1 T.C. 760 (1943)

When a contingent fee is received after a partnership dissolves, and there's a dispute over the division of the fee with the deceased partner's estate, a subsequent agreement between the parties can retroactively determine the taxable income for the year the fee was received.

Summary

H. Lewis Brown, a surviving partner, received a contingent legal fee in 1937 for services rendered partly by his former partnership (dissolved in 1929) and partly by himself. A dispute arose with the deceased partner's estate over the fee's division. Brown initially paid a portion to the estate but the executor later claimed a larger share. In 1938, Brown and the estate reached a final agreement on the division. The Tax Court addressed how this subsequent agreement affected Brown's 1937 income tax liability, holding that the 1938 agreement should be given retroactive effect in determining Brown's 1937 tax liability. The court also held that a portion of the payment to the estate represented a capital expenditure for the deceased partner's goodwill, taxable as income to Brown.

Facts

- Brown and Burroughs were law partners under the name Burroughs & Brown.
- The partnership agreement stipulated that upon a partner's death, the partnership would continue for six months, with the deceased partner's estate sharing in income and expenses.
- The agreement was later amended to specify how fees for work in progress at dissolution would be divided, allocating a portion to the firm for services rendered during its existence and the remainder to the partner(s) completing the work.
- The firm represented a client in a patent infringement suit and entered into a contingent fee agreement in 1929.
- Burroughs died in June 1929. Brown continued the practice under the same firm name.
- In 1937, a settlement was reached in the patent case, resulting in a fee of $228,068.44 payable to Burroughs & Brown.
- A dispute arose between Brown and Burroughs' estate regarding the estate's share of the fee.

Procedural History

- The IRS determined a deficiency against Brown for 1937, arguing that nearly the entire fee constituted income to him.
- Brown contested this, claiming he overreported his income and was entitled to a refund.
- The Tax Court heard the case to determine the amount of the fee taxable to

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Brown in 1937.

Issue(s)

1. Whether the agreement reached in 1938 regarding the division of the legal fee between Brown and the Burroughs estate should be given retroactive effect in determining Brown's 1937 income tax liability.
2. How much of the payment to the Burroughs estate is taxable income to Brown in 1937.

Holding

1. Yes, because the court relied on precedent (*Lillie C. Pomeroy et al., Executors, 24 B.T.A. 488*) allowing for retroactive application of such agreements to accurately reflect income for the prior year.
2. A portion of the payment to the estate representing a capital expenditure for the good will of the deceased partner in the practice, is income to the petitioner.

Court's Reasoning

The Tax Court reasoned that while income is generally determined at the close of the taxable year, exceptions exist. The court found the *Pomeroy* case persuasive, where a subsequent agreement was retroactively applied to determine income for prior years. The court emphasized that it now had definitive information on the fee division, making a theoretical allocation unnecessary. Because the agreement fixed the estate's share at $14,995.50, Brown's 1937 income should reflect this amount. The court rejected Brown's argument that he should only be taxed on half the fee in 1937, distinguishing it from cases where funds were held in true escrow and not freely available. Citing *City Bank Farmers Trust Co., Executor, 29 B.T.A. 190*, the court determined that the portion paid to Burroughs estate for the 6-month period after Burroughs' death, represented a capital expenditure by Brown for Burroughs' interest in the partnership and was therefore income to Brown. The court allocated the payment to the Burroughs estate between the period before and after Burrough's death.

Practical Implications

- This case demonstrates that agreements made after the close of a taxable year can, in some circumstances, retroactively determine income tax liability, particularly when resolving disputes over contingent fees or partnership income.
- Taxpayers and their advisors should consider the potential for retroactive adjustments when dealing with uncertain income streams or disputed liabilities.
- The ruling clarifies that payments for a deceased partner's goodwill, even

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when part of a larger settlement, may be considered taxable income to the surviving partner.
- Legal professionals dealing with partnership dissolutions and contingent fees must carefully document all agreements and allocations to support their tax positions.
- Later cases will need to distinguish situations where funds are genuinely held in trust versus cases where the taxpayer has effective control over the funds, as in Brown’s case.

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