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PRATT AND DEDUCTIONS FOR PAYMENTS TO PARTNERS

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I. INTRODUCTION

When does a deduction result from a compensation or interest payment a partnership makes to one of its members? Controversy and confusion concerning this fundamental question have existed throughout the history of our income tax. Prior to the Internal Revenue Code of 1954,¹ neither salaries paid to partners nor interest paid them on their capital contributions were deductible in the computation of partnership taxable income or loss. In certain situations, however, partners were permitted to directly deduct portions of payments made to fellow partners. A major change was made by section 707 of the 1954 Code, which specifically authorizes partnership deductions for certain types of payments to partners. Until quite recently, there had been remarkably little judicial or administrative authority interpreting the provision, which has come to be relied upon quite extensively. Real estate partnerships, for example, frequently allocate promoters a percentage of gross receipts for their managerial abilities, and interest on any sums they loan to the partnership. Although the Tax Reform Act of 1976² contained numerous changes to and clarifications of the partnership provisions of subchapter K, it dealt with only one small facet of the member payment issue. It failed to clarify the basic principles that determine when deductions may be claimed for payments to partners. Within a relatively few months after the passage of the 1976 Act, the Fifth Circuit affirmed in part and reversed in part the Tax Court's decision in *Edward T. Pratt*,³ which interpreted and applied sections 707(a) and 707(c). The purpose of this paper is to explore the reasoning and aftermath of *Pratt*, which is an extremely significant decision in the long and troubled history of the treatment of payments to partners.

II. PRE-1954 CODE DEVELOPMENTS

The law of partnerships has long been characterized by efforts to identify those issues that will be resolved in accord with the entity theory of partnerships and those that will be resolved in accord with an aggregate

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¹INT. REV. CODE OF 1954, as amended [hereinafter "CODE" or "1954 CODE"].

²The Tax Reform Act of 1976, H.R. 10613, Pub. L. No. 94-455 [hereinafter "1976 Act"].

³64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

theory of partnerships. The dichotomy existed under state law long before there were any questions of federal income taxation of partners and partnerships. Traditionally, the common law aggregate approach declined to recognize the partnership as a separate legal personality. The aggregate approach viewed the partnership as nothing more than a conduit for the collection of individuals it embraced. Opposed to the aggregate approach was the entity theory, which viewed the partnership as an independent legal personality. As the state law of partnership developed, the adoption of the entity approach was urged on the ground that it was a feature of the law merchant that reflected business reality more accurately than the aggregate or conduit theory. Ready acceptance of the entity theory was probably impeded by two nineteenth century common law preconceptions. The first was the notion that the separate legal personality of a business organization is associated with relieving its owners from personal liability. The second was the related notion that organizational personality was a special something to be dispensed only by the legislature. Neither of these notions transferred readily to the relations of partners, who were unlimitedly liable and whose relation as such could be judicially established independent of their intent. Tension between the two theories continues under state law in part because the Uniform Partnership Act is a product of men who espoused opposing theories. Although the Uniform Act does not expressly adopt the entity theory, entity notions permeate.⁴

Tension between the two approaches exists in federal income tax law even though none of our general revenue codes has ever taxed partnerships as entities.⁵ A certain amount of schizophrenia is unavoidable as the law now stands. Although the partnership is not a separate tax-paying entity,⁶ it is a separate entity for the purposes of computing, reporting, and allocating the economic and tax consequences of partnership activities. The partnership has its own taxable year⁷ and it, rather than the individual partners, makes the basic decisions with respect to the computation of partnership income.⁸ It determines, for example, the method of computing depreciation of partnership property,⁹ whether to use a cash or accrual

⁴See J. CRANE AND A. BROMBERG, *LAW OF PARTNERSHIP* 16-29 (1968).

⁵The War Revenue Act of 1917 is a notable supplement to the basic revenue code because it imposed an income tax on partnerships as entities. War Revenue Act of 1917, § 201, 40 Stat. 300, 313, 65th Cong., Sess. I, Ch. 63 (1917):

Sec. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of any corporation, partnership, or individual, a tax . . . equal to the following percentages of net income

The tax was based on the ratio of "net income" to "invested capital for the taxable year," and was supplemental to taxes imposed by the Revenue Act of 1916, which provided, in part, as follows:

(e) Persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid under the provisions of this title.

Revenue Act of 1916, 39 Stat. 756, 762, Pub. L. No. 271, 64th Cong., Sess. I, Ch. 463 (1916).

⁶CODE § 701.

⁷CODE § 706.

⁸CODE § 703(b).

⁹CODE § 167.

method of accounting,¹⁰ and whether to elect to report income under the installment method.¹¹

Prior to the 1954 Code it was clear that salaries paid to partners could not be deducted in the computation of partnership taxable income or loss.¹² This conclusion was explained in terms of the aggregate theory of partnerships. A man working for a partnership was not viewed as working for a separate entity, he was viewed as working for a collection of individuals. He who worked for his own partnership, therefore, was viewed as partly self-employed and partly working for his fellow partners. It was said that a man may not, in contemplation of law, pay a salary to himself, either directly or through a partnership. No matter how labeled, the theory went, a partner's "salary, so-called," was merely a share of partnership profits. Interest payments to partners received the same treatment.¹³ This approach generated controversy over the appropriate tax treatment of payments that could not be said to consist entirely of partnership profits because they exceeded partnership profits. In short, it was rationalized that the only possible source of payments in excess of profits was partnership capital. An aggregate theory of partnerships was applied to allow each partner to deduct the amount by which his capital had been depleted by salary and interest payments to his fellow partners. To the chagrin of the Service, this approach enabled some partners to treat portions of their salaries as non-taxable returns of their own capital. To the chagrin of all concerned, the computations associated with this approach were exceedingly complicated.

*Augustine M. Lloyd*¹⁴ is generally considered the classic pre-1954 Code case on the treatment of payments to partners. *Lloyd* involved an attempt by the Service to tax the three managing partners of a six-person partnership on the entire amount of "salary" payments they received. Although the partnership reported a taxable income of only \$8,751, which the Board also referred to as its "net income" and "earnings," the managing partners' salaries totaled \$21,600. The partnership agreement authorized the three to "pay to themselves such salary as they may deem reasonable," and further provided that the salaries were operating expenses that were not to be charged against their interest in partnership assets or profits. In addition to the salary, each of the three shared in partnership book income or loss, computed by subtracting the salary payments, in accordance with his contribution to partnership capital. The partnership internally computed a \$12,848 book loss for the year in question.

The Board held that the partners did not have to pay tax on the entire amount of their salaries because it was "evident" that the salary each received was "not the measure of his gain."¹⁵ It felt that no partner should be

¹⁰CODE §§ 446(c) and 703(b); Treas. Reg. § 1.703-1(b) (1974).

¹¹CODE § 453.

¹²S. U. Tilton, 8 B.T.A. 914 (1927), *acq.*, VII-1 CUM. BULL. 31 (1928).

¹³John A. L. Blake, 9 B.T.A. 651 (1927), *acq.*, VII-2 CUM. BULL. 3 (1928).

¹⁴15 B.T.A. 82 (1929), *acq.*, VII-1 CUM. BULL. 27 (1929).

¹⁵*Id.* at 85.

There was but one source from which the payments made to the petitioners as salaries, in excess of the partnership earnings, could be made, and that was the capital contributions of the partners. So the gain of each of the petitioners could not be greater than the excess of the amount which he received over and above his proportionate share of the partnership loss.

taxed on any amount greater than his "net gain," which it deemed to be his salary reduced by his prorata share of the partnership's book loss, which it referred to as "loss of capital." It then addressed the problem

of determining how . . . the income and loss of each petitioner is to be accounted for so that no one of them will be required to pay tax on any greater amount than . . . his net gain.¹⁶

To emphasize, the Board did not allocate among the partners the results of a computation it made at the partnership level. Rather, it computed the taxable income or loss of each partner as follows. First, each salary constituted taxable income to the extent it represented the recipient's share of the taxable income reported by the partnership. Proceeding from the fact that the combined salaries exceeded partnership taxable income, the Board allocated the entire partnership taxable income among the three salaried partners in accordance with their salary-sharing ratios. Second, each salary also constituted taxable income to the extent it was "paid out of the capital" of fellow partners. Conversely, no partner's salary constituted taxable income to the extent it was paid out of his own capital. Each recipient's general profit-sharing ratio was used to determine how much of his salary that was not traceable to partnership taxable income was traceable to the capital accounts of his fellow partners. Finally, the overall profit-sharing ratio was used to compute how much "capital depletion" each partner had suffered as a result of the salary payments made to his fellow partners. The Board said that each partner could deduct the capital depletion he suffered on account of the expenses because they were ordinary and necessary. To sum up in one unavoidably complicated sentence, each partner received taxable income to the extent his salary represented partnership taxable income, to the further extent it represented a depletion in the capital of his fellows, but from which he was permitted to deduct the amount by which his own capital had been depleted by salaries paid to his fellows.

Lloyd was a boon to both salaried and non-salaried partners. It permitted salaried partners to avoid paying tax on portions of "salaries" that would have been fully taxable had they come from unrelated parties. They were permitted to trace their salaries to their source to demonstrate that they did not consist entirely of taxable income and outlays of fellow partners. It appeared to follow quite logically from *Lloyd* that, for example, a partner's "salary, so called" was completely non-taxable if it was traceable entirely to tax-exempt interest income.¹⁷ *Lloyd* benefitted all partners because it permitted them to deduct directly portions of salaries that could not be deducted at the partnership level. It did so by permitting them to individually expense the amounts by which their capital accounts has been charged for the salary payments of their fellow partners. *Lloyd* did not discuss any limit on the ability of partners to claim that charges against their capital accounts support exclusions from income or direct deductions. Is it sufficient that capital account has been charged, or must it also be shown that the charge reflects something in the nature of an out-of-pocket expen-

¹⁶*Id.* at 86.

¹⁷See P. LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS 9, 39-42 (1952).

diture? Such is the stuff of *Joe W. Stout*,¹⁸ decided some thirty years after *Lloyd*.

Stout is a pre-1954 Code case that has received only slight attention even though it substantially restricts *Lloyd* and is particularly instructive for real estate partnerships. *Stout*, as *Lloyd*, involved an attempt by the Service to tax the full amount of "salary" partners received from their partnership for services. It also involved the extent to which partners could directly deduct portions of salaries paid to fellow partners. In November, 1951, five individuals formed a partnership to construct rental housing. They agreed to share "net profits" and "net losses" in accordance with their initial capital contributions, which aggregated a nominal \$2,500. Their partnership agreement designated three of them "to plan and supervise all construction work done by the partnership," in exchange for which each was to receive a salary equal to a fixed percentage of the cost of all construction. The agreement directed that the salaries were to be deducted in the computation of partnership net profit. It specifically provided that if salaries exceeded net income computed without regard to the salaries, the excess would constitute a loss to the partnership that would be borne by the partners according to the ratio of their capital contributions. The partnership borrowed \$1,075,700 from a bank to construct an apartment project, which was completed and fully occupied by the following July. The three salaried partners were paid \$99,349 for managing construction by the close of the partnership's fiscal year on August 31, 1952. The following day, the completed project was conveyed to a newly organized corporation in exchange for the stock of that corporation. As part of the exchange, the corporation assumed all partnership liabilities attributable to the project, including the \$1,075,700 bank loan.

