Since the court had already decided that an exchange of partnership interests qualifies for section 1031(a), presumably it found no need to discuss the issue.[46]

Because the *Gulfstream* litigation began before Revenue Ruling 78-135 was issued,[47] the ruling itself was not subject to the Tax Court's scrutiny. The court in *Gulfstream*, however, rejected the substance of that ruling's interpretation of the parenthetical clause. To the extent the Service maintains the position that an exchange of partnership interests does not qualify for nonrecognition treatment, it can no longer justifiably base its position on an interpretation of the parenthetical clause. Revenue Ruling 78-135 should be withdrawn by the Internal Revenue Service because its interpretations of section 1031(a) have been rejected for a second time by the Tax Court.

After holding that a general partnership interest is not described by the parenthetical clause, the Tax Court tested the transaction under the general requirements of section 1031(a).[48] The court noted that the joint venture interests exchanged were like-kind property[49] and were held for productive use in trade or business. The court then stated that the language of section 1031(a) focuses only on the property actually exchanged.[50] In *Gulfstream*, as in *Meyer*, partnership interests were exchanged, and not the underlying partnership assets. Thus, at the partnership interest level, the court found that the transaction met all the requirements of section 1031(a).[51]

The Commissioner, however, urged the court to look behind the partnership interests exchanged to the underlying partnership assets.[52] He argued that the transaction was a constructive exchange of stock in trade held primarily for sale. The court, persuaded by this argument, noted that the legislative history of section 1031(a) indicates a clear congressional pol-

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46. This argument appears to be a tenuous one, nevertheless. One commentator calls the argument "patently incorrect." 1 A. WILLIS, *supra* note 25, § 26.07 (Supp. 1979). Another asserts that "the analysis is 'pure invention.' " Burton & Pennell, *supra* note 37, at 64.

The legislative history behind § 741 reveals no suggestion that Congress considered the section as a mandatory recognition provision. *See* H.R. REP. NO. 1337, 83d Cong., 2d Sess. 70, 71 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 96 (1954). Furthermore, there are other nonrecognition provisions in the Internal Revenue Code that apply to the exchange of partnership interests. The regulations specifically acknowledge that § 351 will allow the tax-free transfer of a partnership interest to a corporation for shares in the corporation. Treas. Reg. § 1.741-1(c) (1957). Therefore, § 741 does not appear to be a mandatory recognition provision.

47. Taxpayer's petition for relief was filed in the Tax Court on Jan. 14, 1977. Revenue Ruling 78-135 was not issued until Apr. 10, 1978.

48. 71 T.C. at 594; *see* note 5 *supra*.

49. 71 T.C. at 594. It was unchallenged in *Gulfstream*, as in *Meyer*, that an exchange of one general partnership interest for another is an exchange of like-kind property. *See* note 30 *supra* and accompanying text. It appears that the Tax Court agrees that the like-kind test is to be applied at the partnership interest level for purposes of § 1031(a).

50. 71 T.C. at 595.

51. *Id.* at 594.

52. *Id. See generally* Andelman, *Reorganizations of Partnerships*, 35 N.Y.U. INST. FED. TAX. 151, 154 (1977); Blankenship, *After the Meyer Case: An Analysis of Tax-Free Partnership Exchanges*, 38 J. TAX. 278, 279 (1973).

icy to prohibit the tax-free exchange of inventory-type assets.[53] In order to justify an examination of the underlying partnership assets, the court stated that the caveat in *Meyer* indicates that it will carefully analyze any partnership interests exchanged to determine if section 1031(a) should apply and to ensure that the provision is not abused.[54] The court further stated that the language in the *Meyer* caveat "referring to scrutiny of the underlying assets of the partnerships is directed to the detection of such abuse."[55] The court recognized, however, that scrutiny of the underlying partnership assets would be in conflict with its reading of section 1031(a) as requiring that the transaction meet the section 1031(a) tests solely at the partnership interest level.[56]

