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TAX ASPECTS OF A PARTNERSHIP AGREEMENT

By Charles F. Coates, C.P.A.

At Annual Meeting of American Institute of Accountants
at Chicago, Illinois, September 21, 1948.

I. Partnerships for Professional Practitioners:

In considering the form of a practice organization of certified public accountants, attention naturally centers toward the formation of a partnership in order to place full responsibility for their acts upon practitioners so joining together. Rule 11 of the rules of professional conduct of the American Institute of Accountants forbids its members from engaging in the practice of public accounting in corporate form. Many of the states have statutory prohibition against either the practice of public accounting or the use of the designation "certified public accountants" by corporations. Likewise, some state organizations of certified public accountants prohibit corporate practice of public accounting to its members.

Although partnerships are not subject to Federal income taxes, Section 187 of the Internal Revenue Code, requires a partnership return for each taxable year, sworn to by one of the partners, to be filed whether or not transactions of the partnership result in net income. Each partner includes in his individual return his share of certain items appearing on the partnership return, whether distributed to him or left in the partnership.

II. Tax Concepts of Payments Made Upon the Death or Withdrawal of a Partner:

As compared to a partnership, in theory of existence, a corporation is regarded as a legal entity distinct and separate from the stockholders composing it, and is so treated for Federal income taxation purposes. The law endows a corporation with legal personality. The death or withdrawal of a stockholder in no respect affects the corporate existence.

A partnership can be created by agreement of its members and may do anything which is not unlawful. However, a partnership lacks the "continuity of being" inherent in a corporation. Under normal conditions, if a partner dies, the partnership ceases. If a partner sells or otherwise transfers his

interest in the firm, the partnership is automatically dissolved. A new partnership may be formed by the surviving partners.

As previously stated, practicing certified public accountants, by virtue of their relation to the public and professional development, cannot avail themselves of the corporate form of organization. Therefore, a professional practitioner ordinarily does not create a business which can produce income for his dependents after death. After a lifetime of practice, the only assets available for realization in a public accounting partnership may consist of little more than used office furniture and equipment, possibly a few second-hand textbooks plus his uncollected accounts and work in process.

In order to avoid disruption of the business resulting from such liquidation, the partners, while all living, may provide by contract for the continuation of the business despite withdrawal or death of a partner. Thus, for both economic and social reasons, partnership agreements providing for the continuation of the business upon death or withdrawal of a partner have become relatively common. The forms of such agreements vary but, from the standpoint of Federal income tax consequences, they may be classified under two general headings (1) those under the "purchase concept", (2) those under the "income concept".

The Internal Revenue Code and Regulations have not clarified the treatment of cases arising under such circumstances and it has been obvious that the approach of the Commissioner of Internal Revenue has been to attempt to collect the highest taxes possible, irrespective of being consistent from case to case.

Courts have applied the "purchase concept" when there has been surrender by the decedent of valuable property recognized as such by the parties and the intention of the parties to effectuate a purchase and sale, supported by language of the partnership agreement expressing the transactions in terms of purchase and sale.

In cases where the partners, while all living, have agreed, in event of decease of a partner, to continue the business and distribute a share of

post-death net earnings to the deceased partner's estate for a period of time, the courts have applied the "income concept".

III. Decisions Under "Purchase Concept":

Following are some of the cases under the "purchase concept", which resulted in the surviving partners being subject to individual Federal income taxes upon all the net income of the partnership out of which payments were made to the estates of the deceased partners.

In the case of Arthur K. Pope v. Commissioner, 39 F (2d) 420, decided in 1930 involving a fire insurance business, payments were made to the estates of members of a former partnership pursuant to a new partnership agreement between two surviving partners and three new individuals, such payments representing a share of new partnership profits. The Court held the partnership agreement effected a sale of the interests of the two estates to the new partnership.

In the case of Willard C. Hill, 14 B.T.A. 572, decided in 1928 involving an insurance agency and brokerage business, the partnership agreement provided, upon death of one partner, there should be paid to his estate for a period of years a share of partnership earnings to which deceased would have been entitled if living and upon completion of such payments the business became the sole property of the surviving partners,- the Tax Board held that the partnership agreement provided for sale of the deceased partners' interest to the surviving partners.

