31 T.C. 1199 (1959)

Amounts designated as “salaries” paid to partners are not deductible as business expenses by the partnership but are treated as distributions of profits, and a partner’s share of such “salary” income is taxable except to the extent it represents a return of capital.

Summary

The case involved a construction partnership that paid “salaries” to some partners, effectively reducing the capital accounts of all partners. The court addressed whether these “salaries” were deductible as business expenses or constituted a distribution of partnership profits. The Tax Court held that these were not deductible salaries, but rather distributions of profits. The partners who received the salaries had to include the amounts in their taxable income (except to the extent they were returns of their own capital contributions), while the partners who did not receive salaries could deduct the amounts from their capital accounts. The case also addressed the deductibility of various taxes paid by the partnership during the construction of buildings.

Facts

Joe W. Stout, Florence L. Rogers, and others formed a partnership, Fayetteville Building Company, to build apartment houses. The partnership agreement provided that Stout, McNairy, and Bryan would receive “salaries” based on a percentage of construction costs. These salaries were to be deducted from the partnership’s net profits. If the salaries exceeded net income, the excess would be treated as a loss, shared by all partners. The initial capital contributions were small. The partnership obtained a large construction loan to build the Eutaw Apartments. The partnership kept its books on an accrual method. Pursuant to the partnership agreement, the partnership paid the salaries to Stout, McNairy, and Bryan. The partnership’s net loss, without considering the salaries, was allocated among the partners. The partnership did not deduct the salaries as expenses on its tax return but treated them as withdrawals, which created deficits in the partners’ capital accounts. The IRS determined deficiencies, disallowing the claimed deductions for the salaries and certain taxes.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in income tax and additions to tax against Joe W. Stout, Eudora Stout, and Florence L. Rogers. The Stouts and Rogers petitioned the Tax Court to challenge these deficiencies. The Tax Court consolidated the cases and considered issues related to the taxability of Stout’s salary, the deductibility of various taxes paid by the partnership, and the Stouts’ claimed net operating loss carryback from 1953 to 1952, among other things.

Issue(s)

1. Whether the amount paid to Stout as “salary” was fully taxable to him.
2. Whether Florence L. Rogers, a partner who did not receive salary, was entitled to a deduction.
3. Whether the partnership could deduct Federal social security, Federal unemployment, North Carolina sales, North Carolina use, and North Carolina unemployment taxes.
4. Whether the Stouts were entitled to a net operating loss carryback from 1953 to 1952.
5. Whether the Stouts were liable for an addition to tax for failure to file a declaration of estimated tax.

Holding

1. Yes, but only to the extent that his “salary” payments exceeded his capital contribution.
2. Yes, to the extent of her capital contribution.
3. Yes, regarding Federal social security and unemployment taxes, North Carolina unemployment taxes, and North Carolina use taxes. No, regarding North Carolina sales taxes.
4. No, the Stouts failed to prove entitlement to a deduction.
5. Yes.

Court’s Reasoning

The court applied the principle that “salaries” paid to partners are not deductible expenses in computing partnership income, but are distributions of profits, as established in *Augustine M. Lloyd*. The court reasoned that the payments to Stout, McNairy, and Bryan were not true salaries but a means of dividing partnership profits. Stout was required to include his “salary” in his income, except to the extent it represented a return of his capital. Rogers was entitled to a deduction to the extent her capital contribution was used to pay the salaries of other partners, as her capital was reduced. The court distinguished the facts from those of other cases, concluding that the payments were made according to the partnership agreement. The court found that the partnership could deduct Federal social security and unemployment taxes because of the regulations providing an election to capitalize or deduct such taxes. The court further held that the partnership was able to deduct North Carolina use and unemployment taxes. However, North Carolina sales taxes were not deductible as the partnership had not proved that it was the entity liable for those taxes. Regarding the net operating loss carryback, the court held that the Stouts failed to sustain the burden of proof. Finally, the court upheld the addition to tax for the Stouts’ failure to file a declaration of estimated tax, as they did not show reasonable cause.

Practical Implications

This case is essential for structuring partnerships, particularly those involved in real estate or construction. The court's holding reinforces that payments designated as salaries to partners are treated as distributions of profit. Practitioners must advise clients to structure partner compensation to accurately reflect economic reality, avoiding the characterization of distributions as deductible expenses. The case also informs how to determine the taxability of payments made under partnership agreements, including whether the payments were made to compensate for services rendered, and in that context, the amounts are taxable income to the partner receiving them, except to the extent that the payments represented a return of capital. The case also demonstrates the importance of understanding the legal incidence of state taxes to determine their deductibility. Later cases in partnership taxation cite this case when considering partnership agreements and partners' distributions.

