21 T.C. 733 (1954)

A partner is taxed on their share of partnership income until the date their partnership interest is actually sold, even if the sale agreement relinquishes their right to some of that income.

Summary

In 1944, George Johnson and Leonard Japp were partners in Special Foods Company, sharing profits equally. Johnson and Japp decided to dissolve the partnership and Johnson agreed to sell his interest to Japp. The agreement, finalized on June 20, 1944, stated the partnership dissolved on May 20, 1944 and that Johnson would relinquish rights to all profits earned after that date. However, Johnson reported only the amount he withdrew from the partnership as income for the period January 1 to May 20, 1944. The Commissioner of Internal Revenue argued that Johnson was taxable on his full share of the partnership income up to the date of sale, which the court agreed with.

Facts

George F. Johnson and Leonard M. Japp formed Special Foods Company in 1938, with each owning a 50% interest. Profits and losses were shared equally. In 1944, they decided to dissolve the partnership and Johnson agreed to sell his interest to Japp. On May 20, 1944, they executed "Articles of Dissolution," and on June 20, 1944, they executed a sales contract, which included Johnson relinquishing any claims to profits earned after May 20, 1944. Johnson reported only the amount he withdrew from the partnership during the period from January 1, 1944, through May 20, 1944, as his share of the partnership income on his 1944 tax return. The Commissioner determined that Johnson should have included his full 50% share of the partnership income for the period up to the date of sale. The partnership's ordinary net income for the period January 1, 1944, through May 20, 1944, was $112,085.80.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to George F. Johnson, asserting that Johnson had underreported his income. Johnson disputed the deficiency in the U.S. Tax Court, arguing that he was only liable for income received, and that his share ceased on May 20, 1944. The Tax Court sided with the Commissioner.

Issue(s)

Whether the taxpayer, George F. Johnson, was required to include in his income his full distributive share of the partnership's earnings, as determined under the original partnership agreement, up to the date of sale of his partnership interest, or whether his income was limited to only the amount he withdrew from the partnership during the period in question.

Holding

Yes, because a partner's distributive share of partnership income is taxable to them until the date their partnership interest is actually sold, irrespective of any agreement that attempts to alter this after the fact.

Court's Reasoning

The court relied on established tax law, particularly the principle that a withdrawing partner is taxable on their share of partnership profits up to the time of their withdrawal, regardless of current distribution or sale of the partnership interest. The court found that there was no change in the profit-sharing agreement until the sale of the interest. The "Articles of Dissolution" and the sale contract executed June 20, 1944, were not relevant to income earned before that date. Therefore, Johnson was taxable on one-half of the partnership income from January 1, 1944, to the date of the sale.

The court referenced the cases of *LeSage v. Commissioner* and *Louis* as precedent. The court also noted that limiting withdrawals was not the same as changing the profit-sharing ratio. The court found that the agreement to sell his interest did not change his tax liability for the period prior to the sale, because the sales agreement and the relinquishing of right to profits was not effective until the actual sale date.

Practical Implications

This case underscores the importance of determining the exact date of the sale when calculating a partner's taxable income. The decision clarifies that the date of sale, and not the date of the dissolution agreement, determines the income allocation. Legal practitioners should be mindful of the timing of sales, dissolutions, and profit-sharing agreements in partnership arrangements to accurately advise clients on their tax obligations.

Attorneys should advise clients of the tax implications of withdrawing from a partnership and the importance of accurately reporting their share of income up to the date their interest is transferred. The court's emphasis on the date of sale has important implications for drafting partnership agreements, especially in terms of how income will be allocated upon a partner's departure.

This case also reinforces the IRS's position that the substance of the transaction, not the form, determines the tax consequences. While the agreement tried to assign profits differently, it was not effective for the period prior to the sale. This case is distinguishable from situations where partners are not selling their interests, but are merely agreeing to shift how income is allocated during the ongoing life of the partnership. The date of the sale is key.