In the case of Stephen J. Callahan, 14 B.T.A. 584, decided in 1928 involving a general fire insurance business, the partnership agreement provided upon death of any partner, surviving partners should have an option of purchasing the deceased partner's interest, payment to be a proportionate share of the deceased partner in earnings of business for three years succeeding death, or a cash payment. Upon death of two partners, survivors organized a new partnership with three new members, and it was agreed estates of deceased partners would be paid a fixed percentage of profits of the new partnership

for three years, but such estates would assume no responsibility under the new contract. This arrangement was agreed to by the executors of the estates and distributions were made to them. The estates were also paid amounts which the two deceased partners had contributed to the capital of the old partnership. The Tax Board held that upon death of the two partners, the partnership was dissolved; the estates were not members of new partnership and amounts paid to the estates were for sale of the deceased partners' interests.

In the case of Raymond S. Wilkins, 7 T.C. 519, decided in 1946 involving a law partnership, the partnership agreement provided upon any partner's decease, payment to his estate within one year of an amount equal to one-fourth the amounts distributed to decedent during the two years preceding his death. The Court held, payment so made at an arbitrary figure, regardless of period in which earned, was equivalent to purchase of a receivable by the surviving partners and all fees collected during period of settlement were taxable to the surviving partners.

In the case of Arthur C. Hillmer, 27 B.T.A. 1165, decided in 1933 involving a general brokerage business, the partnership agreement provided, upon death of one partner, there should be paid to his estate, in partial satisfaction for the assets so acquired, a percentage of the net profits of the partnership for a period of years - the Tax Board held that the payments were the personal obligations of the surviving partners.

In the case of W. Frank Carter, 36 B.T.A. 60, decided in 1937 involving a law partnership, the partnership agreement provided, upon death of any partner, his estate should receive a sum equal to one-half of the amount received by the deceased partner during the two calendar years next preceding his death in payment of his interest in the firm and its assets, - the Tax Board held the payment was a sale.

In the case of Bavier C. Miller, 38 B.T.A. 487, decided in 1938 involving an insurance business, the partnership agreement provided, upon death of a partner, his interest would cease and be divided per capita among the surviving partners, who were to pay to his estate, in monthly installments,

the deceased partner's share of earnings up to date of death and for thirty months thereafter - the Tax Board held the payments to represent the purchase of the deceased's partner's interest.

In the case of Estate of George R. Nutter, 46 B.T.A. 35, decided in 1942 involving a law partnership, affirmed on other grounds sub nom. Edward F. McClennen, etal v Commissioner, 131 F (2d) 165, there was an investment of capital in, and tangible property owned by, the partnership; there was a clear recognition that each partner had a valuable capital interest in the partnership assets. The gross estate included the value of a contract between the partners providing for payments of a percentage of net profits of the succeeding partnership for a certain period after death, as consideration for the deceased partner's interest in capital, assets,receivables, possibilities and good will of the firm. The Court held that such payments after the partner's death were not income of the deceased's heir to whom it was distributed.

IV. Decisions Under "Income Concept":

The "income concept" has been applied in decisions where, upon the death of a partner, by partnership agreement contracted during his life, his estate continues as a partner or becomes a partner in a new partnership and such participation in post-death earnings is not for the purpose of purchasing the interest of the estate.

In the case of Bull v United States, 295 U.S. 247 and 55 Sup. Ct. 695, decided in 1935 involving a business of ship-brokers, the partnership agreement provided that, in event of death of a partner, the survivor should continue the business for one year thereafter, and the estate was to share profits and losses in the same manner as if the deceased partner was living. It was held that the Commissioner erred in asserting an estate tax upon the estate's share of post-death income, which was paid in 1921, and subject the same amount to income tax in the hands of the estate which was paid in 1930. Suit for recovery of both the income tax and estate tax was instituted in 1930. Although the statute of limitations for bringing suit had expired, the Court held the estate

tax recoverable on the grounds that in the claim for income taxes asserted by the Government in 1925, the taxpayer was entitled to recoupment for the estate taxes because retention of the money by the United States was against morality and good conscience. The Supreme Court concurred with the Court of Claims decision that the amounts paid to the estate as profits after the decedent's death were income to the estate.