Pursuant to the agreement, the salaries were treated as an expense on the partnership books and a \$114,692 loss was computed and charged among the partners in accordance with the ratio of their capital contributions. For tax purposes, the partnership reported a loss of \$15,342. The partnership return described the salaries as "withdrawals" that resulted in substantial deficits in the capital accounts of each of the five partners. Each nonsalaried partner claimed a deduction in the amount of the "distributive share of net loss of the partnership" charged against his capital account. Similarly, the managing partners offset their salaries by the amounts their capital accounts had been charged with book loss.

The Service attempted to distinguish *Lloyd* rather than challenge it head-on. First, it argued that the salaries in *Stout* should not be treated as distributions of partnership capital and profits because they were not paid to the partners in their capacity as partners. It stressed that the partners paid to manage construction in *Stout* had been paid "to perform a specific, technical nonrecurring service, and [were] dealing with the partnership as would a third party."¹⁹ The court rejected this argument on the ground that the salaries were paid pursuant to the provisions of the partnership

¹⁸31 T.C. 1199 (1959), (hereinafter referred to as *Stout*), *aff'd in part and rem'd sub nom de Rogers v. Commissioner*, 281 F.2d 233 (4th Cir. 1960).

¹⁹31 T.C. 1208 (1959).

agreement and not pursuant to a separate contract for services. Accordingly, the amounts were treated "as distributions pursuant to the partnership agreement."

Second, the Service attempted to confine *Lloyd* to situations in which the charges against capital accounts represent "in fact" depletions of partnership assets. *Stout*, it asserted, did not involve asset depletion because the partnership "simply substituted for cash a rental housing project; the 'salaries' were capital expenditures for the buildings."²⁰ Perhaps because the absence of capital depletion was urged on the ground that a capital asset had been created, two independent arguments against deductibility were slurred together before the Tax Court: (1) the charge against partners' capital accounts did not represent an actual economic outlay necessary to support a deduction; and (2) the economic outlay, if any, was capital in nature.

The Tax Court focused on the absence of an economic outlay and stressed that the charges against capital accounts did not represent an economic loss to the partners. It distinguished *Lloyd* on the ground that the partners there had contributed cash sufficient to meet the salary payments made in excess of partnership income. Stated differently, it confined *Lloyd* to situations in which the charges against capital accounts reflect that payments have actually been made out of cash contributions. The Tax Court said it was "obvious" that no more than \$2,500 of the total salaries paid in *Stout* "could have been paid from the contributions of the partners."²¹ The remainder, it said, must have been paid from the proceeds of the construction loan. It held that the total amount a partner "is entitled to exclude from taxable income, either by return of capital or deduction, cannot be greater than his total contribution"²²

The Tax Court was not swayed by the provision in the partnership agreement that salaries in excess of net income were to be borne by all partners in accordance with their overall sharing ratio.

[A]s we construe the partnership agreement, it merely means that the capital accounts of the partners were to be charged proportionately and would be in this way a factor upon a division of profits or assets at some future time. Each partner's capital account was proportionately charged, resulting in a deficit in each such account. It does not appear that any of the partners have paid in more capital.²³

The partners argued that they had made the equivalent of additional capital contributions by incurring personal liability on the construction loan. The court said it was "problematical" whether the personal liability would ever be called on. The partners were on a cash method of accounting, and the possibility of future resort to their personal liability was not sufficient "to render the claim of right doctrine inapplicable" to the partners who received salaries. Nor was it sufficient to entitle any partner to salary payment deductions in excess of his actual cash contribution.

²⁰*Id.*

²¹*Id.*

²²*Id.* at 1209. Compare Treas. Reg. § 1.752-1(a) (1960).

²³1 T.C. 1209-10 (1959).

The Tax Court recognized that as it was discarding the *Lloyd* rationale for permitting deductions for salary payments it was also discarding the *Lloyd* rationale for including salaries in income. Recall that *Lloyd* said that partners' salaries are taxable to the extent they constitute partnership taxable income and to the further extent they constitute transfers from the capital of fellow partners. *Stout* involved no partnership taxable income and a relatively insignificant amount of contributed capital.

Nevertheless, we think that since the full amount of [salary] was received . . . under a claim of right and without restriction as to disposition, that amount, less the return of capital [limited to actual capital contribution], constitute taxable income to [the partner] under the broad provisions of [the predecessor of section 61(a)].²⁴

On appeal, the Fourth Circuit agreed that the salaries should be taxed except to the extent they represented a return of actual capital contribution and also agreed that losses that could be reported from salaries were limited to the amount of cash contributions. It further agreed that liability on the construction loan was not the equivalent of a cash contribution:

[W]hile the partners may have had a technical liability for the debt, at least until September 1, 1952, it does not appear that it was ever intended that they should pay it. The corporation's assumption of the debt on September 1, 1952 suggests that no part of the debt will be paid by the partnership or by the partners as individuals and that was the plan from the outset. If the obligation to repay the borrowed funds is not, in a practical sense, that of the individual partners, the proceeds of the loan need not necessarily be regarded as their contributed capital.²⁵

The Fourth Circuit took a somewhat different approach to the "primary contention of the Commissioner . . . that the salary disbursements occasioned no loss." It questioned whether the salaries were a capital expenditure of the partnership:

Such a fee, similarly computed, paid to a builder who was a stranger to the partnership would have been capitalized on the partnership's books and would have increased by that amount the book value of the project.

* * *

The usual rule applicable to salaries for income-producing services may very well give way in the face of the rule which requires the capitalization of the cost of capital assets.²⁶

It remanded for further consideration whether the disbursements should be treated as "anticipatory withdrawals of future earnings," its characterization of the Tax Court's initial approach, or as capital expenditures:

If [the salaries] be anticipatory withdrawals of future earnings, the partners will be entitled to exclusions from income, deductions or credits in future years if the partnership has earnings, or if they repay the bank loan. On the other hand, if the disbursements be treated as part of the cost of capital assets, the partnership, until August 31, 1952, and the corporation thereafter, will be entitled to additional depreciation allowances.²⁷

²⁴*Id.* at 1209.

²⁵281 F.2d at 236.

²⁶*Id.*

²⁷*Id.* at 237.

No further opinion issued after remand, and the question went unanswered, perhaps because the 1954 Code had intervened to answer a great many questions about partners' salaries.

In summary, prior to the 1954 Code the treatment of salary and interest payments to partners was complicated and unclear. Too little was explained by the basic rule that such payments constituted distributions of partnership profits not deductible in the computation of partnership taxable income or loss. Because *Lloyd* and the General Counsel's Memorandum that purported to follow it²⁸ permitted some partners to trace their salaries to returns of their own capital and others to trace their capital to salaries expensed to their fellow partners, it was assumed that salaries could also be traced to tax-exempt or preferred income and treated accordingly.²⁹ Complications other than computational arose from the development of limitations on the *Lloyd* tracing approach. One was the principle that a transaction between partnership and partner will be treated as a transaction with a third party if it is entered into by a partner other than in his capacity as a partner. This argument was occasionally successful,³⁰ although it was never very clear when it would be invoked by the Service and the courts. Another limitation on *Lloyd* was the principle that charges against capital accounts can be scrutinized on a case-by-case basis to see if they represent sufficiently current and substantial economic outlays to support deductions or exclusions.³¹ Another limitation was the notion that partnership doctrine cannot be used to deduct outlays of a capital nature.³² The development of each of

²⁸G.C.M. 6582, VIII-2 C.B. 200 (1929), *declared obsolete*, Rev. Rul. 69-31, 1969-1 C.B. 307.

²⁹*Supra* note 17.

³⁰In *Shirley v. O'Malley*, 91 F. Supp. 98 (D.Neb. 1950), a partnership was held entitled to deduct rental paid to its two members of equipment rented from them. In *H.H. Wegener*, 41 B.T.A. 857 (1940), *aff'd*, 119 F.2d 49 (5th Cir. 1941), one of three equal joint venturers was held taxable on the entire amount of net compensation he received from his joint venture for drilling oil wells. His argument that one-third of the amount should be treated as a return of his own capital was rejected because he drilled for his partnership "as any outsider might have done," 119 F.2d at 51. *See also* *Leif J. Sverdrup*, 14 T.C. 859, 866 (1950); *Harvey M. Toy*, 1942 T.C.M. (P-H) ¶ 42,542.

³¹In *George D. Rosenbaum*, 16 T.C. 664 (1951), *aff'd on reh.*, 18 T.C. 35 (1952), general partners were not permitted to deduct the amounts by which their capital accounts had been charged as the result of a compromise of an internal partnership dispute:

[T]he compromise did not entail a liquidation of the partnership or the disposition of the interest of any partner. It was a capital transaction and its net effect was to enlarge the partnership interests of the senior partners and to reduce the partnership interests of the junior partners.

16 T.C. at 670. For a case in which partners were held to realize income because of increases in their capital accounts from transfers from the capital accounts of their fellow partners, *see Harry W. Lehman*, 19 T.C. 659 (1953).

³²In addition to *Stout*, *see H. H. Wegener*, *supra* note 30, in which a joint venturer was not permitted to treat a portion of his payment for drilling oil wells for the joint venture as a return of his own capital:

The \$130,594.50 which was paid to petitioner by [the joint venture of which he was one-third owner] was merely changed from capital assets in cash to capital assets consisting of oil wells, in which petitioner retained the same undivided interest he had in the cash. He can not, therefore, be said to have subtracted from the newly acquired assets a part of his capital investment therein and at the same time continue to hold an equal interest with his coadventurers in the property. He cannot retain his capital in the joint venture and withdraw it too.

41 B.T.A. at 862. *See also* *George D. Rosenbaum*, *supra* note 31.

these notions can be viewed as part of a gradual shift toward the entity approach with respect to salary and interest payments to partners.³³ The shift is highlighted by the statements in *Stout* that partners' salaries are ordinary income under basic principles governing compensation rather than under partnership doctrine. While the shift was still equivocal in the courts it was mandated by the Congress in the 1954 Code even more clearly than it had been decades earlier in the Uniform Partnership Act.

III. THE 1954 CODE

The House and Senate Reports introduce the partnership provisions of the 1954 Code with a statement in the nature of a declaration of war against the confusion that had dominated the partnership area:

The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result partners today cannot form, operate, or dissolve a partnership with any assurance as to tax consequences.³⁴

The confusion was said to be particularly unfortunate because of the great number of businesses, particularly small businesses and farming operations, conducted in the partnership form. Accordingly, "simplicity, flexibility, and equity as between the partners" were the principle objectives of the first comprehensive statutory treatment of partners and partnerships.

Congress sought to simplify the area of partnership payments to partners by providing a "statutory pattern" for transactions between a partner and his partnership:

SEC. 707 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP.

(a) Partner Not Acting in Capacity as Partner. — If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

* * *

(c) Guaranteed Payments. — To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partner-

³³See, e.g., *Shirley v. O'Malley*, 91 F. Supp. 100 (D. Neb. 1950):

It is true . . . that if the partnership is under a binding liability to one of the partners for the expense, that it should be allowed as a partnership deduction.

