8 T.C. 1327 (1947)

A partner's distributive share of partnership income is taxable as ordinary income in the partner's taxable year when the partnership terminates due to the partner's withdrawal and sale of their interest, even if the partnership's fiscal year has not yet ended.

Summary

Louis Karsch sold his partnership interest in Crown Thread Co. in July 1943. The central issue was whether Karsch's share of the partnership income from February 1 to July 31, 1943, should be treated as ordinary income or as a capital gain from the sale of his partnership interest. The Tax Court held that Karsch's distributive share of partnership income up to his withdrawal was taxable as ordinary income in 1943, the year the partnership effectively terminated for him, regardless of the partnership's fiscal year.

Facts

Louis Karsch was a partner in Crown Thread Co. The partnership agreement was set to expire but continued as a partnership at will. Karsch sold his one-third interest in the partnership in July 1943. The sale agreement stipulated payment based on the partnership's net worth as of July 31, 1943. Karsch received $101,340.60 for his interest. The partnership's books were not closed until January 31, 1944, the end of their fiscal year, but Karsch's interest was terminated in August 1943. Karsch did not report any distributive share of partnership income on his 1943 or 1944 tax returns, treating the entire amount as a long-term capital gain.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Karsch's 1943 income tax, treating a portion of the proceeds from the sale of Karsch's partnership interest as his distributive share of ordinary income, not capital gains. Karsch petitioned the Tax Court for a redetermination. Karsch conceded certain adjustments made by the Commissioner, but disputed the ordinary income treatment of his share of the partnership's earnings.

Issue(s)

Whether a partner's distributive share of partnership income earned up to the date of their withdrawal and sale of their partnership interest is taxable as ordinary income in the partner's taxable year, even if the partnership's fiscal year would not otherwise have terminated until the following calendar year.

Holding

Yes, because the partnership was dissolved and liquidated as of the date of Karsch's

© 2025 SCOTUSreports.com. All rights reserved.

withdrawal; therefore, Karsch's share of the income earned by the partnership up to that point was taxable to him as ordinary income in the year of the withdrawal.

Court's Reasoning

The court reasoned that under Section 182 of the Internal Revenue Code, a partner must include their distributive share of the partnership's ordinary net income, whether or not it's distributed. The sale of a partnership interest does not convert a partner's distributive share in past earnings into a capital item. Citing *Helvering v. Smith*, the court stated that purchasing future income does not transform it into capital. The court also noted that assigning income already earned does not relieve the assignor of tax liability, citing *Helvering v. Eubank*. The court distinguished this case from situations where the partnership continues after dissolution for liquidation purposes or due to the death/resignation of a partner, referencing *Mary D. Walsh*. Here, the old partnership was dissolved and terminated. The court found a close analogy in *Guaranty Trust Co. v. Commissioner*, where a partner's death dissolved the partnership, and the partner's earnings were taxable in the year of death. The court concluded that the amount of partnership profits and Karsch's one-third share were correctly determined by the Commissioner, based on figures provided by Karsch's own accountant.

Practical Implications

This case clarifies that a partner cannot avoid ordinary income tax on their distributive share of partnership income by selling their partnership interest. It reinforces the principle that income is taxed when earned, even if not formally distributed. Legal professionals should advise partners that upon withdrawal from a partnership, their share of the partnership's income up to the point of withdrawal will be treated as ordinary income, taxable in the year of withdrawal. This ruling impacts tax planning for partners considering withdrawing from a partnership and selling their interests. It also emphasizes the importance of properly accounting for the partnership's income and the withdrawing partner's share at the time of withdrawal. This case has been cited to support the principle that the taxable year of a partnership can end prematurely for a partner who leaves the partnership, even if the partnership continues for the remaining partners.

© 2025 SCOTUSreports.com. All rights reserved.