The Supreme Court's decision led the Income Tax Bureau and even the Board of Tax Appeals to believe at that time that post-death income-sharing agreements afforded a method of tax avoidance in that they felt the decision permitted only an income tax upon the estate in a post-death "income-sharing arrangement", whereas in the case of a "purchase arrangement" an income tax could be imposed upon the survivors and an estate tax upon the decedent's estate. Because of that interpretation, the Bureau thereafter was inclined to hold that a "purchase arrangement" was present in every borderline case. This interpretation was clarified in the case of Estate of George R. Nutter 46 B.T.A. 35, affirmed by the First Circuit, wherein the Court pointed out that the Bull decision prohibited an estate tax upon the identical money which the estate received as income, but the decision did not preclude estate tax upon the value of the right of the estate to receive post-death partnership earnings, which under the partnership agreement were paid expressly for the deceased partner's interest in the partnership.

In the case of Walter T. Gudeon, 32 B.T.A. 100, decided in 1935 involving a life insurance agency, an agreement required a general agent to pay to a deceased partner's estate certain amounts based on renewal commissions on business written before his death. The Tax Board held that the net income taxable to the surviving partners was the net earnings from all commissions less the amount required to be paid under the contract to the deceased partner's estate.

In Gussie K. Barth, 35 B.T.A. 546, decided in 1937, the petitioner was the widow of a lawyer who had been a member of a law partnership prior to

his death, under a partnership agreement which provided that the partnership should not be immediately dissolved upon the death of a partner, but his interest therein should be determined by payment to his widow or estate over a period of three years of certain stipulated percentages of the profits to which the deceased partner would have been entitled if he were living. It also provided for continued individual ownership of capital assets. The surviving partner continued the practice of law, under the old firm name, and made the payments provided for in the agreement. Taxpayer reported these amounts as income and later claimed overpayment on the ground that the payments were capital items, received by her as consideration for the sale of her husband's interest in the firm pursuant to his contract with his surviving partner. The Tax Board held the amounts received by the taxpayer did not represent capital payment, but that they were properly treated as income.

The case of Richard P. Hallowell, 39 B.T.A. 50, decided in 1939, involved a partnership engaged in marketing wool. Capital was essential to the business and each partner made substantial contributions. The partnership agreement provided that, in the event of the death of a partner, the partnership should terminate after six months, or earlier by notice of a majority of survivors, but that all of the survivors might elect to continue the partnership as to themselves until the end of the period prescribed for the life of the partnership in the articles or until the interest of the deceased partner terminated, whichever was longer. It was provided that during the continued existence of the partnership the estate of the deceased partner should continue to have the same interest in the profits and be responsible for the same share of losses as the deceased partner would have had or borne, had he lived, but that the estate should have no voice in the management of the business. The agreement further provided for the method of determination and settlement of the capital interests of the partners. The controversy involved the Commissioner's treatment of all partnership profits after the partner's death as income of the surviving partners. The Tax Board felt it was unnecessary to decide whether the estate was or was not a partner during the period in question, since,

in any event, it was clear that the estate had a direct right, by virtue of the partnership agreements, to a share of the partnership income as such.

In Estate of Hunt Henderson, 4 TC 1001, decided in 1945 involving a sugar refining business, where provision in partnership agreement was made for continuance of partnership for one year after date of death of partner, the Court held the deceased partner's share of profits and losses for fractional year belonged on the return filed for that period, and thus all remaining portion of accounting period belonged on return filed for his estate.

In case of Estate of Frederick C. Bellinger, Tax Court Memo Decision, Docket #4562 (Entered Feb. 14, 1946) involving a law partnership, taxpayer and his estate, after his withdrawal from a law partnership firm, received each year for two years an amount equal to the proportion of the firm's profits which he had been receiving during the period of his membership in accordance with the partnership agreement. The Tax Court held the payments taxable to decedent's estate upon the findings that decedent made no contributions to the partnership and had no assets or investment in the firm which they could have bought from him upon his retirement.

