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Taxation—Income—Long-Term Compensation—Partnerships

If an individual or a partnership receives¹ in a tax year at least 80 per cent of the total compensation² for personal services³ rendered over a period of thirty-six months or more,⁴ § 107 (a) of the Internal Revenue Code may provide relief from the application of a high tax bracket in that particular year.⁵ This relief is granted by limiting the tax on such compensation to the additional tax that would have been payable if the compensation had been received on a pro rata basis over the period of service prior to the receipt of the qualifying payment.⁶ Thus the taxpayer is allowed the benefit of paying the smaller

¹ If the taxpayer is on an accrual basis then an accrual is sufficient. INT. REV. CODE § 107(a).

² Total compensation is important in determining whether the payment received represents 80 per cent thereof. Thus what appears to be a qualifying payment in a particular year may be reduced below 80 per cent by a subsequent payment for the same services. Also, there is a problem concerning the separability of lump-sum payments. For example, in one case the severance pay received by an employee after 26 years of service was held to be not separable from total compensation received over that period and so the 80 per cent test was not met. *Carrigan v. Commissioner*, 197 F. 2d 246 (2d Cir. 1952). In another case the additional pay to a corporate officer for services in connection with a patent controversy between his employer-corporation and another corporation was held separable from his regular salary. *E. A. Terrell*, 14 T. C. 572 (1950).

³ It has been held that advance payments from a client set apart in a trust fund do not constitute compensation for personal services until withdrawn. *Hanna v. Commissioner*, 156 F. 2d 135 (9th Cir. 1946). In another case it was held that the proceeds arising from the compromise of a copyright infringement suit did not constitute compensation for personal services. *Jack Rozenzweig et al.*, 1 T. C. 24 (1942).

⁴ The period of thirty-six months or more is measured from the beginning of services until their termination. The following cases are illustrative of the problems arising in this area: (a) Was there a thirty-six month period? *Lucilla de V. Whitman*, 12 T. C. 324 (1949), *aff'd*, 178 F. 2d 913 (2d Cir. 1949) (corporate salary of officer was for services rendered in current year, rather than compensation for the officer's services during the period in which the corporation was formed); (b) When did the period begin? *James D. Gordon*, 10 T. C. 772 (1948), *aff'd per curiam*, 172 F. 2d 864 (2d Cir. 1949) (the period included unsuccessful attempts to sell stock by a broker in addition to the time spent by him on successful negotiations); *Guy C. Myers*, 11 T. C. 447 (1948) (time spent in finding a customer may not be included); (c) When did the period end? *Norman R. Williams*, 1951 P-H TC MEMO DEC. ¶ 51,207 (1951) (in the sale of a corporation the broker's services continued until the last stockholder turned in his stock).

⁵ INT. REV. CODE § 107(a) provides: "If at least 80 per centum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual."

⁶ If the payment of 80 per cent or more is received upon the completion of services, then the compensation will be spread over the period during which the services were rendered. If the date of payment and the date of the completion of services are different, then the earlier date is used as the ending date for the allocation of the lump-sum compensation for purposes of computing the tax. Thus, in computing the tax, the allocation period may be less than thirty-six

of either (1) the tax on the special compensation for the current year without adjustment or (2) the additional tax on such compensation which would have been payable if the pay had been spread evenly over the period during which services were rendered prior to the receipt of the qualifying payment. The tax for other years is not changed, as the statute merely provides a formula for computing the income tax on long-term compensation in the year in which it is received.

This statutory provision is of special interest to professional persons and partnerships who frequently render services over a long period of time and who may receive a large payment in one tax year.⁷ Proper tax planning is desirable to insure that the requirements of § 107 (a) are met.⁸ The problems to be considered here are some which are peculiar to partnerships. These particular situations arise in connection with the admission of new partners and the change of the business "entity" while services are being rendered.

In *Van Hook v. United States*,⁹ the taxpayer, an attorney, was requested in 1945 to join in the appeal of a case on which another attorney had been working for a period of about four years. The taxpayer was to share in the contingent fee only in the event that the outcome was favorable. In 1946 there was a favorable disposition of the case and the taxpayer claimed the benefit of § 107 (a) of the Internal Revenue Code, even though the services which he performed covered a period of only about thirteen months. The district court determined that a joint venture existed and that this relationship qualified as a partnership under § 107 (a).¹⁰ Then the court held that the taxpayer was entitled to spread the fee over the entire period during which the services were rendered. In reversing, the circuit court, assuming that there was a joint venture, held that the joint venture did not exist prior to 1945 and, consequently, the taxpayer could not

months where the payment of 80 per cent or more of total compensation is received prior to completion of services. U. S. TREAS. REG. 118, § 39.107-1 (1953).

⁷ Thus this section is available to doctors, lawyers, accountants, executors, architects, consultants, or anyone who may render personal services and meet the other requirements.

