T.C. Memo. 1951-175

A partner is taxed on their distributive share of partnership income, regardless of whether the income is actually distributed to them during the tax year.

Summary

Freese and Barber formed a partnership with a 50-50 profit-sharing agreement. Disputes arose, leading to a lawsuit and eventual settlement. Freese argued that because of the ongoing dispute, his distributive share of partnership income was indefinite until the settlement. The Tax Court held that Freese was taxable on his distributive share of the partnership's income for the years in question, irrespective of the dispute, because he had a right to that income based on the original partnership agreement. The settlement, including cash and distributed assets, represented a distribution of profits already earned.

Facts

In 1938, Freese and Barber entered a partnership agreement to share profits equally. Disputes arose regarding Barber's management fees and capital contributions. In 1943, Freese sued Barber, seeking his 50% share of partnership profits and an accounting. A settlement was reached in 1944 where Freese received cash and producing wells. Freese only reported the cash received as income and argued that the value of the wells was not taxable until dissolution.

Procedural History

The Commissioner determined deficiencies in Freese's income tax for 1942, 1943, and 1944, arguing he failed to report his full distributive share of partnership income. Freese petitioned the Tax Court for a redetermination. The Tax Court upheld the Commissioner's determination. Freese's argument, that the income was indefinite until the settlement, was rejected.

Issue(s)

1. Whether Freese's distributive share of partnership income was unascertainable due to an ongoing dispute with his partner, thus deferring tax liability until the settlement year.
2. Whether the distribution of producing wells as part of the settlement agreement should be included in Freese's taxable income for the years in question.

Holding

1. No, because Freese had a right to a 50% share of the partnership profits under the original agreement, regardless of the dispute. The settlement merely quantified and distributed that share.
2. Yes, because the distribution of wells represented a distribution of partnership

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profits earned during those years, and therefore constitutes taxable income.

Court’s Reasoning

The Tax Court relied on Section 182 of the Internal Revenue Code, which states that a partner must include their distributive share of partnership income in their individual income, whether or not it’s actually distributed. The court emphasized that the original partnership agreement entitled Freese to 50% of the profits. The court cited *First Mechanics Bank v. Commissioner*, 91 F.2d 275, to support the principle that the right to income, not its actual receipt, triggers tax liability. The court stated that Freese’s primary purpose in the lawsuit was to claim one-half of the profits of the venture between him and Barber. The court stated: “Here the primary purpose of petitioner’s lawsuit was to claim one-half of the profits of the venture between him and Barber. So far as the facts show the settlement determined that question.”

Practical Implications

This case reinforces the principle that partners are taxed on their distributive share of partnership income when it is earned by the partnership, irrespective of actual distribution or ongoing disputes. It clarifies that settlements resolving disputes over partnership profits are treated as distributions of those profits, triggering tax consequences. The case also serves as a reminder that non-cash distributions, like the producing wells in this case, are considered taxable income to the extent they represent a share of partnership profits. Attorneys should advise partners to accurately determine and report their distributive share each year, even if disputes exist, and to account for the fair market value of non-cash distributions when calculating taxable income.

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