26 T.C. 485 (1956)

A payment made by a partner to acquire a co-partner's interest in a partnership is a capital expenditure, but may be amortized over the remaining life of the partnership agreement if the purchased interest has a limited lifespan.

Summary

Peter Risko, the petitioner, sought to deduct a payment made to his partner, Mary Backus, to buy out her interest in their employment agency partnership, Approved Personnel Service. The Commissioner of Internal Revenue disallowed the deduction, classifying it as a capital expenditure. The Tax Court agreed, holding that the payment was a capital expense, not a deductible business expense. However, the court allowed Risko to amortize the expense over the remaining term of the partnership agreement, because Backus's interest was limited to the agreement's lifespan. The court distinguished this situation from cases involving the purchase of a partnership interest of indefinite duration.

Facts

Peter Risko owned and operated an employment agency, Provident Employment Service. In 1947, he purchased another agency, Approved Personnel Service. He then formed a partnership with Mary Backus to run Approved Personnel Service. Under their agreement, Risko contributed the existing business, while Backus contributed $500. Profits and losses were split 60/40 in Risko's favor. The partnership was to last five years, automatically renewing annually absent termination. In 1950, Backus's husband started a competing agency, and she refused to leave. Risko offered Backus $7,500 to leave the partnership, which she accepted, dissolving the partnership and transferring all her interest. Risko sought to deduct the $7,500 payment, which the Commissioner disallowed.

Procedural History

The case originated in the U.S. Tax Court. The Commissioner of Internal Revenue determined a deficiency in the petitioners' 1950 income tax, disallowing the deduction of $8,543 (including the $7,500 payment). The Tax Court heard the case, and issued a ruling.

Issue(s)

Whether the payment made by Risko to Backus to acquire her interest in the partnership was a deductible expense or a capital expenditure?

Whether the payment, if a capital expenditure, could be amortized over the remaining life of the partnership agreement?

Holding

Yes, the payment was a capital expenditure because it was made to acquire Backus's partnership interest. However, Yes, the capital expenditure could be amortized over the remaining 20-month life of the partnership agreement.

Court's Reasoning

The court determined that the payment made by Risko to Backus was for her partnership interest, rather than a current business expense. The court referenced the agreement's terms, which indicated that the payment was made to acquire Backus's share of the business and its assets. Because the payment secured a definite benefit (exclusive control of the business) the payment had the characteristics of a capital expense. The court distinguished this from the purchase of a partnership of indefinite duration. The court then determined the payment could be amortized because Backus's interest, and therefore Risko's new interest, was limited by the remaining life of the partnership agreement (20 months). The court analogized it to a landlord buying out the remainder of a lease, which is amortizable over the remaining lease term.

Practical Implications

This case established that payments to acquire a partner's interest are generally capital expenditures, not deductible expenses. However, the case carved out an important exception. If the acquired interest has a definite, limited lifespan, the acquiring partner may amortize the expense over that period. This distinction is crucial for tax planning. Attorneys advising clients on partnership agreements must consider this case and the tax implications of buyouts, especially regarding the duration of the acquired interest. This case also highlights the importance of structuring agreements carefully, as the court will consider the parties' own characterization of their relationship and the terms of their agreements.