INT. REV. CODE § 107(b) provides for similar treatment of income received by individuals from artistic works or inventions.

INT. REV. CODE § 107(d) provides somewhat similar treatment for the back pay received by an individual under specified circumstances.

⁸ For 107(a) problems in general, see 29 A. L. R. 2d 592 (1953); Comments, *Current Problems Under I. R. C. Section 107*, 48 N. W. U. L. R. 51 (1953); Bayly, *Proper Use of Section 107 Lessens Tax Burden on Lump-Sum Income*, 96 J. ACCOUNTANCY 582 (1953); Note, *Section 107(a) and the Partnership*, 65 HARV. L. REV. 1193 (1952); Tannenbaum, *Recent Developments Under Section 107*, 9 INST. FED. TAX. 381 (N. Y. U. 1951).

⁹ 204 F. 2d 25 (7th Cir. 1953), reversing 107 F. Supp. 499 (N. D. Ill. 1952), cert. denied 74 Sup. Ct. 42 (1953).

¹⁰ INT. REV. CODE § 3797(a)(2) provides, in part: "The term 'partnership' includes a . . . joint venture . . . by means of which any business, financial operations, or venture is carried on. . . ."

tack on the services rendered by his partner in order to meet the thirty-six month requirement. Furthermore, since there was no evidence that the compensation received by the taxpayer covered any of the services rendered prior to the formation of the joint venture, the fee was considered to cover only current services.

Section 107 was brought into the law by the Revenue Act of 1939 and its provisions then covered compensation received for personal services rendered "by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services. . . ."¹¹ Under this statute it was held that a taxpayer could not tack on the individual services of his new partner rendered prior to the formation of the partnership.¹² Under the prior law, the statutory language seemed to make it plain that a partner must actually participate in the services throughout the required time.

An amendment in 1942 changed § 107 (a) of the Internal Revenue Code to its present form.¹³ One of the changes liberalized the requirements so that a partner who shares in long-term compensation may be entitled to the benefits of the section, even though he performed none of the services.¹⁴

If a partner is a member of the partnership during the time in which the services are rendered, he is entitled to the benefits of § 107 (a), providing the other requirements are met, regardless of whether or not he participates in the work.¹⁵ In *Elder W. Marshall*,¹⁶ where a new

¹¹ Revenue Act of 1939, § 220, 53 STAT. 878 (1939).

¹² Ralph G. Lindstrom, 3 T. C. 686 (1944), *aff'd*, 149 F. 2d 344 (9th Cir. 1945).

¹³ Revenue Act of 1942, § 139, 56 STAT. 837 (1942).

¹⁴ The Congressional intent was stated in the following language: "In order for section 107(a) to be applicable, it is not necessary that the individual who includes in his gross income compensation for such personal services be the person who rendered such services. For example, a partner who shares in compensation for such personal services rendered by the partnership may be entitled to the benefits of section 107(a), notwithstanding that he took no part in the rendering of such services. Likewise, in community property states, the spouse of a person who renders such personal services may be entitled to the benefits of section 107(a)." SEN. REP. NO. 1631, 77th Cong., 2nd Sess. 109 (1942).

¹⁵ Although the partner does not perform any of the particular services he is a part of the partnership for the required time and his share of partnership income represents a return from all partnership services.

¹⁶ 14 T. C. 90 (1950), *aff'd per curiam*, 185 F. 2d 674 (3d Cir. 1950); *accord*, Burnham Enersen, 1950 P-H MEMO. DEC. ¶ 50,024 (1950), *aff'd per curiam*, 187 F. 2d 233 (9th Cir. 1951); Sigvald Nielsen, 1950 P-H MEMO. DEC. ¶ 50,025 (1950), *aff'd per curiam*, 187 F. 2d 233 (9th Cir. 1951). In each of these cases the new partner was an employee of the firm before being made a partner. In Burnham Enersen, *supra*, the partner, as an employee, participated in the services from the beginning. However, this factor does not seem to be an important element in the court's decision.

In *Elder W. Marshall*, *supra*, the court noted that the admission of a new partner did not bring about a dissolution of the old firm or create a new one, so that it could not be argued that the services were not rendered by the same partnership. The opinion cited *Callahan v. War Contracts Price Adjustment*

partner was admitted to the firm less than thirty-six months prior to the receipt of the qualifying fees, the court held that he could avail himself of the benefits of the statute and spread his share of the fees back to the beginning of the services. The court held that it is "the status of the recipient of the income in the year of receipt and not either his status in prior years . . . or the identity of the individual who contributed the services that is made to govern the application of section 107. . . ." ¹⁷

