Logan v. Commissioner, 51 T. C. 482 (1968)

Payments for a partner's interest in a partnership's unbilled fees (work in progress) are taxable as ordinary income as unrealized receivables under Section 751.

Summary

In Logan v. Commissioner, the Tax Court ruled that payments received by a retiring partner for his share of the partnership's unbilled fees must be treated as ordinary income under Section 751 of the Internal Revenue Code. The case involved Frank Logan, who sold his partnership interest to his partner, Thomas Dawson, upon retirement. Logan received payments for his share of unbilled legal fees, which he argued should be treated as capital gains. The court held that these payments constituted 'unrealized receivables,' thus taxable as ordinary income, emphasizing that the intent of Section 751 is to prevent the conversion of potential ordinary income into capital gains.

Facts

Frank Logan and Thomas Dawson formed a law partnership in 1959, sharing profits equally. Logan contributed legal work in progress with a zero basis, which later generated fees for the partnership. In 1960, Logan sold his partnership interest to Dawson for $18,000 in cash and an assumption of $3,089. 75 in liabilities. The sale agreement allocated $10,000 of the payment to Logan's interest in unbilled fees and $8,000 to other partnership assets. Logan received $12,000 of the payment in 1961, with $4,000 attributed to unbilled fees.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Logan's 1961 tax return, treating the $4,000 received for unbilled fees as ordinary income. Logan petitioned the Tax Court for a redetermination, arguing for capital gains treatment. The Tax Court upheld the Commissioner's determination, ruling that the payments for unbilled fees were unrealized receivables under Section 751.

Issue(s)

1. Whether the $4,000 received by Logan in 1961 for his interest in the partnership's unbilled fees constitutes a payment attributable to 'unrealized receivables' under Section 751, and thus taxable as ordinary income?

2. What was Logan's adjusted basis in his partnership interest at the time of sale for determining his gain or loss?

Holding

1. Yes, because the payment for unbilled fees was for services rendered, which

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Logan would have shared as ordinary income had he remained in the partnership, and thus falls within the definition of ‘unrealized receivables’ under Section 751.

2. Logan’s adjusted basis in his partnership interest at the time of sale was $11,258. 61, as calculated by the Commissioner, taking into account contributions, share of profits, withdrawals, and adjustments for partnership liabilities.

Court’s Reasoning

The court reasoned that the purpose of Section 751 is to prevent the conversion of potential ordinary income into capital gains. The court found that the partnership had a legal right to payment for work done, even if the amount was uncertain, which constituted an ‘unrealized receivable. ‘ The court emphasized that the term ‘unrealized receivables’ in Section 751(c) includes rights to payment for services rendered or to be rendered, and this broad definition encompasses unbilled fees from work in progress. The court rejected Logan’s argument that the absence of express agreements with clients meant no ‘unrealized receivables’ existed, stating that implied obligations are sufficient. The court also calculated Logan’s basis in his partnership interest, considering his contributions, share of profits, withdrawals, and the impact of partnership liabilities.

Practical Implications

This decision clarifies that payments for unbilled fees in the sale of a partnership interest are treated as ordinary income, not capital gains, under Section 751. Practitioners must carefully allocate payments in partnership dissolution agreements to avoid unintended tax consequences. This ruling impacts how partnership interests are valued and sold, especially in service-based partnerships where work in progress is significant. It also underscores the need for accurate basis calculations in partnership transactions, considering all adjustments for contributions, profits, withdrawals, and liabilities. Subsequent cases have applied this ruling to similar situations, reinforcing the broad interpretation of ‘unrealized receivables’ in partnership tax law.

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