V. Charles F. Coates Et Al 7 TC 125 (1946):

The Coates case is of particular interest to professional practitioners. It related to a partnership of certified public accountants and was decided by the Tax Court under the "income concept". It was reviewed by the entire Court without a dissent and was acquiesced in by the Commissioner of Internal Revenue.

(a) Essential Features of Partnership Agreement:

The partnership agreement provided that upon the death of a partner his estate would continue as a partner for five years and that the estate would be paid (1) the amount of his undrawn earnings or so-called capital, at date of death, plus (2) a participation in the net earnings of the partnership for five years from the end of the month in which a partner died. The essential features of the partnership agreement are as follows:

1. Parties agree to become partners. Any partner may withdraw on three months' notice. Partnership books are kept on a calendar year basis.

2. In event of withdrawal or death of any partner, it shall not operate to dissolve the partnership, but the estate of a deceased partner shall continue as a partner for five years from end of month in which death occurs. Partners may admit additional partners, but the death percentage of a deceased partner shall not be affected. To provide funds to finance partnership, undrawn earnings shall be treated as capital of the partnership. Provides for stated participation percentages in net earnings for each partner while living, and lower participation percentages in net earnings after death of a partner for five years.

3. Drawings during a year shall not exceed 85% of prior year earnings, but not to exceed partners' interest as shown by the books.

4. Partner's estate payments shall be made in equal quarterly installments, but finally paid for any year not later than the last day of February of succeeding year.

5. No partner shall engage in any business in competition or take any engagement that the firm might undertake or had declined to undertake.

6. In event of death of any partner, partnership shall continue as an existing partnership between surviving partners and estate of deceased partner. Capital interest of deceased partner shall be determined and settled as soon as possible, but not more than five years, from date of death in equal quarterly installments without interest. Upon the death of a partner, work in process shall be valued at twice the cost thereof, which increase shall be credited to capital accounts of deceased partner and surviving partners.

7. To effectuate more surely performance of contract and to protect the estate of the deceased partner, the partnership agreement constitutes a Trust Co. to be trustee for the several parties and their respective estates with stipulated powers, providing:

   In the event of death of a partner and until his estate is fully paid under the agreement, surviving partners will furnish monthly financial statements showing condition of affairs, partners' interests, amounts paid and unpaid under agreement, analysis of capital accounts of each partner.

   Said trustee has power to examine books and investigate on his own account the condition of partnership for protection of the estate of a deceased partner.

   Charges for services of trustee shall be paid by partnership. Said trustee at its discretion shall have power to require liquidation and immediate settlement in full with estate of a deceased partner, if not satisfied that letter and spirit of agreement is being faithfully performed,

or interest of partner's estate is becoming impaired. The trustee is empowered to enforce the agreement by any action at law and in equity including appointment of a receiver.

8. If surviving partners fail to carry on and fully perform under the agreement, earnings and capital interests of estate of deceased partner shall first be paid out of liquidation proceeds, and balance of earnings interest remaining unpaid of the five years' period, established for a deceased partner's estate, shall be computed on the basis of average annual earnings of the two preceding calendar years.

9. In consideration of the terms of the agreement, surviving partners have the right to continue to use the name of the deceased partner in the partnership name as it was used immediately prior to his death.

10. In event of withdrawal of a partner, he forfeits all claim to death benefits and remaining partners may continue business under same firm name as theretofore, and upon payment of his interest, he shall not insist upon liquidation of the firm. In event of withdrawal, a partner agrees not to engage in public accounting directly or indirectly in Connecticut for a period of five years, nor serve in that capacity any then client of the partnership located within or without Connecticut.

11. In event of misconduct or inattention to business of the partnership, senior partners have right to elect to give written notice of the retirement of such partner forthwith, whereupon he shall no longer participate in the net earnings of the firm.

12. The partnership agreement was executed by the various partners and also the Trust Co. named therein as trustee to evidence its acceptance of the trust.

