5 T.C. 1112 (1945)

When a will directs a partnership to pay a portion of its net income to the testator's widow as a bequest, and the bequest is directly tied to the income from the testator's share of the business, those payments are income to the widow and not to the surviving partners.

Summary

The Malloy case addresses whether payments made to a widow from a partnership's net income, as directed by her deceased husband's will, should be included in the taxable income of the surviving partners. The Tax Court held that because the bequest to the widow was specifically tied to the income generated from the deceased partner's share of the business, these payments constituted income to the widow, not the surviving partners. This decision hinged on the fact that the surviving partner acquired the business interest through bequest, not purchase, and the payments to the widow were a charge against the business's income, not a personal obligation of the partners.

Facts

Frank P. Malloy's will bequeathed $250 per month to his wife, Catherine, to be paid from one-half of the net earnings of his partnership. If one-half of the net earnings was less than $250, she was to receive only that amount, with any shortfall being cumulative and paid later. Catherine elected to take under the will, foregoing any claim under community property laws. The will bequeathed the remaining portion of Frank's partnership interest to his son, Frank E. Malloy. The partnership subsequently made payments to Catherine under the will's terms.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against the surviving partners, arguing that the payments to Catherine Malloy were not deductible business expenses. The partners petitioned the Tax Court for a redetermination, arguing that the payments were income to the widow, not to them.

Issue(s)

Whether payments made to the testator's widow from the partnership's net income, as specified in the testator's will, constitute taxable income to the surviving partners.

Holding

No, because the bequest to the widow was directly dependent on the income generated from the deceased partner's share of the business; therefore, the payments were income to the widow and not to the surviving partners.

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Court’s Reasoning

The court distinguished this case from those where surviving partners purchase a deceased partner’s interest and make payments to the widow as part of the acquisition. In those cases, the payments are considered capital expenditures. Here, Frank E. Malloy inherited his father’s interest, taking only what the will provided. The court emphasized that the payments to Catherine were not personal obligations of the surviving partners but were a charge against the business’s income. The court reasoned that the testator, in effect, gave his wife a portion of the income from his share of the business. The court stated, “In substance, the bequest was a portion of the net income from that particular property, which, in equity, would ordinarily be treated as giving her an interest — a sort of life estate — in the property itself.” Therefore, the payments were deemed income to the widow, aligning with the principle established in *Irwin v. Gavit*, 268 U.S. 161 (1925), where income from property bequeathed to a beneficiary was taxable to the beneficiary, not the estate.

Practical Implications

This case provides guidance on the tax treatment of payments made to beneficiaries under the terms of a will when those payments are directly linked to business income. It clarifies that bequests tied to specific income streams are generally taxable to the beneficiary receiving the income, not to the entity generating it. The case highlights the importance of distinguishing between payments made as part of a purchase agreement (capital expenditures) and those made as distributions of income pursuant to a testamentary bequest. In structuring estate plans and partnership agreements, careful consideration must be given to how income is distributed to beneficiaries to ensure appropriate tax treatment. Later cases distinguish *Malloy* based on the specificity of the income source and the nature of the obligation to make the payments. If the payment is a general obligation not tied to a specific income stream, it is more likely to be considered a capital expenditure or a personal obligation of the partners.

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