In resolving this dilemma the court invoked the judicial doctrine of "substance over form,"[57] reasoning that the substance of this transaction may be an exchange of assets that Congress had declared ineligible for nonrecognition treatment even though the form of the transaction satisfies the requirements of section 1031(a).[58] The court also stated that its scrutiny of the underlying assets in *Meyer* was an application of the substance over form doctrine, although in *Meyer* the court found that the form of the transaction accurately reflected its substance.[59] Since the extent that the underlying partnership assets in *Gulfstream* constituted stock in trade was still an issue of fact, the court denied petitioner's motion for partial summary judgment.[60]

The Tax Court's holding in *Gulfstream* further clouds the issue, left unanswered in *Meyer*, of under what circumstances the court will scrutinize the exchange of partnership interests at the partnership asset level rather than at the partnership interest level. It now appears, however, that to some extent the partnership exchange transaction may be analyzed at either level, depending on the result the court is attempting to reach. If the court desires to prevent the exchange of a limited partnership interest for a general partnership interest, as in *Meyer*, it will examine the transaction on the partnership interest level. If, however, the court's goal is to prevent the

53. 71 T.C. at 594; *see* S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921); note 11 *supra* and accompanying text.

54. 71 T.C. at 595; *see* text accompanying note 32 *supra*.

55. 71 T.C. at 594.

56. *Id.* at 595.

57. The court stated that "the form of a transaction will not be given effect for tax purposes if the substance of the transaction would yield a contrary tax result." *Id.* at 595; *see* Gregory v. Helvering, 293 U.S. 465 (1935); Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976) (substance over form doctrine applied in the context of a tax-free exchange); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968) (substance over form doctrine applied to a like-kind exchange). *See generally* 3 J. MERTENS, *supra* note 8, § 20.16.

58. The court noted that "even though the form of the exchange here fills the requirements of section 1031(a), we . . . must look at the underlying assets . . . to decide whether the form of the transaction accurately reflects its substance." 71 T.C. at 595.

59. *Id.*

60. Upon a motion for partial summary judgment, "[t]he existence of any reasonable doubt as to the facts at issue must result in denial of the motion." Hoeme v. Commissioner, 63 T.C. 18, 20 (1974); *see* TAX CT. R. PRAC. & PROC. 121.

tax-free exchange of the underlying partnership assets for any purpose it deems appropriate, the court will not hesitate to scrutinize the partnership assets and conclude that the substance of the transaction does not accurately reflect its form.

Application of these two rationales on a mutually exclusive basis will produce results inconsistent with the decided cases. For example, as Judge Dawson correctly pointed out in his dissent in *Meyer*, the majority in that case did not use a substance over form analysis.[61] The substance of Meyer, Sr.'s exchange of a general for a limited partnership interest was clearly an exchange of like-kind property at the partnership asset level.[62] Yet the majority in *Meyer* analyzed that transaction at the partnership interest level and found that the exchange of a general for a limited partnership interest was not an exchange of like-kind property.[63] Conversely, the Tax Court in *Gulfstream* found that the exchange of one general partnership interest for another met all the requirements of the statute at the partnership interest level,[64] but upon application of the substance over form doctrine the transaction failed at the partnership asset level.[65]

The Tax Court's analysis in *Gulfstream* of the transaction at both the partnership interest and asset levels still produces inadequate results. The congressional policy of gain recognition on the exchange of certain assets cannot be fully complied with by the court's use of the substance over form doctrine to analyze the transaction at the partnership asset level. The doctrine will continue to permit the tax-free treatment of many exchanges on which some gain would be recognized under section 1031 if the underlying partnership assets themselves had been exchanged. For example, in *Gulfstream* the facts presented to the court indicate one of the joint ventures involved in the exchange held installment notes receivable from the sales of improved lots and homes.[66] A reading of the *Gulfstream* and *Meyer* opinions suggests that if the court later found the real estate held by the joint ventures exchanged in *Gulfstream* not to be stock in trade, the partnership exchange transaction would be permitted totally tax-free.[67] The substance of such a transaction presumably would be considered as the exchange of property qualifying for section 1031(a). If, however, the joint venture assets themselves had been exchanged, the installment notes re-

61. 58 T.C. at 315.

