Holman v. Commissioner, T.C. Memo. 1975-29

Payments received by expelled partners from a law firm for their share of accounts receivable and unbilled services are considered ordinary income, not capital gains, under sections 736 and 751 of the Internal Revenue Code.

Summary

Francis and William Holman, partners in a law firm, were expelled and received payments for their partnership interests, including undistributed income, capital accounts, accounts receivable, and unbilled services. The tax treatment of undistributed income and capital accounts was not disputed. The IRS determined that payments for accounts receivable and unbilled services should be taxed as ordinary income, while the Holmans argued for capital gains treatment. The Tax Court sided with the IRS, holding that these payments constituted ordinary income under sections 736 and 751 because they represented unrealized receivables and were substitutes for what would have been ordinary income had the partners remained in the firm.

Facts

Francis and William Holman were partners in the law firm Holman, Marion, Perkins, Coie & Stone. On May 13, 1969, the firm's executive committee expelled them without prior notice. The partnership agreement stipulated that expelled partners would receive their interest in undistributed income, capital accounts, and a percentage of the firm's inventory, which included accounts receivable and unbilled services. The Holmans received payments for these items, reporting the amounts related to receivables and unbilled services as capital gains. The IRS reclassified this portion as ordinary income.

Procedural History

The IRS determined deficiencies in the Holmans' federal income taxes for 1969 and 1970, classifying payments from the law firm as ordinary income. The Holmans contested this determination in Tax Court. Prior to Tax Court, the Holmans had unsuccessfully sued the law firm in Washington State court, alleging breach of the partnership agreement; the Washington Court of Appeals affirmed the dismissal of their lawsuit.

Issue(s)

1. Whether payments received by expelled partners from a law partnership for their share of accounts receivable and unbilled services are taxable as ordinary income under sections 736 and 751 of the Internal Revenue Code, or as capital gains under section 731.
2. Whether the expelled partners incurred a deductible capital loss due to the 10 percent reduction applied to the value of accounts receivable and unbilled

© 2025 SCOTUSreports.com. All rights reserved.

services as per the partnership agreement.

Holding

1. Yes, the payments for accounts receivable and unbilled services are taxable as ordinary income because they fall under the exceptions in section 731(c) and are governed by sections 736 and 751, which treat such payments as ordinary income.
2. No, the expelled partners did not incur a deductible capital loss because they had no basis in the accounts receivable and unbilled services, as these amounts had not previously been included in their taxable income.

Court's Reasoning

The court reasoned that section 731(c) explicitly states that section 731 (capital gains for partnership distributions) does not apply to the extent provided by sections 736 and 751. Section 736(a)(2) treats payments in liquidation of a retiring partner's interest, determined without regard to partnership income, as guaranteed payments, taxable as ordinary income. The court noted that the definition of a retiring partner in Treasury Regulation §1.736-1(a)(1)(ii) includes expelled partners. Furthermore, section 736(b)(2)(A) clarifies that payments for unrealized receivables are not treated as payments for partnership property, thus not eligible for capital gains treatment. Section 751(a) directly addresses unrealized receivables, stating that money received for a partnership interest attributable to unrealized receivables is considered ordinary income. The court quoted *Roth v. Commissioner*, 321 F.2d 607, 611 (9th Cir. 1963), stating that section 751 prevents converting ordinary income into capital gains through partnership interest transfers. Regarding the capital loss claim, the court found no basis for a loss deduction because the Holmans had not previously included the receivables and unbilled services in their income, and therefore had no basis in those assets. The court cited *Hort v. Commissioner*, 313 U.S. 28 (1941), stating that a deduction for failure to realize anticipated income is not permissible.

Practical Implications

Holman v. Commissioner clarifies that payments to departing partners, whether through retirement or expulsion, which represent their share of unrealized receivables (such as accounts receivable and unbilled services in service-based partnerships like law firms or accounting firms), are taxed as ordinary income. This case reinforces the application of sections 736 and 751 to prevent the conversion of what would be ordinary income into capital gains upon a partner's departure. Legal professionals advising partnerships and partners need to ensure that distributions are properly characterized to reflect the ordinary income nature of payments for unrealized receivables. This case is frequently cited in partnership tax disputes concerning the characterization of payments to retiring or expelled partners, emphasizing the priority of ordinary income treatment for unrealized receivables

© 2025 SCOTUSreports.com. All rights reserved.

over capital gains.

© 2025 SCOTUSreports.com. All rights reserved.