* * *

It is not necessary for the decision in this case to distinguish between the "aggregate" and "entity" theory of partnerships. The hybrid nature of any partnership makes it necessary in certain instances to recognize it as a unit separate and distinct from its members. . . . It is clear that it would be stretching the "aggregate" theory of partnerships to hold that under the conditions of this case the plaintiff was merely renting equipment to himself. Especially in view of the fact that he would be liable for one-half of any loss occasioned by the equipment rentals, but would not be entitled to one-half of the rentals paid by the partnership since he did not own nor rent one-half of the equipment to the partnership.

³⁴H. R. REP. NO. 1337, 83d Cong., 2d Sess. 65 (1954) [hereinafter "HOUSE REPORT"]; S. REP. NO. 1622, 83d Cong., 2d Sess. 89 (1954) [hereinafter "SENATE REPORT"].

ship, but only for the purposes of section 61(a) (relating to gross income) and, *subject to section 263, for purposes of section 162(a)* (relating to trade or business expenses).

Subsection (b), not reproduced above, is an exception to the general rule of subsection (a) that disallows losses and taxes gain as ordinary income in the case of certain sales or exchanges with a controlled partnership. The italicized portion of subsection (c) was added by the Tax Reform Act of 1976 to make clear that otherwise capital expenditures are not made currently deductible by section 707.³⁵

A. Section 707(a)

Section 707(a) provides the general rule that when a partner engages in a transaction with his partnership other than in his capacity as a partner, the transaction shall be treated as occurring between the partnership and a non-partner. We have seen that such a principle was occasionally applied by the courts prior to the 1954 Code.³⁶ The question is, therefore, whether subsection (a) was intended merely to approve of the holdings of these relatively isolated cases, or whether it was intended to render the principle more generally applicable.

It is clear that Congress intended to treat a wide range of transactions between partnership and partner as occurring between unrelated third parties. In general, with respect to sales of property and the rendition of services, the House and Senate Reports declare unequivocal Congressional intent to adopt an entity approach "because of its simplicity of operation"³⁷ With respect to partnership payments to partners of salary and interest in particular, the Senate Report's general explanation of provisions states:

The payment of a salary by the partnership to a partner for services again raises the problem as to whether the partnership is to be viewed as an entity or merely as an aggregate of the activities of the members. Under present law, fixed payments to a partner are not recognized as salary but considered as a distributive share of partnership earnings. This creates obvious difficulties where the partnership earnings are insufficient to meet the salary. The existing approach has been to treat the fixed salary in such years as a withdrawal of capital, taxable to the extent that the withdrawal is made from the capital of other partners. *Such treatment is unrealistic and unnecessarily complicated.* The House bill provides that payment of a fixed or guaranteed amount for services is to be treated as salary income to the recipient and allowed as a business deduction to the partnership. [Y]our committee . . . extends the rule to interest payments.³⁸

Note that the application of the entity approach to salaries and interest can be to the disadvantage of the recipient: although the entire payment is

³⁵The same result has been reached under 707(c) as it stood prior to the passage of the 1976 Act. Jackson E. Cagle, Jr., 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976); Rev. Rul. 75-214, 1975-1 CUM. BULL. 185. A related change, albeit one that does more than reiterate existing law, is effected by 1976 Act § 213 (b) (1), which adds section 709 to subchapter K to govern the treatment of partnership organization and syndication fees.

³⁶*Supra* note 30.

³⁷HOUSE REPORT at 67; SENATE REPORT at 92.

³⁸SENATE REPORT at 92.

deducted in the computation of partnership taxable income or loss, it must be included in the ordinary income of the recipient. The entity approach, for example, prevents a partner from relying on *Lloyd* to claim that a portion of his salary should not be taxed as ordinary income because it represents a return of his own capital or is traceable to tax-exempt interest income.

What is not clear is the extent to which entity treatment of salaries and interest is required by section 707(a), the extent to which it is required by section 707(c), and the extent to which, if at all, the aggregate approach continues to apply. It is not clear, for example, whether the general explanation just quoted slurs together discussion of 707(a) and 707(c), or whether it ignores section 707(a) completely. The legislative history of section 707 almost completely ignores subsection (a). The entire "detailed discussion" of 707(a) is as follows:

Subsection (a) provides the general rule that a partner who engages in a transaction with the partnership, other than in his capacity as a partner, shall be treated as though he were an outsider. Such transactions include the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partner to the partnership or by the partnership to the partner. Transactions involving contributions of money or property to the partnership by the partner, or distributions of money or property by the partnership to the partner are not governed by this section.³⁹

The Regulations add that 707(a) transactions include loans of money or property between partnership and partner.⁴⁰

The Regulations suggest that 707(a) mandates entity treatment of transactions that are within the normal activity of partnership and partner:

Where a partner retains the ownership of property but *allows the partnership to use* such separately owned property *for partnership purposes* (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction *is treated as* one between a partnership and a partner not acting in his capacity as a partner.⁴¹

The transaction described is within the normal activity of the partnership insofar as it is specified to be in pursuance of partnership purposes. It is within the normal function of a partner because partners frequently loan property to their partnerships for partnership purposes to protect their partnership interests or to satisfy a perceived obligation to the partnership. Indeed, if the words "allow the partnership to use" have their ordinary connotation, the transaction would rarely be undertaken with a non-partner because no payment is made for the use of the property. The use of the words "the transaction *is treated as* one [with] a partner not acting in his capacity as a partner" also indicate that section 707(a) was intended to mandate entity treatment of transactions that fall within the normal interaction between partner and partnership.

³⁹Senate Report at 386. The language of the House Report is identical except insofar as it refers to the rendering of services "for pay" by the partner to the partnership. HOUSE REPORT at A226.

⁴⁰Treas. Reg. § 1.707-1(a) (1960).

⁴¹*Id.* (emphasis added)

The origin of 707(a) also indicates that it was originally intended to mandate entity treatment of salary payments to partners. Section 707(a) is based on virtually identical proposals of the American Law Institute and the American Bar Association:

[I]f a partner . . . receives payments from the partnership in exchange for services rendered by him to the partnership, or otherwise engages in a transaction with the partnership wherein he is not acting in his capacity as a partner, the transaction shall be treated as occurring between the partnership and one who is not a partner.⁴²

Both the American Law Institute⁴³ and American Bar Association⁴⁴ explanations state a clear intent to achieve simplicity by adopting an entity approach to the treatment of salaries to partners.

An intent to mandate entity treatment of salaries would explain why neither the legislative history nor the Regulations attempt to distinguish between transactions that are in a capacity as a partner and those that are not. The legislative history states only that 707(a) is not intended to apply to contributions or distributions. The Regulations add nothing more than the following two sentences, which constitute the only portion of the Regulations to deny 707(a) treatment:

However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph (c) (3) of § 1.731-1.⁴⁵

The reference to § 1.731-1(c)(3) offers no guidance on this point. That Regulation simply provides that "turnaround" contributions and distributions may be treated as exchanges.⁴⁶ Thus, for example, if property is "contributed" by one partner and immediately "distributed" to another partner, an exchange of property between the two partners may be deemed to have taken place.

Section 707(a) as finally passed differs from its ALI and ABA origins in two important respects. First, its basic structure is different. The ALI and ABA drafts specifically refer to payments to a partner for services, after which they refer generally to transactions in which a partner is "otherwise" not acting in his capacity as a partner. The removal of the specific reference to services followed by "or otherwise" leaves 707(a) susceptible to a literal interpretation that the only services covered are those performed by a part-

⁴²American Law Institute, Federal Income, Estate, and Gift Tax Project, Section X755(a) (January 1954 Draft). The entire Draft of the proposed subchapter on Partnerships and Partners is reproduced as Appendix A of Jackson *et al.*, *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 170-189 (1954). The proposal of the American Bar Association was virtually identical. See Appendix to the Statement on Behalf of the American Bar Association by Mark H. Johnson, Esq., *Forty Topics Relating to the General Revision of the Internal Revenue Code: Hearings Before the House Committee on Ways and Means*, 83d Cong., 1st Sess. 1371, 1374 (1953).

⁴³Jackson *et al.*, *supra* note 42 at 138-39.

⁴⁴*Forty Topics*, *supra* note 42, at 1380-81.

⁴⁵Treas. Reg. § 1.707-1(a) (1960).

⁴⁶Treas. Reg. § 1.731-1(c) (3) (1960).

ner "other than in his capacity" as a partner. Second, section 707(a) was finally enacted in tandem with 707(c), which has no counterpart in the ALI or ABA proposals. Section 707(c)'s specific reference to services made it inevitable that it would be difficult to define the respective applications of the two sections.⁴⁷

B. Section 707(c)

Section 707(c) embraces fewer types of transactions than 707(a). It does not embrace any payments running from partner to partnership, nor does it govern sales of property. It includes only payments by a partnership to a partner for services or for the use of capital, and only if those payments are determined without regard to partnership income. Guaranteed payments under 707(c) are included in the ordinary income of the recipient and deducted in the computation of partnership taxable income or loss provided they are not capital in nature.⁴⁸ Unlike 707(a), which treats the transactions it covers as third party transactions for all purposes, 707(c) treats the payments it covers as third party payments only for the purposes of sections 61(a) and 162(a).⁴⁹ As a consequence, a guaranteed payment is not considered an interest in partnership profits to limit the partnership's choice of taxable year, to determine whether losses will be disallowed on sales or exchanges, or to determine whether there has been an automatic termination of the partnership for tax purposes.⁵⁰ For the purposes of other provisions of the Code, "guaranteed payments are regarded as a partner's distributive share of ordinary income."⁵¹

Section 707(c) was added in the House out of fear that partnerships would be given excessive discretion to time the reporting of income if all salaries paid to their members were treated as paid to third parties. The fear appeared to be that salaries would be increased or decreased to suit the occasion. The House Report treats only "guaranteed salaries" as third party salaries:

A partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated to the extent of such amount like any other employee who is not a partner, and the partnership shall be allowed a deduction for salary expense. The amount of such salary shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income.⁵²

The American Bar Association Tax Section asked the Senate to reconsider the "without regard to income" language:

The restriction . . . is unnecessary to prevent tax avoidance, and is unrealistic considering the extent to which compensation is customarily tied with profits of the business. The Commissioner . . . and the courts can adequately protect the interest of the revenue in the extremely few cases where the Trea-

⁴⁷A. ARONSOHN, PARTNERSHIPS 14, n. 65 (1957).

⁴⁸Text accompanying note 35, *supra*.

⁴⁹The scope of the cross-reference to sections 61 and 162 has been the subject of litigation. See 1 A. WILLIS, PARTNERSHIP TAXATION 214-17 (2d ed. 1976).

⁵⁰Treas. Reg. § 1.707-1(c) (1960).