62. *See* note 32 *supra*.

63. *See* notes 28, 29 & 31 *supra* and accompanying text.

64. *See* notes 48-51 *supra* and accompanying text.

65. *See* notes 57-58 *supra* and accompanying text.

66. 71 T.C. at 590, 591 n.5.

67. The facts in the *Meyer* opinion indicate that the underlying assets of each partnership interest exchanged were encumbered by mortgage. 58 T.C. at 312. Consideration received for the assumption of liabilities by a transferee or the transfer on property subject to liabilities is treated as boot property requiring the recognition of gain when property otherwise qualifying for nonrecognition under § 1031(a) is exchanged. I.R.C. § 1031(b); Treas. Reg. § 1.1031(b)-1(c), T.D. 6935, 1967-2 C.B. 272, 276. The court, however, permitted the completely tax-free exchange of Meyer, Jr.'s general partnership interest for another general partnership interest, finding that the substance of the transaction accurately reflected its form. 71 T.C. at 595.

ceivable would trigger the recognition of gain on the transaction.[68] This shielding of gain recognition is exactly the abuse the court attempted to prevent in *Gulfstream*. It is inappropriate to permit on one hand a completely tax-free exchange of general partnership interests if the underlying partnership assets include any amount of cash, nonqualifying, or non-like-kind property as long as the assets are not predominately stock in trade and, on the other hand, to refuse to permit a tax-free exchange of general partnership interests if the underlying assets happen to be predominately stock in trade.

The Tax Court in *Gulfstream* also failed to indicate what amount of inventory or other nonqualifying property would be permitted in the underlying partnership assets before the court would find that the substance of the transaction did not accurately reflect its form. It is clear from the *Meyer* opinion, however, that the court will allow the underlying partnership assets to contain some nonqualifying property and still permit the transaction to be eligible for nonrecognition treatment.[69] Only by the use of the vague judicial doctrine of substance over form can the court distinguish cases in which the amount of nonqualified property in the underlying partnership assets is sufficient to deny section 1031(a) treatment to an exchange of general partnership interest. This approach creates uncertainty and prevents taxpayers from structuring a transaction for which they can be assured nonrecognition treatment.

The Tax Court could restore consistency while preventing the abuses of section 1031(a) it sought to curtail in *Gulfstream* by expanding upon its rationale in *Gulfstream* and adopting an aggregate theory of partnership when analyzing an exchange of partnership interests.[70] The aggregate theory treates the exchange of partnership interests as if the underlying assets themselves are exchanged. Application of this concept requires the complete fragmentation of each partnership interest exchanged where multiple underlying assets and liabilities are involved. The tests of section 1031(a) would then be applied to each underlying partnership asset. Although this approach focuses on the partnership asset level only and therefore would permit an exchange of limited for general partnership interests, the trans-

68. Notes receivable are a type of nonqualifying property interest described by the parenthetical clause of I.R.C. § 1031(a). *See* note 2 *supra*. Section 1031(b) requires the recognition of gain realized to the extent of any money or nonqualifying property received in an exchange otherwise qualifying for § 1031(a).

69. *See* note 67 *supra*.

70. The aggregate theory of partnership taxation treats each partner as owning a direct interest in each partnership asset and taxes him directly on his share of partnership income. Under the entity theory the partnership is considered to be a separate entity from the partners. The partnership itself owns property and transacts business. Subchapter K of the Internal Revenue Code (partnership taxation rules) applies the aggregate theory for some purposes and the entity theory for other purposes. The United States Supreme Court has stated: "The 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." United States v. Basye, 410 U.S. 441, 448 n.8 (1973). *See generally* 1 W. McKEE, W. NELSON & R. WHITMIRE, *supra* note 27, ¶ 1.02; 1 A. WILLIS, *supra* note 25, §§ 2.01-04.