McElhinney v. Commissioner, 17 T.C. 7 (1951)

The characterization of income from a partnership interest as separate or community property is determined by the domicile of the taxpayer, not the location of the partnership's business activities, except for income directly attributable to rents from real property owned by the partnership.

Summary

The Tax Court addressed whether income from a Texas partnership, where the taxpayer was domiciled in Virginia (a non-community property state), should be treated as separate or community income. The taxpayer argued that because the partnership operated in Texas, a community property state, all income should be characterized as community income. The court held that the taxpayer's domicile controlled, meaning the income was separate property, except for a small portion attributable to rents from real estate owned by the partnership, which was treated as community income due to the law of the situs of the land.

Facts

The taxpayer, McElhinney, was domiciled in Virginia during the tax years in question. He received income from a partnership organized and operating in Texas. His income derived solely from earnings on his capital investment in the partnership, which was his separate property. The partnership's income came from rice farming (on owned and rented land), an interest in Universal Motor Company, and an interest in Wilcox Grocery.

Procedural History

The Commissioner of Internal Revenue determined that the income from the partnership was the taxpayer's separate income and taxable to him alone. McElhinney challenged this determination in the Tax Court, arguing that the income should be treated as community income divisible between him and his wife.

Issue(s)

Whether the taxpayer's distributive share of income from the Texas partnership constitutes separate income, taxable solely to him because of his domicile in Virginia, or community income, divisible between him and his wife, due to the partnership's location and activities in Texas, a community property state.

Holding

No, because the taxpayer was domiciled in a non-community property state (Virginia), the income from the partnership is considered his separate property, except for the portion of income derived from rents on real estate owned by the partnership, which is considered community property because the law of the situs of

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the land controls the character of rental income.

Court’s Reasoning

The court distinguished between income derived from real property and other sources. Citing *W.D. Johnson, 1 T.C. 1041*, the court acknowledged that income from rents, issues, and profits from land is governed by the law of the situs, regardless of the taxpayer’s domicile. However, the majority of the partnership’s income did not derive from real property. For income from other sources (rice farming, grocery business, auto sales), the court applied the principle that the law of the taxpayer’s domicile controls the characterization of income. The court relied on *Estate of E.T. Noble, 1 T.C. 310, aff’d, 138 F.2d 444 (10th Cir. 1943)* and *Trapp v. United States, 177 F.2d 1 (10th Cir. 1949)*, where partnership income was taxed to the spouse who owned the separate partnership interest and was domiciled in a separate property state. The court stated, “Interests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicile of the parties when the movables are acquired.”, quoting from the Restatement (Conflict of Laws) § 290.

Practical Implications

This case clarifies that the location of a business enterprise does not automatically dictate the characterization of income for tax purposes. Attorneys must consider the taxpayer’s domicile when advising on the tax implications of partnership income. The decision reinforces the principle that domicile generally governs the characterization of income from intangible property like partnership interests. It provides a clear exception for income directly attributable to real property, which remains subject to the law of the situs. This ruling has been followed in subsequent cases involving similar issues and helps to determine the proper reporting of partnership income when partners reside in different states with varying community property laws.

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