9 T.C. 720 (1947)

Payments to a retiring partner that represent a share of fees collected on work done during their time with the firm are taxed as ordinary income, not capital gains, even if structured as a sale of partnership interest.

Summary

James McAfee, a retiring partner from a law firm, received payments in 1944 pursuant to a dissolution agreement. The agreement stipulated he would receive his share of fees collected on cases he had worked on before leaving. The Tax Court addressed whether these payments constituted capital gains or ordinary income. The court held that the payments were ordinary income because they represented a distribution of profits earned through his prior services, not the sale of a capital asset or partnership interest. The agreement's form did not override its substance as a profit-sharing arrangement.

Facts

James McAfee was a partner in the law firm of Igoe, Carroll, Keefe & McAfee. In 1941, McAfee withdrew from the firm to become president of Union Electric Co., a client of the firm. A written agreement outlined the terms of his departure, stating that McAfee would receive a portion of fees collected after his departure for work completed before his exit. The agreement initially characterized the arrangement as a sale of McAfee's partnership interest for $20,000, subject to adjustments based on future collections. McAfee continued to receive payments under this agreement, including $1,647.67 in 1944.

Procedural History

McAfee reported the $1,647.67 received in 1944 as a capital gain. The Commissioner of Internal Revenue determined the amount was taxable as ordinary income, leading to a tax deficiency assessment. McAfee petitioned the Tax Court to contest the Commissioner's determination.

Issue(s)

Whether payments received by a retiring partner, representing a share of fees collected after their departure for work done while a partner, should be taxed as capital gains or as ordinary income.

Holding

No, because the payments represented a distribution of profits earned through past services, not the sale of a capital asset. The Tax Court determined the arrangement was effectively a profit-sharing agreement, regardless of its formal characterization as a sale.

© 2025 SCOTUSreports.com. All rights reserved.

Court’s Reasoning

The court emphasized the substance of the agreement over its form. Despite the initial language suggesting a sale of partnership interest, the court found that the payments were directly tied to fees generated from McAfee’s prior work with the firm. The court distinguished this situation from a true sale of a partnership interest, where the retiring partner relinquishes all rights to future earnings in exchange for a fixed sum. The court cited *Bull v. United States*, noting that payments representing a share of profits are considered income, not corpus. The court also noted the relatively small value of McAfee’s physical interest in the firm’s assets (approximately $438). The court concluded that the contingent nature of the payments, tied to the collection of fees, indicated a profit-sharing arrangement rather than a sale of goodwill or assets. Judge Learned Hand’s opinion in *Helvering v. Smith* was cited: “The transaction was not a sale because he got nothing which was not his, and gave up nothing which was. Except for the ‘purchase’ and release, all his collections would have been income; the remaining partners would merely have turned over to him his existing interest in earnings already made.”

Practical Implications

This case clarifies that the IRS and courts will look beyond the formal language of partnership agreements to determine the true nature of payments to retiring partners. Attorneys drafting partnership agreements should be aware that characterizing payments as a “sale” will not automatically result in capital gains treatment if the payments are essentially a distribution of future profits. The key factor is whether the payments represent compensation for past services or a genuine transfer of a capital asset, such as goodwill or tangible property. This case emphasizes the importance of clearly defining the assets being transferred and ensuring that the payments are not contingent on future earnings if capital gains treatment is desired. Later cases have cited *McAfee* to support the principle that substance prevails over form in tax law, particularly in the context of partnership dissolutions and retirement agreements.

© 2025 SCOTUSreports.com. All rights reserved.