⁵¹*Id.*

⁵²HOUSE REPORT at A226-27.

sury will be unfairly deprived of tax through transferring income from one year to another by the employment of artificial salary.⁵³

The Senate amended 707(c) to include payments for capital, and directed in its Report that the timing of the inclusion of guaranteed payments would differ from the timing of payments from third parties:

The House provisions were amended by your committee to accord the same treatment as that provided in the case of guaranteed salaries to payments for the use of capital, to the extent the payments are determined without regard to partnership income. It should be noted that such payments, whether for services or for the use of capital, will be includible in the recipient's return for the taxable year with or within which the partnership year in which the payment was made, or accrued, ends.⁵⁴

Neither the House nor Senate Report gives any further guidance as to the meaning of the "without regard to income" limitation. Each uses the terms "guaranteed payments," "fixed salary," and "minimum annual amount." The House Report states that a partner who is guaranteed a minimum annual amount for his services "shall be treated as receiving a salary in that amount,"⁵⁵ and the Senate provides he shall be treated as receiving "a fixed payment in that amount."⁵⁶ Neither Report makes any express mention of salaries determined on the basis of a percentage of gross receipts or net profits. The Staff of the Joint Committee, however, explained as follows:

Where a minimum payment is guaranteed but the maximum depends on the net earnings of the partnership, it will be necessary to examine the intent of the partners

⁵³American Bar Association, Section of Taxation, Supplemental Statement Filed with the Senate Finance Committee in Connection with Hearings on H.R. 8300, *Hearings on H.R. 8300 Before the Senate Committee on Finance*, 83d Cong., 2d Sess. 343, 467 (1954).

⁵⁴SENATE REPORT at 387.

⁵⁵HOUSE REPORT at A227.

⁵⁶SENATE REPORT at 387. This statement is significant because it suggests a different result than that adopted in Treas. Reg. § 1.707-1(c) (1960):

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000. The income of the partnership is \$60,000, and C is entitled to \$18,000 (30 percent of \$60,000) as his distributive share. No part of this amount is a guaranteed payment.

The language from the *Senate Report* would appear to require that the entire \$10,000 in this example be considered a guaranteed payment. The approach taken by the Regulations, on the other hand, provides that guaranteed payment treatment shall only be accorded to the difference between the partner's minimum guarantee and his distributive share of partnership income before taking into account the guaranteed payment:

[I]f the partnership had income of \$20,000 instead of \$60,000, \$6,000 (30 percent of \$20,000) would be partner C's distributive share, and the remaining \$4,000 payable to C would be a guaranteed payment.

Thus, ironically, the Regulations require a consideration of the amount of partnership income in order to determine the existence and size of the guaranteed payment, that is, the amount supposedly determined without regard to income. Rev. Rul. 66-95, 1966-1 CUM. BULL. 169, which concerned a guaranteed minimum return on capital contributions to a limited partnership, rejected an attempt to draft around the Regulations:

The fact that a partnership agreement provides that, in the event a minimum payment must be made to certain partners, the payment shall in all respects be treated as if it were an expense of the partnership, does not control as to whether the entire minimum amount will be considered an expense for Federal income tax purposes.

in determining whether or not payments made under such an arrangement constitute salary [E]ven *when such income is to be treated as a salary* it is to be reported [at the same time as a distributive share of income].⁵⁷

This language is support for the proposition that payments based on gross receipts or net earnings may qualify for entity treatment under 707(c). That is, the inquiry into intent is to determine whether the payments represent an irrevocable obligation of the partnership rather than a withdrawal by the recipient of an anticipated share of future earnings or a loan to him from the partnership. The payments would be without regard to income if they were irrevocable and did not serve to reduce the recipient's share in future earnings or liquidation proceeds.⁵⁸ On the other hand, the payments would be with regard to income if they were treated as a partner's drawing charged against his capital account to reduce his share in partnership earnings or assets or represent a debt to the partnership. Thus, for example, a salary based on a percentage of gross receipts is made without regard to the income of the partnership if it is made independent of the profitability of operations and is not chargeable against the recipient's interest.⁵⁹

In conclusion, the legislative history is ambiguous with respect to whether 707(c) payments must be of predetermined dollar amounts. There are several reasons why it would be appropriate to interpret 707(c) to include binding partnership obligations to make percentage payment salaries that are not charged against the interest of the salaried partner. The first is that Congress showed a clear intent to avoid the "unrealistic and unneces-

⁵⁷Staff of the Joint Committee on Internal Revenue Taxation, Summary of the New Provisions of the Internal Revenue Code of 1954, 91 (1955) [hereinafter "Staff Report"] (emphasis added).

⁵⁸See the Service's argument before the Tax Court in *Pratt*, text accompanying notes 83-86, *infra*, that a binding payment of a percentage of gross receipts is not a drawing but a 707(c) guaranteed payment. In short, its position was that the purpose of Code § 707(c) is to distinguish between those payments that are actual part of a partner's distributive share and those payments that had no relation to the profit or loss of the partnership.

Note 85, *infra*. Compare the 1939 Code case of James L. Ruane, Sr., 17 T.C.M. (CCH) 865, 872 (1958) (citations omitted):

It is well settled . . . that, in the absence of an agreement to the contrary, a partner is not entitled to compensation for services rendered a partnership beyond his share of partnership profits. Therefore, withdrawals made by a partner, whether termed salary or not, in excess of his distributive share of partnership profits would be chargeable against his capital account, unless otherwise agreed to by the partners. Especially would that be true where, as here, those withdrawals exceeded partnership profits for the year. It was necessary that petitioners show that the payments received by Ross represented guaranteed payments of salary which the other members of the firm had agreed were to be treated as a business expense in the determination of partnership profits and losses.

⁵⁹Compare, e.g., the 1939 Code case of *Shirley v. O'Malley*, 91 F. Supp. 100(D. Neb. 1950), in which the court permitted the partnership to deduct rental payments made to its two members even though the allocation of the profits remaining after the rent was paid was based on the amount of rent paid to each partner:

We can only point out that the rental payments were in no way tied up or contingent upon the partnership profits in this case. It is true that the distribution of the profits was contingent upon the rental payments, but the converse obviously does not follow. The contradicted testimony of the partners was to the effect that the rental payments had to be made even if a loss resulted and the loss was to be shared equally.

sarily complicated" prior law and adopt, for the sake of simplicity, an entity approach to salaries paid to partners. The second is that the focus of legislative attention was on 707(c), rather than on 707(a), as the vehicle for requiring entity treatment. The third is that the simplicity achieved will cost little, if anything. Discussion of the adoption of the entity approach generally concluded that, apart from the matter of timing, there would be little difference in most cases in the result under the entity or aggregate approach.⁶⁰ The House fear of unbridled discretion to time income appears to be met by the Senate Report directive that guaranteed payments must be reported at the same time as distributive shares and as soon as paid or accrued by the partnership.

IV. THE PRATT CASE

A. *The Facts*

The taxpayers in *Edward T. Pratt*⁶¹ were the three general partners of two limited partnerships that had each been formed to purchase, develop and operate a particular shopping center. The three owned a combined 44 percent share of one partnership and a 27 percent share of the other. Each of them and both partnerships reported income on the basis of the calendar year. However, the partners were cash method taxpayers whereas their partnerships reported according to an accrual method. At issue was the proper treatment of amounts credited on the partnership books to accounts payable to the three general partners (a) for managing the partnership and (b) as interest on notes issued to them by the partnership.

The partnership agreements provided as follows with respect to the management fees at issue:

Such General Partners shall contribute their time and managerial abilities to this partnership, and each such General Partner shall expend his best effort to the management of and for the purpose for which this partnership was formed. That for such managerial services and abilities contributed by the said General Partners, they shall receive a fee of five (5%) percent of the Gross Base Lease Rentals of the said leases, and then the said General Partners shall receive (10%) percent of all overrides and/or percentage rentals provided for in said leases as a fee for such managerial services.

* * *

The General Partners shall give their personal services to the Partnership and shall devote thereto such time as they may deem necessary, without compensation other than the managerial fees are hereinbefore set out. Any of the Partners, General or Limited, may engage in other business ventures of every nature and description, independently or with others. . . .⁶²

⁶⁰See *A Proposed Revision*, *supra* note 42 at 138; Jackson *et al.*, *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1200 (1954); Statement of Mark H. Johnson, Esq., *supra* note 42 at 1383. Currently, elaborate allocation mechanisms are frequently used to separate tax benefits from cash benefits and allocate them differently. See generally Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. L. REV. 1, 37-45 (1977).

⁶¹*Supra* note 3.

⁶²64 T.C. 205 (1975).

The management fee thus assigned to the general partners as a class was allocated equally among the three. It was stipulated that the fees were reasonable and proper and that a like amount would have had to have been paid to an unrelated third party to manage the shopping centers. For each of the years in question, the fees were credited to accounts payable to the general partners and accrued and deducted by the partnerships in the computation of partnership taxable income or loss. The fees, however, were neither paid nor reported by the general partners during any of the years in question. Their position was that they, as cash method taxpayers, need not include the fees in income until actually received.

Each partnership also issued a note to the general partners in return for a loan. They agreed to repay principal plus "interest at the rate of 6 percent of the principal per annum without regard to the partnership receipts or income."⁶³ Little else is clear about the loans other than that they took place shortly after partnership formation and that the amounts of interest accrued were significant. Indeed, with respect to one of the partnerships, the annual interest accrued was from 31 to 52 percent greater than the management fees. The strategy with respect to the interest was the same as with the management fees. The interest was credited to accounts payable to the general partners and was accrued and deducted in the computation of partnership taxable income or loss. The interest payments were neither made to the general partners nor reported by them in any of the years in question.

B. *The Peculiar Posture of Pratt*

Pratt involved the least sympathetic situation for treating payments to partners as deductible expenses of the partnership. The general partners attempted to have their cake and eat it too—share today in deductions for items accrued but unpaid by their partnerships and at the same time don the hat of cash method taxpayers to postpone indefinitely tax liability for the credits that generated the deductions. In short, the gravamen of *Pratt* was the tax advantage being taken of the differential in accounting methods of partnership and partner. The Service did not challenge the arrangement on the ground that the credits to the accounts payable to the general partners were never intended to have economic effect. It had been stipulated:

Petitioners could have legally caused the two partnerships to pay the management fees and interest to them had they chosen to do so.

It was the intent of all the partners in [each partnership] that the management fees and interest were to be expenses to the partnerships.⁶⁴

Nor did the Service argue that the general partners were in constructive receipt of the amounts in question,⁶⁵ or that the interplay of accounting methods had resulted in a material distortion of income.⁶⁶ Rather, it made its attack solely within the confines of section 707.

⁶³64 T.C. 206 (1975).

⁶⁴64. T.C. 207 (1975).

⁶⁵See text accompanying note 78, *infra*.

⁶⁶See generally CODE § 446(b) and Treas. Reg. §§ 1.446-1(b) and (c) (1973).