However, in a later case law partners were not allowed to spread back their share of long-term compensation where a different partnership had rendered the services.¹⁸ The taxpayers were special partners in a law firm which had performed services for an estate. The firm was dissolved due to the bankruptcy of one of the partners and a second partnership was formed by the same parties. The taxpayers' status remained the same as special partners with no interest in the assets. The second partnership was dissolved because of the death of a partner. A third firm was organized in which the taxpayers were general partners owning a percentage interest in the assets, and this firm purchased the claim against the estate from the first firm at public auction. Upon the collection of the claim the taxpayers claimed that their share represented payment for services rendered by them as members of the first firm. The court held that the controlling factor was that the partnership receiving the income was not the partnership which performed the services and, therefore, § 107 (a) was not applicable. The court stated that the amendment in 1942 "did not dispense with the requirement that the partnership through which the taxpayer received his income, must have performed the services for which the income is paid."¹⁹

The decision in the *Van Hook*²⁰ case appears to be sound. The court's main consideration was the purpose for which § 107 was enacted and that was to provide relief from the hardship resulting from the receipt of long-term compensation in one year and subjecting it to tax at higher surtax brackets.²¹ The court noted that the 1942 amend-

Board, 13 T. C. 355 (1949) and the Uniform Partnership Act §§ 29, 31.

But see dissenting opinion, 14 T. C. at 95 (1950). Three judges in the Tax Court (Hill, Leech and Arnold) dissented on the following grounds: (1) A new partnership is formed when a new partner is admitted. The Uniform Partnership Act does not change the common law rule that the old partnership is ended. (2) The compensation received by the new partner was to cover only services since admission.

¹⁷ 14 T. C. at 94, 95 (1950). § 107(a) has been applied to income earned by a husband but attributable to his wife in a joint return filed under the income splitting provisions. *Hofferbert v. Marshall*, 200 F. 2d 648 (4th Cir. 1952).

¹⁸ *Sovik v. Shaughnessy*, 191 F. 2d 895 (2d Cir. 1951).

¹⁹ 191 F. 2d at 896 (2d Cir. 1951). ²⁰ See note 9 *supra*.

²¹ 204 F. 2d at 27 (7th Cir. 1953). The court cited SEN. REP. No. 648, 76 Cong., 1st Sess., p. 7.

ment eliminated the requirement that the recipient of the compensation be the one who performs the services, but the court emphasized that "there is nothing in the legislative history to indicate that Congress abandoned the 'burden' theory which was the motive for enacting the original legislation."²² In this case it is obvious that the compensation received by the taxpayer was for the services he had rendered and those services covered only a thirteen month period.

It is submitted that this "burden" test represents a desirable approach to the problem of the new partner in § 107 (a) situations. It seems that the *Marshall*²³ rationale is an unwarranted extension of the purpose behind the statute, even though the situation came under the literal language of the section, because the compensation received by the new partner was for current services although it was measured, in part, by long-term compensation. Perhaps the *Marshall* line of cases may be justified by the fact that in each of these cases the new partner was a former employee. However, under the "burden" test this should not be significant because the employee is paid for his services. Nevertheless, the Bureau of Internal Revenue has announced that it would follow these cases.²⁴

The *Van Hook* decision appears to be a justifiable limitation on the scope of § 107 (a) of the Internal Revenue Code.

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Torts—Malicious Prosecution—Public Officers

It would seem that all persons capable¹ of instituting, or causing to be instituted, a malicious prosecution² without probable cause should

²² 204 F. 2d at 27 (7th Cir. 1953). ²³ See note 16 *supra*.

²⁴ In G. C. M. 26993, 1951 INT. REV. BULL. No. 22 at 2, the Bureau of Internal Revenue announced that it would follow the *Marshall* line of cases (see note 16 *supra*), and noted that in each of these cases there was a proper business motive. It stated that a partner would be entitled to allocate his share of long-term compensation over the entire period "notwithstanding the fact that part of the services" were rendered prior to the admission of the partner.

One author has suggested the possibility that the Bureau may oppose allocation where *all* of the work was done prior to the admission of the new partner, because of the wording of G. C. M. 26993, *supra*, quoted above. For this point and for a discussion of several partnership questions that have not been considered by the courts see note, 65 HARV. L. REV. 1193, 1197 (1952).

¹ It is held in some instances that a mentally incompetent person, or an infant, is not capable of instituting a malicious prosecution. 34 AM. JUR., *Malicious Prosecution* § 84 (1941).

² In order to establish an action for malicious prosecution, the plaintiff must prove (1) that the defendant instituted or procured the institution of the criminal prosecution against him; (2) that it was with malice; (3) that the prosecution was without probable cause; and (4) that it was terminated in favor of the plaintiff in the action. *Alexander v. Lindsey*, 230 N. C. 663, 55 S. E. 2d 470 (1949). No action will lie for the prosecution of a civil action with malice and without probable cause, where there has been no arrest of the person or seizure of his property. *Jerome v. Shaw*, 172 N. C. 862, 90 S. E. 764 (1916). Generally, see 34 AM. JUR., *Malicious Prosecution* §§ 1-171 (1941).