Between December 1941 and November 1945, three of the six partners signatory to this agreement died and in each instance there was a sickness period approximating two years prior to death. During this period two of the partners were paid their regular percentage participations in the net earnings of the partnership as though active, while the third, contemplating an extended sickness and in realization that his working days were over, agreed to reduction of his percentage participation to his death percentage stated in the partnership agreement without prejudice to the rights of his estate under the agreement.

When the first partner died in December 1941, the estate appraisers decided the right to receive post-death earnings was too speculative to warrant valuation for estate inventory purposes and accordingly assigned no value thereto. Upon field examination of the estate return, the Federal examining officer assigned a valuation to this contractual right to participate in

post-death earnings based on the partnership earnings for the past five years, reduced however to present value because the payments were made from partnership earnings over a period of five years after death. The resultant additional estate tax was paid.

The income tax returns of the surviving partners were field examined for the years 1942 and 1943 and the Federal examining officer held that all earnings of the partnership subsequent to the death of a partner were taxable to the surviving partners. The surviving partners and the estate of the deceased partner had made income tax returns for those years including their individual share of income under the partnership agreement. The income tax cases went to the Tax Court of the United States.

Contentions of Internal Revenue Bureau in Coates Case:

The Commissioner of Internal Revenue, before the Tax Court, contended (1) that the payments of the partnership firm to the estates of the deceased partners from earnings after their deaths constituted income of the surviving partners, (2) the estates were not partners and the post-death payments did not constitute a distribution of partnership income as such, (3) only the living partners could render the personal services and they should be taxed for the income which they earned, (4) the post-death payments constituted a purchase by the surviving partners of a deceased partner's interest in the partnership, that the partnership firm had "goodwill" which had a definite value; a part thereof was the partnership name which had a value, (5) the treatment as income of the post-death payments out of earnings by the Court of Probate for the District of Hartford, Connecticut, was not binding upon the Tax Court.

Contentions of Surviving Partners in Coates Case:

The contentions of the surviving partners before the Tax Court were: (1) post-death income of the partnership paid to a deceased partner under the partnership agreement was not the income of the surviving partners; (2) each partner agreed by written contract to percentage participations in earnings to each partner during his period of activity as a partner and for five years

after his decease, provided he was a partner at time of death; (3) the partners each recognized that each contributed his share to the building of the firm and that some part of the income earned after death of any partner could be attributed to the time and skill which the decedent devoted to the firm during his lifetime; (4) each partner realized that he might be the one first to die and he was willing to place a contingent lien upon his future earnings in return for his receiving such a lien upon the other partners' earnings for the benefit of his estate; (5) the partnership agreement was a contract made before death in consideration of the reciprocal commitments by all and was basically an agreement for the sharing of income, not a contract of purchase and sale; (6) the estates of the deceased partners were partners of the partnership together with the surviving partners by express terms of the partnership agreement; (7) the estates of the deceased partners share in post-death partnership earning under the terms of the partnership agreement and surviving partners have no greater share in the partnership income than the partnership agreement stipulate (8) the only income taxable to the survivors is the amount reserved to them by the agreement.

Tax Court Decision:

The Tax Court Decision was written by Judge Kern without any dissents. The Court quoted Section 182 of the Internal Revenue Code which provides:

"In computing the net income of each partner, he shall include, whether or not distribution is made to him *******
(e) His distributive share of the ordinary net income *** of the partnership ***

Reference was made to the case of Bull v. United States 55 S. Ct. 295 U. S. 247
and quoted from that decision as follows:

*** "Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not. Here, however, the survivors have purchased nothing belonging to the decedent, who had no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was therefore income and not corpus; and this is so whether we consider the executor a member of the old firm for the remainder of the year, or hold that the estate became a partner in a new association formed upon the decedent's demise.

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Since the firm was a personal service concern and no tangible property was involved in its transactions, if it had not been for the terms of the agreement, no accounting would have ever been made upon Bull's death for anything other than his share of profits accrued to the date of his death *** and this would have been the only amount to be included in his estate in connection with his membership in the firm."