In short, the Service sought to make 707 function in the partnership area in much the way section 267 functions in the corporate area. Section 267 disallows losses on sales or exchanges with a related corporation⁶⁷ and further provides that an accrual method corporation may not deduct trade or business or interest expenses it accrues to related persons unless they are actually paid within 2½ months after the close of the taxable year of the accrual.⁶⁸ The effect of the latter rule is to deny the deduction entirely. The general partners emphasized that 267 does not apply to partnerships, which the Tax Court accepted quite readily. The 267 Regulations,⁶⁹ however, which were referred to by the Tax Court, direct the reader to section 707 for the rules governing transactions between partner and partnership. Section 707(b), which deals with sales or exchanges with a controlled partnership, is based on section 267.⁷⁰ The Tax Court may have assumed that section 707(a) and 707(c) were intended to treat the problem of different accounting methods in an analogous way to section 267. The general partners tried to prevent the court from interpreting 707 in such a way by emphasizing that, if the partnerships had been corporations, the recipients had an insufficient ownership interest to bring 267 into play.⁷¹

Given that 707 does not contain a specific 267-type provision to limit the interplay of accounting methods, the Service argued in the alternative that the payments were not deductible in the computation of partnership taxable income or loss and that, if they were deductible by the partnership, they were also includible in the partners' income even though not actually received. The general partners argued that all the credits were deductible under 707(a), which, we have seen, has no counterpart to the 707(c) "paid or accrued" Regulation.

C. *The Interest on the Loans*

The Tax Court characterized the position of the general partners with respect to the interest payments as follows:

[The general partners] agree with [the Service] that under section 707(c) the interest on the notes are guaranteed payments but argue that these amounts

⁶⁷CODE §§ 267(a) and 267(b) (2) and (3).

⁶⁸CODE § 267(a) (2).

⁶⁹Treas. Reg. § 1.267(b)-1(b)(1)(1960).

⁷⁰CODE § 707(b)(3):

(3) Ownership of a capital or profits interest. — For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section.

⁷¹64 T.C. at 208:

Petitioners further argue that even were the provisions of section 267 applicable to partnerships they would not qualify as related taxpayers under the provisions of section 267 since they did not own over a 50 percent interest in either partnership. Petitioners suggest that if we do not accept the position that the partnerships are entitled to deduct the accrued management fees and interest expense and petitioners are not for that reason required to include these amounts in their incomes for the years in which the partnerships take the deduction, then, rather than including the items in the incomes of each petitioner, the basis of each one's partnership interest should be decreased to the extent of the accrued fees and interest as provided in section 1.267(b)-1(b) (2), *example* (1). Income Tax Regs.

The Tax Court said that the inapplicability of 267 rendered it unnecessary to consider the Regulation just cited.

are includible in their income only when received, and that the regulation making such payments includible in income by partners in the year paid or accrued by the partnership . . . is "an overextension of [the Service's] authority."⁷²

Not surprisingly, the Tax Court relied on the legislative history discussed earlier to uphold the "paid or accrued" Regulation.⁷³ On appeal, the general partners objected strenuously to the Tax Court's assertion that they had conceded the interest payments were guaranteed payments under 707(c).⁷⁴ They stressed that their primary argument was that the interest was deductible by the partnership under 707(a), and not under 707(c), and that their assertion of the invalidity of the 707(c) Regulation was merely a fall-back position.

The basic position of the partners was that 707(a) covers interest on loans from partners and that 707(c) embraces only "interest" on their capital contributions:

[T]he use by Congress of the well-defined and commonly understood term "capital" clearly indicates that . . . 707(c) is applicable only to guaranteed returns on capital contributions while . . . 707(a) applies to interest paid by a partnership to a partner on loans.⁷⁵

They stressed that the 707(a) Regulations specifically refer to interest on loans from partners and that the 707(c) Regulations do not. To treat the loans in this case as falling outside 707(a) and within 707(c), they argued, would render the 707(a) Regulations nugatory because if the loans in *Pratt* did not qualify under 707(a), none would:

The loan transactions in the instant case were straight loan transactions occurring subsequent to the formation of the partnerships and were neither contemplated or required by the limited partnership agreement of either.⁷⁶

At the very most, they said, the only loans that would fall within 707(c) would be those that were required of the partners in the partnership agreement.

In its Brief, the Government joined the taxpayers in their request that the Tax Court be reversed on the matter of interest payments and that they be held deductible under section 707(a) rather than under 707(c):

The Commissioner . . . concedes that, since there is no dispute . . . that taxpayers' loans . . . were bona fide loans (as opposed to, for example, disguised capital contributions), the loan transactions are to be treated under . . . Section 707(a) and that the interest accrued on such loans therefore does not constitute a "guaranteed payment" under Section 707(c). As a result, the rules for recognizing income regarding "guaranteed payments" . . . are inapplicable. Rather, taxpayers, as cash basis taxpayers, must recognize the interest payments when they are actually or constructively received by them.⁷⁷

⁷²64 T.C. 212-13 (1975).

⁷³Text accompanying note 54, *supra*.

⁷⁴Brief for Appellants at 17-18, *Pratt v. Commissioner*, 550 F.2d 1023 (5th Cir. 1977) [hereinafter "Brief for Appellants"].

⁷⁵Brief for Appellants at 21.

⁷⁶*Id.*

⁷⁷Brief for the Appellee at 7-8, *Pratt v. Commissioner*, 550 F.2d 1023 (5th Cir. 1977) [hereinafter "Appellee's Brief"].

In a footnote, the government warned that the doctrine of constructive receipt of income should prevent the result in the case but would not be urged for the first time on appeal.⁷⁸ Presumably, future cases involving 707(a) claims for deductions for interest on loans to partners might also be met with challenges by the Service that the "loans" do not represent genuine indebtedness, that they represent contributions to capital rather than debt,⁷⁹ or that the interest deductions, under the circumstances, represent a material distortion of income.⁸⁰

D. *The Management Fees*

The Tax Court characterization of the partners' argument about the management fees is similar to its characterization of their argument with respect to the interest payments:

Petitioners contend that the management fees credited to them fall within the provisions of either 707(a) or 707(c) and under either section are properly deductible by the partnership but not includable in their income for the years accrued by the partnership and credited to their accounts.⁸¹

Again, the characterization is somewhat misleading because the partners sought to have the fees treated under 707(a) in order to avoid the 707(c) "paid or accrued" Regulations. Although they apparently recognized it was unlikely that the "paid or accrued" Regulations would be invalidated, they made no attempt to argue that the payments were deductible in the computation of partnership taxable income or loss under any other provisions or Regulations than those of 707(a).⁸²

The Service argued that the management fees were guaranteed payments even though they were in the form of a percentage of gross receipts. *F. A. Falconer*,⁸³ it said, made clear that the substance of the "without regard to income" requirement, rather than the form of the payment in question, controls:

The touchstone for determining "guaranteed payments" is whether they are payable without regard to partnership income. And, in determining whether in a particular case an amount paid by a partnership to a partner is a "drawing" or a "guaranteed payment," the substance of the transaction, rather than its form, must govern. These are both factual matters to be judged from all the circumstances.⁸⁴

Falconer involved a member of a two person partnership who claimed that his salary payments were not guaranteed payments because they were sim-

⁷⁸*Id.* at 8 n. 4.

⁷⁹See Joseph W. Hambuechen, 43 T.C. 90, 100-01 (1964).

⁸⁰See generally CODE § 446(b) and Treas. Reg. §§ 1.446-1(b) and (c) (1973).

⁸¹64 T.C. 209 (1975).

⁸²*Id.* at 209:

Petitioners point to no provisions of the statute other than sections 707(a) and 707(c) under which management fees to partners for services to the partnership might be treated differently than such items were treated under the law prior to the enactment of the 1954 Code.

⁸³40 T.C. 1011 (1963).

⁸⁴40 T.C. 1015 (1963) (citation omitted).

ply withdrawals. The Tax Court held they were guaranteed payments because they had been treated by the partners as compensation for services, were subject to change only by mutual agreement, and were treated as partnership expenses that were to be paid even when the partnership was unprofitable. *Pratt* involved all these factors, said the Service, and the same result should follow even though the payments were based on gross rent receipts. The "without regard to income" requirement, it said, refers to net income, and does not require a predetermined dollar amount:

Code § 707 (c) and the regulations thereunder do not require a fixed salary. . . .

It is submitted that the purpose of *Code* § 707(c) is to distinguish between those payments that are actually part of a partner's distributive share and those payments that have no relation to the profit or loss of the partnership. Thus it appears that in substance the management fees in question were guaranteed payments.⁸⁵

In advocating that salaries in the form of a percentage of gross receipts constitute guaranteed payments, the Service urged an interpretation adopted by many in the real estate industry. Although 707(c)'s scope has never been clear, many have assumed that payments based on a percentage of gross receipts would satisfy the "without regard to income" requirement, even if payments based on a percentage of net cash flow would not.⁸⁶ The reasoning was that salaries in the form of a percentage of gross receipts are "guaranteed" because they constitute an enforceable obligation of the partnership independent of its profitability. The Tax Court found

no merit to such a distinction. The amounts of the management fees are based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income. To us it follows that the payments are not determined without regard to the income of the partnership as required by section 707(c)

. . . .⁸⁷

The Tax Court also rejected the taxpayers' argument that the management fees were deductible by the partnership pursuant to 707(a). It noted the lack of authority interpreting the "other capacity" requirement⁸⁸ and, ironically, turned for guidance to 1939 Code cases that had been cited by the commentators as part of the confusion that gave rise to the need for

⁸⁵Brief for Respondent at 22-24. Edward T. Pratt, 64 T.C. 203 (1975).

⁸⁶See, e.g., Sexton and Charyk, *Does the Recent Pratt Case Provide A Method of Insuring Guaranteed Payment Deductions?*, 43 J. TAX. 66 (1975). But see I A. WILLIS, *supra* note 49 at 214:

The present statute makes no change with respect to salaries or interest paid to a partner, if based on partnership income. As under prior law, such amounts are restored to partnership income and are reflected through adjustments to that partner's distributive share of taxable income. This treatment presumably would be applied regardless of whether the salary or interest is a percentage of net income or gross income. Compensation contingent on sales is a debatable point. Technically speaking, it is "determined without regard to the income of the partnership." On the other hand, its character is contingent, unlike the payment of fixed dollar amounts that were contemplated by the draftsmen as "guaranteed payments."

⁸⁷64 T.C. at 210 (1975).

⁸⁸64 T.C. 211 (1975).

section 707.⁸⁹ Its review of the 1939 Code cases moved the court to disqualify the fees from 707(a) because they had been paid to partners "for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement."⁹⁰ It raised, but did not decide, whether payments for the continuing services of a partner could ever be included in 707(a).

E. *The Fifth Circuit*

Because the taxpayers and the government joined in a request that the Tax Court be reversed on its treatment of the interest payments,⁹¹ the Fifth Circuit dealt only with the management fees. It said that the "sole issue" on appeal was

the correctness of the Tax Court's decision that the management fees payable to the . . . general partners . . . were includable in their income as part of their distributive share of partnership profits, or, in the alternative, as a "guaranteed payment" under § 707(c)⁹²

This is a rather surprising statement in light of the Tax Court's opinion that 707(c) is inapplicable because the management fees were based on income.⁹³ The court's language was taken virtually verbatim from the Commissioner's Statement of the Issue on Appeal.⁹⁴ However, the Commissioner's Brief itself recognized that the Tax Court had said that the management fees did not qualify under 707(c). Indeed, the Service changed its position on appeal and argued that the Tax Court had correctly rejected its argument below that 707(c) applied. It said the Tax Court "correctly decided that the managerial fees involved herein could not be treated as guaranteed payments under Section 707(c) since they were, in fact, dependent on the amount of rental income received by the partnership."⁹⁵ In short, no one argued 707(c) before the Fifth Circuit; the sole question became whether the partnership could deduct the fees under 707(a).

