7 T.C. 1481 (1946)

When a partnership dissolves and terminates, the period from the beginning of its fiscal year until the date of termination constitutes a taxable year, and the partners' distributive shares of income earned during that period are taxable in their respective tax years during which the partnership's short taxable year ends.

Summary

The Tax Court addressed whether partnership income earned between the beginning of the partnership's fiscal year and its dissolution date should be included in the partners' income for the year of dissolution or deferred to the following year. The husband, a partner in a partnership with a fiscal year ending March 31, dissolved the partnership on May 31, 1941. The court held that the period from April 1 to May 31, 1941, constituted a taxable year for the partnership, and the husband's distributive share was includible in the 1941 income of both the husband and wife, who filed separate returns on a community property basis.

Facts

Michael S. Jacobs was a partner in Arco Food Center, which operated on a fiscal year ending March 31. The partnership dissolved on May 31, 1941. The income earned by the partnership from April 1 to May 31, 1941, was $6,182.36. Michael and his wife, Anne, filed separate tax returns for the calendar year 1941 on a community property basis. They initially reported their share of the partnership income for the fiscal year ending March 31, 1941, in their 1941 returns and the income from April 1 to May 31, 1941, in their 1942 returns.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in the Jacobs' income tax for 1941, including one-half of the partnership income from April 1 to May 31, 1941, in each spouse's 1941 taxable income. The Jacobs petitioned the Tax Court, arguing that this income was taxable in 1942.

Issue(s)

Whether the period from April 1 to May 31, 1941, constituted a taxable year for the Arco Food Center partnership, requiring the inclusion of the partnership income earned during that period in the Jacobs' 1941 taxable income.

Holding

Yes, because the partnership was completely terminated on May 31, 1941; thus, the period from April 1 to May 31, 1941, is a taxable year. The right to the husband's distributive share of the partnership net income accrued to him on May 31, 1941, making one-half of such share includible in the 1941 income of each taxpayer.

Court’s Reasoning

The court distinguished the cases cited by the petitioners, noting that in those cases, the partnerships, although dissolved, were not terminated; the business had to be wound up by the surviving partners. Here, the partnership was both dissolved and liquidated on May 31, 1941. The court relied on *Guaranty Trust Co. of New York v. Commissioner, 303 U.S. 493*, stating that “receipt of income or the accrual of the right to receive it within the tax year is the test of taxability.” The court noted that the right to receive the income accrued to Michael S. Jacobs on or about May 31, 1941. Furthermore, the court cited Section 48(a) of the Internal Revenue Code, which defines “taxable year” to include a fractional part of a year for which a return is made. The court reasoned that the dissolution and termination of the partnership within its accounting period was “an unusual instance requiring the computation of net income for the period beginning April 1 and ending May 31, 1941.” Therefore, this fractional period is a taxable year, and under Section 188 of the Internal Revenue Code, the distributive share accruing to Michael S. Jacobs on May 31, 1941, is includible in the 1941 income of the petitioners.

Practical Implications

This case clarifies the tax implications when a partnership dissolves mid-fiscal year. It establishes that the period between the start of the fiscal year and the date of dissolution is considered a separate taxable year. This means partners must include their share of the partnership income earned during that period in their individual income for the tax year in which the partnership dissolved, preventing the deferral of income to a later tax year. Attorneys advising partnerships need to make partners aware of this rule when planning a partnership dissolution, as it can significantly impact the timing of income recognition and tax liabilities. Later cases have cited this ruling to support the proposition that a short period return is required when a corporation or partnership terminates its existence before the end of its normal accounting period.