Reference was also made to the cases of Gussie K. Barth 35 B.T.A. 546 and Richard P. Hallowell, 2nd, 39 B.T.A. 30 and with respect to the latter case said:

"We felt it unnecessary to decide whether the estate was or was not a partner during the period in question since, in any event, it was clear that the estate had a direct right, by virtue of the partnership agreements, to a share of the partnership income, as such.

With respect to the question of purchase or sale the Court said:

"The agreement in the instant case provided for the use of undrawn earnings of the partners as the capital of the firm, each partner to be credited on the books with the amount left by him in the business. This is the only "Capital" account the members of the firm had. The office equipment was fully depreciated, the library consisted largely of material renewed each year, and the leases were for short terms. All of these assets were of only nominal value and were not even considered by the partners in the negotiations leading to the execution of the partnership agreement. This agreement provided further for liquidation of the "Capital" account by payment, to the estate of a deceased partner after his death of this "Capital" interest in the firm, computed as therein authorized. These payments have been or are being made, and are not the subject of this dispute. It was not the intention of the parties that any interest of a deceased partner be left in the firm, and none has been or will be left in the firm after the expiration of the time allowed for the orderly liquidation of the capital accounts. Having provided for the return to the estates of any valuable capital interest the decedent had in the firm, it is difficult to find any evidence of an intention to sell that interest to the surviving members. Certainly no language of bargain and sale is used in the agreement. Although respondent feels that the deceased partners had a valuable interest in the goodwill and partnership name, it is apparent from the entire record that the parties to the agreement placed no value upon these items. Ordinarily no value, or nominal value, will be given to goodwill attaching to a personal service partnership such as one composed of physicians, attorneys or accountants See 38 C.J.S., p 952: Rowley, Modern Law of Partnership, Sec. 331. See also D. K. MacDonald, 3 T.C. 720. There is no evidence in the instant case which would justify a conclusion that the parties to the partnership agreement involved herein intended to make a sale of goodwill upon dissolution of the partnership by death, in return for payments to the deceased partner's estate out of income earned after his death. Since the instrument in question does not purport to make a sale of goodwill, upon liquidation, and since, according to general standards of value, the goodwill of this particular partnership would not be sufficiently valuable to be the subject matter of, or consideration for, a sale, we do not feel justified in assuming or reading into the agreement language from which we could spell out an intention to make a sale upon dissolution.

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These payments were not made in liquidation of any capital interest of the deceased partner in the firm's assets. The only payments of this nature required upon the death of a partner were the payments on account of past earnings and work in process, here designated as the "Capital Account". In addition to these payments, the estate of a deceased partner was entitled to the payment

of a share of post-death earnings, not in consideration of a sale of partnership assets on liquidation, but in consideration of mutual promises contained in the original partnership agreement having no relationship to such a sale. These payments arose out of and depended upon the contract and their character must be determined by its terms. The estate acquired, upon the death of the partner, a vested contractual right to a share of the earnings, as earnings, and this right was fortified by a power lodged in the trustee to require a liquidation of the business if its rights were not fully respected by the surviving partners. When and as the income was earned, it became immediately subject to the pre-existing rights of the estates to their share of it. The amounts so distributable to the estates were not distributable to any surviving partner, with the result that here, as in Richard P. Hallowell, 2nd, supra, the disputed amount attributed by the respondent to each surviving partner may not be regarded as "his distributive share, whether distributed or not, of the net income of the partnership".

VI. Aftermath of Coates Case:

The treatment for income tax purposes of the partners' estates of the valuation upon which the estate tax was paid remains to be decided. Claims for refund of estate income taxes have been made based on the contention that this right to receive post-death partnership earnings by the estates is in the nature of a wasting asset and the valuation placed thereon for estate tax purposes should be amortized over the five years of estate participation in such earnings. For protective purposes, in view of the statute of limitations, claims for refund have also been made for the return of the estate taxes paid upon such valuations.

The claims for refund of income taxes paid by the estates based on amortization have been rejected by the Commissioner and suit has been started in the U. S. District Court of Connecticut. Trial has not yet been had.

It is the present understanding of counsel that the Government would be willing to refund the estate tax paid on the valuation assigned to post-death partnership earnings.