As was the case at the Tax Court level, the Fifth Circuit was struck by the results of the interplay in accounting methods:

The fact that the differing methods of reporting income by the partnership . . . and by the taxpayers . . . resulted in somewhat of an anomaly does not of itself, of course, require a holding in favor of the Government The fact, however, that the tax returns of the individual taxpayer partners claimed advantages of losses which, in an economic sense did not

⁸⁹64 T.C. 212 (1975). The Tax Court cited *Svedrup* and *Wegener*, *supra* note 30, which were, in testimony before the House Committee on Ways and Means, cited as inconsistent with other decisions. *Forty Topics*, *supra* note 42 at 1382. See also *A Proposed Revision*, *supra* note 42 at 137 n. 38; *Partnerships*, *supra* note 60 at 1200 n. 41; Crampton, *Partner—Partnership Transactions*, 1957 N.Y.U. 15th Inst. on Fed. Tax. 71, 73 n. 7.

⁹⁰64 T.C. at 212 (1975).

⁹¹Text accompanying notes 76-78, *supra*.

⁹²*Pratt v. Commissioner*, 550 F.2d 1024 (5th Cir. 1977).

⁹³Text accompanying notes 86-7, *supra*.

⁹⁴Appellee's Brief at 1.

⁹⁵*Id.* at 19.

truly exist, may explain the reason why the Commissioner considered it necessary to raise the issue.

* * *

The question thus posed is whether the "transaction" encompassed by the partnership contract providing for the five per cent fees to the partners for their management services is a "transaction" which is carried out "other than in his capacity as a member of such partnership."⁹⁶

By enclosing the word "transaction" with quotation marks, the Fifth Circuit echoed the Tax Court's dictum that the word "transaction" might not include continuing payments for services.⁹⁷ It did not decide the matter, because it held that the "plain meaning" of 707(a)'s "other capacity" requirement had been violated:

It is perfectly clear that the contract creating the partnership, which provided for the percentage payments to the general partners for their management efforts was made with them *qua* partners. Furthermore, it is equally clear that the duties to be performed were activities for which the partnership was created in the first place, *i.e.*, the management of the shopping centers.⁹⁸

These two sentences raise two very different points. The first reflects the Tax Court's emphasis on the fact that the partnership agreement had mandated the services and fees. This interpretation leaves open the possibility that salaries for partners could qualify under 707(a) if they were provided for in a separate contract rather than in the partnership agreement. Although this approach sounds somewhat mechanical, it does reflect the approach taken in some of the pre-1954 Code cases *Pratt* apparently resurrects.⁹⁹ The second sentence, however, suggests that the relation to partnership purpose is what is critical. So, too, does the following language:

. . . Congress determined that in order for the partnership to deal with one of its partners as an "outsider" the transaction dealt with must be something outside the scope of the partnership.

* * *

The particular provision relied on by the taxpayers here simply does not permit a partnership to treat as a deduction for ordinary and necessary business expenses amounts paid to partners, as partners, for the performance of services for which the partnership exists.¹⁰⁰

The rule that 707(a) only embraces transactions outside the scope of the partnership is unsupported by the legislative history and is in conflict with the 707(a) Regulations that specifically embrace a transaction with a partner in pursuance of partnership purposes.¹⁰¹ It is also inconsistent with the treatment of the *Pratt* loans as within 707(a). Nowhere was it suggested that the loans were outside the scope of the partnership business. Not only does

⁹⁶*Pratt v. Commissioner*, 550 F.2d 1025-26 (5th Cir. 1977).

⁹⁷Text accompanying note 90, *supra*.

⁹⁸*Pratt v. Commissioner*, 550 F.2d 1026 (5th Cir. 1977).

⁹⁹*See, e.g., Stout, supra* note 18 at 1208:

But here the stipulated facts show that the amounts were paid to [the partners] pursuant to the provisions of the partnership agreement and not pursuant to a separate contract for performance of services. Cf. *H.H. Wegener [supra, note 30]*.

¹⁰⁰*Pratt v. Commissioner*, 550 F.2d 1026-27 (5th Cir. 1977).

¹⁰¹Text accompanying note 41, *supra*.

Pratt represent an unfortunately restrictive interpretation of sections 707(a) and (c), it relegates the treatment of garden-variety payments based on a percentage of gross receipts to the "other capacity" requirement of 707(a). The grant of vitality to the "other capacity" concept is unfortunate because, long before there ever was an income tax, it was considered a task suitable for only the most skilled of metaphysicians to determine whether or not a percentage payment is made to a person in the capacity of a partner. The late Mr. Justice Story is irresistible on this point:

The distinction, as thus presented, does certainly wear the appearance of no small subtlety and refinement, and scarcely meets the mind in a clear and unambiguous form; for the question must still recur; when may a party properly be said to have "an interest in the profits, *as profits?*" When also may it properly be said, that "the interest in the profits is mutual," and that "each person has a specific interest in the profits, *as a principal trader?*"¹⁰²

V. BEYOND PRATT

Pratt forces us to consider how non-707 salary payments are to be treated by partnership and partner. The Tax Court said that aggregate treatment is "prevailing as under prior law except where the [1954 Code] provides otherwise."¹⁰³ This has led to speculation that *Lloyd* is still good law and that other strategies may be adopted to avoid entity treatment when it is to taxpayer advantage.¹⁰⁴ This section of the paper proceeds to make two, interrelated points. First, *Lloyd* no longer controls. Second, there are other provisions of the Code than 707 that mandate entity treatment of compensation payments to partners, provisions, the Tax Court noted, that were not raised in *Pratt*.¹⁰⁵

There are two basic reasons why *Lloyd* is unlikely to control non-707 payments to partners.¹⁰⁶ First, pre-1954 Code law had developed to the point of substantially restricting the *Lloyd* approach. Most notably, *Stout* held that general principles governing compensation, notwithstanding the partnership doctrine explained in *Lloyd*, require partners to include salaries in income.¹⁰⁷ *Stout* expressly limited the *Lloyd* approach of permitting partners to directly deduct or exclude payments traceable to charges against

¹⁰²J. STORY, LAW OF PARTNERSHIP 50-51 (1841). Somewhat more recent and to the point is Cowan, *Compensating the Promoter-General Partner*, 22d WM. & MARY TAX CONF. 81, 83 n.6 (1977).

Several years ago, a subcommittee of the Committee on Partnerships of the New York State Bar Association's Tax Section, attempted to recommend possible legislation to clarify the definitional problems of § 707. After a full year of discussion among a number of experienced practitioners, it was not possible to develop a consensus either of what the law was or of what it should be, and no recommendation emerged. The major conceptual obstacle was trying to determine when a partner was acting in his capacity as a partner, either generally or in specific instances.

¹⁰³64 T.C. 209 (1975).

¹⁰⁴See, e.g., Sexton and Charyk, *supra* note 86.

¹⁰⁵See note 82, *supra*.

¹⁰⁶See Weiss, *Payments Between Partners and Partnerships*, 1977-1 N.Y.U. 35TH INST. ON FED. TAX. 169, 182, for the opinion that "decisions like *Lloyd* were not intended to survive the 1954 Code."

¹⁰⁷Text accompany note 24 *supra*.

their capital accounts: no partner may deduct or exclude charges against his capital account in excess of the amount of his actual cash contribution. *Stout* applied this limitation even though it assumed that the capital accounts in question had economic significance. If anything, the skepticism about the reality of charges against capital account, particularly in the context of real estate partnerships, has increased in the twenty years since *Lloyd*. In *Stanley C. Orrisch*,¹⁰⁸ for example, the issue was whether a special allocation of depreciation to two partners had substantial economic effect. The taxpayers stressed that the depreciation they had been specially allocated had been charged against their capital account and had resulted in a negative capital account that was far below that of their fellow partners. The Tax Court accepted that, under normal accounting principles, the disparate negative capital account would be treated either as a debt to the partnership or would be taken into account in the division of partnership assets on liquidation. However, it found no evidence that the partners intended normal accounting principles to govern the significance of their capital accounts. No debt was intended and the allocations of economic benefits and burdens continued unchanged. Accordingly, the charges against capital account had no economic effect. Finally, the appellate court in *Stout* indicated that an aggregate approach could not be relied upon to permit individual partners to directly deduct what was, in business reality, a capital expenditure of their partnership.

The second basic reason why *Lloyd* is unlikely to control non-707 payments lies in the 1954 Code and its legislative history. The legislative history is strident in its denunciation of the *Lloyd* approach as “unrealistic and unnecessarily complicated.”¹⁰⁹ The Service years ago declared obsolete the General Counsel Memorandum that explained the proper computations to be performed under the principles outlined in *Lloyd*.¹¹⁰ If, as *Pratt* holds, the legislative intent to reject *Lloyd* and apply an entity theory to compensation payments to partners is only partially realized in 707, the question is whether the realization can be made more complete through other sections. The answer, it is submitted, is yes.

A. Current Distributions

Perhaps the simplest way to begin is to step back and consider the payment of a “salary, so called” that does not actually represent compensation for services. Consider, for example, partner *A* who supplies capital, not services, and has a 10 percent interest in partnership net cash flow, which amounts in year *x* to \$1,000. The actual payment to *A* of the \$1,000 is governed by section 731. It provides that no gain or loss is recognized by a partnership when it makes a current distribution of cash to a partner.¹¹¹ It also provides that no gain is recognized to the partner who receives the distribution, except to the extent it exceeds his basis in his partnership inter-

¹⁰⁸55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R.2d 73-1069 (9th Cir. 1973).

¹⁰⁹Text accompanying notes 34-8, *supra*.

¹¹⁰G.C.M. 6582, *supra* note 28.

¹¹¹CODE § 731(b).

est.¹¹² Stated differently, a current distribution of cash to a partner reduces his basis, but not below zero;¹¹³ to the extent it exceeds his basis in his partnership interest it represents capital gain.¹¹⁴ Note that the consequences of the distribution itself tell us little of the overall tax consequences to partnership and partner. Assume that the partnership has taxable income in year x that equals net cash flow and that A shares in taxable income in the same ratio that he shares in net cash flow. A is required to report \$1,000 in income in year x whether it is distributed to him or not.¹¹⁵ His basis in his partnership interest is increased by the \$1,000 of income he reports.¹¹⁶ The actual distribution to him of the \$1,000 correspondingly reduces his basis in his interest, resulting in a wash.

Distributions do not simply wash out previously increased basis if they differ in amount from taxable income or are allocated differently than taxable income. In real estate partnerships, for example, distributions frequently exceed taxable income because they constitute net cash flow that is sheltered from tax by depreciation deductions. Assume that the \$1,000 distributed to partner A represents his distributive share of net cash flow in year x . Assume further that A shares in taxable income or loss in the same ratio that he shares in net cash flow but that depreciation deductions have resulted in zero taxable income. The only tax consequence to A in year x is the consequence of the distribution itself: his basis in his partnership interest is lowered, but not below zero; he has capital gain if and to the extent the distribution exceeds his basis in his partnership interest. It is not uncommon among real estate partnerships for depreciation deductions to be large enough to result in tax losses passed through to A at the same time as positive cash flow. In such situations, A 's basis in his partnership interest is lowered by both the cash distribution and his share in tax loss.

