Kresser v. Commissioner, 54 T. C. 1621 (1970)

Partners must comply with statutory requirements to modify partnership agreements for income allocation, and such modifications must be bona fide.

Summary

In Kresser v. Commissioner, the Tax Court ruled that partners must report their distributive shares of partnership income based on their percentage interests unless modifications to the partnership agreement meet specific statutory conditions. The case involved a purported reallocation of all 1965 partnership income to one partner, W. H. Appleton, to utilize his expiring net operating loss carryover. The court found that the reallocation did not comply with IRC section 761(c) requirements, nor was it a bona fide modification, as it was intended to be reversed in future years. This decision underscores the importance of adhering to legal standards when altering partnership income distribution.

Facts

Jean V. Kresser and other partners held interests in Canon Manor and Westview Meadows partnerships. W. H. Appleton, the dominant partner, had a net operating loss carryover expiring at the end of 1965. To utilize this carryover, a 'Board of Governors' voted to allocate all 1965 income to Appleton, with the understanding that this income would be restored to other partners in subsequent years. The partnerships operated without written agreements, and the reallocation was reflected on the 1965 partnership tax returns. The other partners did not report any income for 1965, treating their withdrawals as reductions of their capital accounts.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the petitioners' 1965 federal income taxes, including their distributive shares of partnership income based on their percentage interests. The petitioners contested these deficiencies in the U. S. Tax Court, arguing that the partnership agreements had been modified to allocate all income to Appleton. The Tax Court consolidated the cases and heard them together.

Issue(s)

1. Whether the purported reallocation of all 1965 partnership income to W. H. Appleton complied with the conditions of IRC section 761(c) for modifying partnership agreements.
2. Whether the reallocation of 1965 partnership income to Appleton was a bona fide modification of the partnership agreements.

Holding

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1. No, because the petitioners failed to prove that all partners agreed to the modification prior to the filing deadline or that the modification was adopted in a manner provided by the partnership agreements.
2. No, because the evidence indicated that the reallocation was not a genuine modification but rather a temporary paper transaction intended to be reversed in future years.

Court's Reasoning

The court applied IRC sections 702(a), 704(a), and 761(c), which govern the determination of a partner's distributive share of partnership income and the requirements for modifying partnership agreements. The court found that the petitioners did not establish that all partners agreed to the reallocation before the filing deadline or that the 'Board of Governors' had the authority to modify the agreements under the oral partnership agreements. Additionally, the court determined that the reallocation was not a bona fide modification, as it was intended to be reversed in future years, resembling a loan rather than a true income shift. The court emphasized the need for genuine modifications, citing Commissioner v. Court Holding Co. , and noted the lack of clear evidence from key witnesses like Appleton.

Practical Implications

This decision reinforces the strict requirements for modifying partnership agreements under IRC section 761(c), particularly the need for unanimous partner consent or adherence to the partnership agreement's terms for modification. It also highlights that any modification must be a genuine change in the partners' rights, not a temporary tax avoidance scheme. Practitioners should ensure that any modifications to partnership agreements are properly documented and meet statutory requirements. The ruling impacts how partnerships can utilize tax planning strategies involving income allocation and underscores the importance of clear, bona fide agreements. Subsequent cases have cited Kresser to clarify the standards for partnership agreement modifications and the definition of bona fide income reallocations.

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