Myers v. Commissioner, T.C. Memo. 1963-338

A partner's distributive share of partnership income is taxable as ordinary income, even when the partner sells their partnership interest before the end of the partnership's taxable year and the income has not been distributed.

Summary

Hyman Myers, a retiring partner from Lakeland Door Co., argued that the income he received from the sale of his partnership interest, which included his share of the partnership's accrued profits, should be taxed as capital gains. The Tax Court disagreed, holding that his distributive share of partnership income was ordinary income, regardless of the sale. The court reasoned that under the 1939 Internal Revenue Code, partnership income is taxable to the partner whether or not it is distributed. The court also disallowed business expense deductions claimed for trips to Hawaii and South America, finding insufficient evidence to prove the trips were primarily for business purposes.

Facts

Hyman Myers owned a one-third interest in Lakeland Door Co., a partnership using an accrual method of accounting with a fiscal year ending September 30. From October 1, 1954, to March 31, 1955, the partnership accrued a net profit, with Myers' share being $37,680.60. On May 14, 1955, Myers entered into an agreement to sell his partnership interest to the remaining partners for $58,065.23, a figure that included his capital account and undistributed profits. Myers reported the income from the partnership sale as capital gain. He also claimed a business bad debt deduction of $1,000 and business travel expense deductions for trips to Hawaii and South America.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Myers' income tax for the periods in question. The Commissioner argued that Myers' distributive share of partnership income was ordinary income, disallowed the business bad debt deduction (except for allowing it as a non-business bad debt), and disallowed the travel expense deductions. Myers petitioned the Tax Court to contest these deficiencies.

Issue(s)

1. Whether the portion of the payment received by Myers for his partnership interest that was attributable to his distributive share of accrued partnership income should be taxed as ordinary income or capital gain.
2. Whether Myers was entitled to a business bad debt deduction of $1,000.
3. Whether Myers was entitled to deduct travel expenses for trips to Hawaii and South America as business expenses.

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Holding

1. No. The Tax Court held that Myers' distributive share of partnership income was taxable as ordinary income because partnership profits are taxed as ordinary income to the partners whether distributed or not.
2. No, in part. The court upheld the Commissioner's determination that the $1,000 bad debt was a non-business bad debt, allowable as a short-term capital loss, not a business bad debt.
3. No. The court disallowed the claimed travel expense deductions for both trips, finding that Myers failed to prove the trips were primarily for business purposes.

Court's Reasoning

The Tax Court relied on precedent under the 1939 Internal Revenue Code, which was applicable to the tax year in question. The court stated that "where a partner sells his partnership interest to the other members of the partnership, such sale does not effect a transmutation of his distributable share of the partnership net income to the date of sale from ordinary income into capital." The court emphasized that under the 1939 Code, a partner's distributive share of partnership income is taxable as ordinary income, regardless of whether it is actually distributed. The agreement to sell the partnership interest, which included payment for accrued profits, did not change the character of this income. Regarding the bad debt, Myers provided insufficient evidence to show it was related to his business. For the travel expenses, the court found Myers' testimony vague and unconvincing in establishing a primary business purpose for either the Hawaii or South America trips. For the Hawaii trip, the court noted the lack of concrete business activities and the personal aspects of the travel. For the South America trip, the court highlighted that a significant portion was for personal pleasure and the business activities seemed to be related to exploring new business ventures, which are considered capital expenditures, not currently deductible business expenses.

Practical Implications

Myers v. Commissioner reinforces the principle that a partner cannot avoid ordinary income tax on their distributive share of partnership profits by selling their partnership interest. Legal professionals should advise partners selling their interests that accrued partnership income up to the date of sale will likely be taxed as ordinary income, even if it's part of a lump-sum payment for the partnership interest. This case also serves as a reminder of the strict substantiation requirements for business expense deductions, particularly travel expenses. Taxpayers must maintain detailed records and demonstrate a clear and primary business purpose for travel to successfully deduct these expenses. Furthermore, expenses incurred while investigating or setting up a new business are generally not deductible as current business expenses but may be considered capital expenditures.

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