Consider if partner A receives his 10 percent interest in exchange for his personal services to the partnership rather than in exchange for a capital contribution. How, if at all, do partner and partnership treat this 10 percent interest differently than the 10 percent interest given in exchange for a capital contribution? Two distinctions should be made at the outset of our consideration of this question. First, the transfer of a fractional interest must be distinguished from the payments made pursuant to the fractional interest. Second, transfers for past services must be distinguished from transfers contingent on the performance of substantial future services.

B. Section 721

Section 721 has traditionally governed the transfer of a fractional interest in a partnership for services. It adopts an entity approach that permits a deduction in the computation of partnership taxable income or loss, and requires ordinary income treatment to the recipient. The current Section 721 Regulations provide that gain shall be recognized

¹¹²CODE § 731(a)(1) and Treas. Reg. § 1.731-1(a)(1)(i)(1960).

¹¹³CODE § 705(a)(2).

¹¹⁴Treas. Reg. § 1.731-1(a)(3) (1960).

¹¹⁵Treas. Reg. § 1.702-1(a) (1972).

¹¹⁶CODE § 705(a)(1)(A).

[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services. . . . The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.¹¹⁷

The amount of ordinary income to the recipient "is the fair market value of the interest in capital so transferred. . . ."¹¹⁸ The partnership is entitled to a deduction because, to the extent the value of the interest transferred is "compensation for services rendered to the partnership, it is a guaranteed payment under section 707(c)."¹¹⁹

The rule that the value of an interest in capital transferred for services is a guaranteed payment under 707(c) was extended to transfers of interests in partnership profits in the now famous case of *Sol Diamond*.¹²⁰ Diamond was a mortgage broker who received a partnership interest from one Kargman as compensation for obtaining 100 percent financing of the purchase price of an office building. Diamond was not obligated to contribute any money, nor was he obligated to provide any further services. It was agreed that Kargman would pay all acquisition costs above the amount of financing, and that Kargman and Diamond would share profits in a 40-60 ratio and "be chargeable with all losses in the same proportions." Net proceeds of any sale of the building were to be divided in the same ratio, after first being applied to reimburse Kargman for any acquisition expenditures he incurred. Three weeks after closing the acquisition of the building, Diamond sold his interest for \$40,000 and reported that amount as a short-term capital gain from the sale of a partnership interest.

The Tax Court could not resist requiring Diamond to treat as ordinary income the value of the interest he had received for his fully-performed services as a mortgage broker. Prior to *Diamond*, the parenthetical in the 721 Regulation excerpted above had been interpreted to mean that the receipt of an interest in partnership *capital* for services was a taxable event but that the receipt of an interest in partnership *profits* was not.¹²¹ Under the "no taxable event" interpretation, the recipient obtains a zero basis in his partnership interest, except to the extent he shares in partnership liabilities,¹²² must subsequently report as ordinary income his allocable share of partnership profits, and pays capital gain on the sale of the interest. Because Diamond's interest in sales proceeds was subordinated, he argued that he had received an interest in profits, not capital, and that the "no taxable event" interpretation should apply. The court assumed it was dealing with a profits interest and rejected the "no taxable event" interpretation. It said that the "opaque draftsmanship" in the Regulations was insufficient to override the general rule that the fair market value of property received for services must be included in gross income.

¹¹⁷Treas. Reg. § 1.721-1(b)(1) (1960).

¹¹⁸*Id.*

¹¹⁹Treas. Reg. § 1.721-1(b)(2)(i) (1960).

¹²⁰56 T.C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974).

¹²¹See generally Cowan, *Receipt of a Partnership Interest for Services*, 1974-2 N.Y.U. 32d INST. ON FED. TAX. 1501.

¹²²See CODE §§ 752(a) and (c) and the Regulations thereunder.

The Seventh Circuit affirmed the Tax Court, and noted that it was repudiating "a startling degree of unanimity" among the commentators in so doing.¹²³ It then addressed the argument that there will be double taxation if the right to share in future profits and the subsequent receipt of those profits are both taxed. For example, if a partner must include in ordinary income the fair market value of the right to receive approximately \$1,000 a year for several years in the future, will he again be taxed at ordinary income rates on the \$1,000 payments as they are actually received? Or can the basis obtained by paying tax on the fair market value of the interest when it is received be amortized as the profits are earned? The court said that the "absence of a recognized procedure for amortization [did not] militate against the treatment of the creation of the profit share as income."¹²⁴

Diamond came as a shock to many who had believed, with some good reason, that the receipt of an interest in partnership profits was not a taxable event.¹²⁵ As the shock wore off, however, it was realized that *Diamond* might be relied upon to taxpayer advantage. That is, the recipient of a subordinated partnership interest might include the value of the interest in income when it is received, which presumably would be a low value because of the subordination, and report any profit on the sale of the interest as capital gain. However, both *Diamond* opinions express doubt as to whether this can be done. The Tax Court and the Seventh Circuit each raised, but did not decide, whether *Diamond* would have been prohibited from claiming capital gain treatment if he sold at a profit what they characterized as the right to receive a future stream of ordinary income.¹²⁶

*Vestal v. United States*¹²⁷ cast even greater doubt on the extent to which a taxpayer may report a low market value in the year of receipt based on the contingent nature of future profits and claim appreciation realized on the liquidation of the interest as capital gain. Vestal was acquainted with assignees of an oil and gas lease who were attempting to sell limited partnership interests to raise money to drill wells. He contacted four investors who, in 1962, became limited partners and agreed to pay him a finder's fee. Each agreed in writing to convey to Vestal one-eighth of the limited partnership interest acquired upon recovery of investment plus 6 percent interest. Two years later, the partnership's assets were sold at a substantial profit. The four investors received their share of the proceeds, deducted the amount of their investment, plus interest, and paid Vestal one-eighth of the remaining balance, which totalled \$139,730. The district court accepted Vestal's argument that the finder's fee agreements gave him an interest in a capital asset that had a fair market value of \$29,375 in 1962 and should have been reported in that year. Vestal made this argument because the statute of limitations had run against the government for 1962. The court

¹²³492 F.2d at 289.

¹²⁴*Id.* at 290-91. Peter P. Risko, 26 T.C. 485 (1956), has been cited as authority for the proposition that the amount included in income may be amortized when the partnership has a determinable life.

¹²⁵*Cowan*, supra note 121.

¹²⁶56 T.C. at 547, n. 16; 492 F.2d at 287, n.3.

¹²⁷498 F.2d 487 (8th Cir. 1974), *rev'g* 73-1 U.S.T.C. ¶9260 (W.D.Ark. 1973).

held that Vestal had acquired a basis in his partnership interest of \$29,375, a tax cost basis as if he had properly reported in 1962. It permitted him to report his 1964 liquidation proceeds in excess of this basis as long-term capital gain.

The Eighth Circuit reversed, finding that the interests obtained by Vestal in 1962 "were contingent, conditional, and speculative, and as a matter of law, did not constitute income taxable to Vestal in 1962."¹²⁸ The court admitted that his rights had value in 1962, but said that "such recognition does not support a view that Vestal received income under the federal tax laws."¹²⁹ The court did not want "compensatory income taxable at ordinary income rates to be treated as capital appreciation. . . ."

When dealing with a situation such as the present where taxpayer holds an executory contingent contract payable in the future, the tax laws should not be construed . . . to permit him to establish a basis for those same contract rights in the absence of a showing that there was an actual trading or marketing of those rights.¹³⁰

Vestal is somewhat difficult to reconcile with the rationale of *Diamond*.¹³¹ The common ground appears to be hostility to the notion that capital gain can result from interests received as compensation. In any event, these cases are substantially tempered by statutory developments, at least if the proposed section 721 Regulations are followed. They provide that transfers of partnership interests for services made after June 30, 1969 are governed by section 83.¹³²

C. Section 83

Section 83 was passed as part of the Tax Reform Act of 1969.¹³³ The proposed 721 Regulations that state that section 83 controls transfers of partnership interests came as a surprise because section 83 had been discussed and passed in the context of corporate restricted stock plans. Neither section 83 nor its proposed Regulations makes any reference to transfers of interests in partnerships. Although it is often difficult to determine

¹²⁸498 F.2d 490 (8th Cir. 1974).

¹²⁹498 F.2d 491 (8th Cir. 1974).

¹³⁰498 F.2d 493-94 (8th Cir. 1974).

¹³¹*Diamond* was not cited to the *Vestal* court until Vestal's petition for a rehearing, in which he raised it as authority for the proposition that the value of his interest was income in 1962. The court denied the petition and said that the effect of its decision was to tax Vestal upon his acquisition of "the actual joint venture interests" and was consistent with the decision in *Diamond* that the taxable event was "when the parties actually acquired the building to be held as a joint venture." 498 F.2d at 496 (order on petition for rehearing).

¹³²Prop. Reg. § 1.721-1(b)(1)(i)(1971):

If the partnership interest is transferred after June 30, 1969 (except to the extent paragraph (b) of § 1.83-8 applies), then the transfer of such interest in partnership capital shall be treated as a transfer of property to which section 83 and the regulations thereunder applies.

The Proposed Regulations simply parrot the parenthetical in the original section 721 Regulations that *Diamond* said was insufficient to support differential treatment of compensation payments of interests in capital *versus* interests in profits.

¹³³Tax Reform Act of 1969 § 321(a), Pub. L. 91-172.

how some of the language of the proposed Regulations will be applied to partnerships, most of the basic pattern is clear.¹³⁴

Section 83 governs transfers of "property"¹³⁵ for services, "whether such transfer is in respect of past, present, or future services."¹³⁶ It requires, in the words of the Regulations, that the fair market value of property transferred for services be reported as compensation as soon as the transfer is "complete." Even if the property transferred has a clear market value, it need not be reported as compensation until the transfer is complete.¹³⁷ The value reported is the value at the time the transfer becomes complete.¹³⁸ The transfer becomes complete as soon as the property becomes free from substantial risk of forfeiture or transferable.¹³⁹ These two statutory concepts are interdependent. The recipient's rights are subject to a substantial risk of forfeiture "if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."¹⁴⁰ The rights are transferable only if they are free from substantial risk of forfeiture when they are in the hands of the transferee.¹⁴¹ As soon as the transfer is complete and the interest is reported as compensation, a deduction is authorized "to the person for whom were performed the services . . ."¹⁴² However, if the expenditure is capital, an increase in basis, rather than a deduction, results.¹⁴³

Return, now, to our consideration of partner *A* who receives a 10 percent interest in a partnership in exchange for his promise to manage the partnership properties. His interest, whether in his own hands or in the hands of his transferee, is subject to a substantial risk of forfeiture¹⁴⁴ and therefore also nontransferable because it will be extinguished if the services are not performed satisfactorily. Accordingly, the transfer is not complete

¹³⁴Thus, for example, the Regulations provide that section 83 controls transfers of property "to an employee or an independent contractor." Prop. Reg. § 1.83-1(a) (1971). The obvious question is whether a partner is "an employee or an independent contractor" within the meaning of this Regulation. Prop. Reg. § 1.721-1(b)(1)(i) (1971) answers this question in the affirmative. Unfortunately, the Regulations offer no other guidance concerning the applicability of section 83 and its Regulations to partnerships.

¹³⁵It would be helpful if the Treasury would clarify how its proposed definition of property applies in the partnership area:

For purposes of section 83 and the regulations thereunder, the term "property" includes both realty and personalty other than money and other than an unfunded and unsecured promise to pay deferred compensation.

Prop. Reg. § 1.83-3(e) (1971).

¹³⁶Prop. Reg. § 1.83-3(f) (1971).

¹³⁷Prop. Reg. § 1.83-1(e), Example (1) (1971).

¹³⁸*Id.*, Example (2).

¹³⁹CODE § 83(a).

¹⁴⁰CODE § 83(c)(1).

¹⁴¹CODE § 83(c)(2).

¹⁴²CODE § 83(h).

¹⁴³Prop. Reg. § 1.83-6(a) (1971):

[N]o deduction is allowed under section 83(h) to the extent that property transferred in connection with the performance of services constitutes a capital expenditure. In such a case, the basis of the property to which such capital expenditure relates shall be increased at the same time and to the same extent as any amount is includible in the employee's gross income in respect of such transfer.

¹⁴⁴See Prop. Reg. § 1.83-3(c)(1) (1971) for consideration whether the services are substantial.

and *A* is not yet required to report as compensation the value of his 10 percent interest.

Consider the tax consequences to partner *A* of his 10 percent interest prior to the time his transfer is complete. Does *A* receive any different treatment than that outlined earlier for the partner who acquires his interest for cash, not services?¹⁴⁵ The answer of the section 83 Regulations is yes:

Until such transfer becomes complete, the transferor shall be regarded as the owner of such property, and any income from such property received . . . by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received. . . .¹⁴⁶

Thus, *A*'s distributions of net cash flow constitute additional compensation until he reports the receipt of the 10 percent interest. The Regulations also seem to prevent *A* from being treated as a partner until the transfer of the 10 percent interest is complete. If the "transferor," presumably the partnership, "shall be regarded as the owner" of the partnership interest until the transfer is complete, *A* is presumably not a partner for tax purposes until that time. If *A* is not a partner, he is not entitled to a distributive share of partnership losses. Conversely, he would not be responsible for any distributive share of partnership income. There does not appear to be any reason why the Service should insist on a literal application of these Regulations to partnerships.¹⁴⁷ It would presumably have to explain the result if the interests of all of the partners were conditioned on the performance of substantial future services. It might also refrain from a literal interpretation to avoid establishing a mechanism that would pass all tax losses from service partners to high-bracket investor-partners.

A way to avoid the risk that partner *A* will be treated as a non-partner under the section 83 Regulations lies in the election offered by section 83(b). The person who receives an incomplete transfer is given the election to value and report the interest as compensation when the incomplete transfer is first made.¹⁴⁸ The election must be made within 30 days after the incomplete transfer is made.¹⁴⁹ The advantage of the election is that the reporting of the interest as compensation is the equivalent of a purchase of the interest insofar as "any subsequent appreciation in value is not taxable as compensation."¹⁵⁰ The disadvantage of the election is that the transferee is not allowed a deduction if the property is subsequently forfeited.¹⁵¹

¹⁴⁵Text accompanying notes 111-16, *supra*.

¹⁴⁶Prop. Reg. § 1.83-1(a)(2)(1971).

¹⁴⁷See Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161, 209-10 (1972).

¹⁴⁸CODE § 83(b).

¹⁴⁹CODE § 83(b)(2).

¹⁵⁰Prop. Reg. § 1.83-2(a)(1971).

¹⁵¹CODE § 83(b)(1). See also Treas. Reg. § 1.83-2(a)(1971):

[I]f the property is later forfeited or sold in an arm's length transaction before the transfer of such property becomes complete, such forfeiture or sale shall be treated as a disposition upon which there is recognized a loss equal to the excess (if any) of—

(1) The amount that the taxpayer actually paid for such property, over

(2) The amount realized (if any) upon such forfeiture or sale.

If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.

Thus, if partner *A* elects to report his contingent 10 percent interest as compensation when he first receives it, he would appear to be treated as if he acquired it by purchase. Stated differently, a literal application of the section 83 election Regulations appears to permit *A* to treat his interest as if he had acquired it for cash rather than services. Partner *A* would thus presumably be entitled not only to capital gain on sale of his interest and a pass-through of losses, he would be entitled to treat current cash distributions as any other partner: as payments that serve only to reduce his basis in his partnership interest. The Service may recoil from the idea that distributions of net cash flow for services are reported as distributions in reduction of basis rather than as compensation. However, that result flows quite readily not only from the section 83 Regulations, but also from the decision in *Pratt* that non-707 salaries are nothing other than normal distributive shares.

D. *The Special Allocation Approach*

One final approach to non-707 salaries requires mention because it has received considerable attention recently.¹⁵² It treats a non-707 percentage-based salary as a special allocation. Under this approach, the payments of a percentage of gross rentals *Pratt* says are not deductible under 707(a) or (c) have the same effect as guaranteed payments. The allocation of a percentage of gross receipts has the same effect as a partnership deduction because the amount specially allocated is removed from the computation of partnership taxable income or loss and attributed directly to the service partner. It has the same effect as a guaranteed payment to the recipient because the rental income is ordinary income. Such an allocation, it is argued, cannot be disregarded because it represents actual dollars and, hence, has the requisite "substantial economic effect."¹⁵³

Although the special allocation argument as thus initially presented seems relatively inoffensive because it parallels guaranteed payment treatment, it seems vulnerable when applied in other contexts because it proves too much. Consider, for example, if the special allocation is of a share of net cash flow rather than of gross receipts. Although the partnership would not claim a deduction or its equivalent, the recipient would treat the payment as a distribution in reduction of basis rather than as an item of ordinary income. This, it could be argued, is what *Pratt* apparently mandates and is the same result as that apparently mandated if the section 83(b) election is made. The Service may object because the results of the special allocation approach in this situation are far preferable to the recipient than those required by section 707 or section 83. Sections 707(a) and (c) both require payments to be reported as compensation. Section 83 also requires the payments to be reported as compensation until the transfer is complete unless the 83(b) election is made. Note that the special allocation approach also avoids the problem of treating the service partner as a non-partner under section 83. In short, the special allocation approach enables partners

¹⁵²Cowan, *supra* note 102; Weiss, *supra* note 106.

¹⁵³CODE § 704(b)(2).

to claim the advantages of the classical aggregate approach and trace their "salaries, so called" to items of tax-exempt or preferred income.

The special allocation approach may also meet resistance because of the amount of the deduction equivalent it yields. Recall that section 707(c) has never been available to convert capital expenditures into currently deductible items.¹⁵⁴ Guaranteed payments are only deductible to the extent they represent ordinary and necessary business expenses under section 162. Recall, too, that section 83 prohibits deductions for compensation payments that are not ordinary and necessary.¹⁵⁵ It has already been suggested that the special allocation approach produces the "equivalent of a deduction" for payments that would not be deductible if made to third parties:

Allocating an item of income to the general partner removes it from the computation of partnership taxable income or loss allocable to the other partners; therefore, it has the same "bottom line" impact as a deduction—except that it need not run the gamut of § 162 as an ordinary and necessary business expense.¹⁵⁶

This approach is similar in effect to the old argument that guaranteed payments are automatically deductible even though they would not be deductible if made to third parties.

The question remains whether and how a percentage allocation for services could be disregarded. It is clear that the "substantial economic effect" requirement was intended "to prevent the use of special allocations for tax avoidance purposes. . . ."¹⁵⁷ However, an allocation that is disregarded is normally reallocated. For example, if a 100-0 allocation of the depreciation deduction in an otherwise 50-50 partnership is disregarded, the deduction will be reallocated on a 50-50 basis. An actual dollar allocation of a percentage of gross receipts would not be reallocated. It would be the characterization of the allocation, rather than the allocation itself, that could be disregarded.

One final argument can be made to qualify percentage salaries as guaranteed payments. The Code provides that the partnership agreement controls allocations that have substantial economic effect.¹⁵⁸ It also defines the partnership agreement to include any modifications made up until the time required for the filing of the partnership return.¹⁵⁹ It can be argued that 707(c) applies if the partnership agreement is amended at the end of the year to restate a percentage-based salary in terms of a fixed dollar amount. Unlike the special allocation approach, the retroactive allocation approach does not result in treating salaries as distributions of preferred or exempt income or in the equivalent of a deduction for expenses that are not ordinary and necessary.

¹⁵⁴*Supra* note 35.

¹⁵⁵*Supra* note 143.

¹⁵⁶Cowan, *supra* note 102 at 87.

¹⁵⁷S. REP. No. 94-938, 94th Cong., 2d Sess. 100 (1976).

¹⁵⁸CODE §§ 704(a) and (b).

¹⁵⁹CODE § 761(c).

VI. CONCLUSION

The partnerships in *Pratt* deducted amounts they credited to accounts payable to their members for salaries and interest, even though the accruals were never actually paid. Unfortunately, this unsympathetic case for the taxpayers was litigated entirely within the confines of 707, rather than under principles of constructive receipt or material distortion of income. The result of the litigation, during which the Service changed its position with respect to the proper treatment of both interest and management fees, is restrictive interpretations of 707(a) and 707(c) by the Tax Court, and a restrictive interpretation of 707(a) by the Fifth Circuit. The opinions appear to frustrate the intent behind 707 to reject the "unrealistic and unnecessarily complicated" approach of prior law and adopt, for the sake of simplicity, an entity approach to payments to partners for services and capital. In particular, 707(c) was intended to be the primary vehicle for the application of the entity approach to payments to partners for their services and capital. Although the legislative history is cast primarily in terms of fixed dollar amounts, legislative intent would appear to be furthered, not frustrated, if 707(c) were interpreted to include binding obligations to pay ordinary and necessary compensation in the form of a percentage of gross or net receipts. Stated differently, the Government's position before the Tax Court should have been adopted: 707(c) is not confined to predetermined dollar amounts because the "without regard to income" limitation was intended only to exclude partners' drawings that were conditional or that served to reduce the recipient's interest in partnership assets or profits.

A great deal of confusion would be avoided if the Service would indicate its disapproval of the reasoning in *Pratt*. If it does not, it should clarify how non-707 salaries are to be treated by partner and partnership. The aggregate approach of *Lloyd* was denounced by commentators and the Congress as "unrealistic and unnecessarily complicated." The Service will probably oppose a revival of the *Lloyd* approach for the additional reason that it permits partners to directly deduct charges against their capital accounts. The Service may also oppose the notion that payments based on gross receipts are special allocations, at least to the extent the argument is made to achieve the effect of a deduction for compensation payments that fail to qualify as ordinary and necessary business expenses. The most likely vehicle for applying an entity approach to non-707 salary payments is section 83, which proposed Regulations say controls transfers of partnership interests for services. Unfortunately, the section 83 Regulations do not explain their application to partnerships. The Service should make clear how garden-variety payments based on gross receipts are to be treated. Now, just as prior to the 1954 Code, the primary goal of all concerned is certainty.