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THE "CONVENIENCE OF THE EMPLOYER" EXCLUSION AND THE PARTNER-EMPLOYEE: A NEW LOOK

ALBERT A. GORDON*

I. INTRODUCTION

Under the present tax structure, many of the tax benefits that are available to the stockholder-employee are denied to the sole proprietor and the partner-employee. The reason for this is that in the stockholder-employee situation, there are two separate taxable entities, the stockholder and the corporation, both of which are subject to taxation on income.[1] It is the absence of this buffer of a separate taxpaying entity which is said to justify the denial to the sole proprietor and the partner-employee of the same tax prerogatives that the shareholder-employee enjoys. One of these prerogatives is the Section 119 "convenience of the employer" exclusion. A recent decision,[2] however, has used Section 707 of the partnership tax laws[3] to elevate the partner-employee to the same favorable tax position as the shareholder-employee, with respect to the Section 119 exclusion. This paper will consider the status of the partner-employee insofar as the "convenience of the employer" exclusion is concerned, and also the effect of Section 707 upon that status.

II. BACKGROUND

The 1939 Code, for the most part, completely ignored the many transactions between a partnership and its partners. It has been suggested that perhaps one reason for this is that the partnership has never been treated for tax purposes as a separate taxable entity, its annual return merely serving as a means for determining the taxable income of its members.[4]

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1. *See* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.01 (1957).
2. Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).
3. INT. REV. CODE OF 1954, § 707.
4. J. CHOMMIE, FEDERAL INCOME TAXATION 354 (1968).

Owing to this dearth of statutory authority prior to the 1954 Code, responsibility for guidance in this area was left to the courts. The decisions, however, were inconsistent. Some courts adopted an aggregate approach, holding that to the extent of his interest in the partnership, a partner dealing with the partnership is dealing with himself. Other courts took an "entity" approach, holding that transactions between a partnership and a partner were to be treated as occurring between the partnership and an outsider.[5]

There was one area, however, where the concept of the partnership as an aggregate of individuals was uniformly adopted. The case law interpreting the 1939 Code made it clear that a partner could not be an employee of his partnership for any purpose,[6] including the "convenience of the employer" exclusion, which is now codified as Section 119 of the 1954 Code.[7] Section 119, which permits an employee to exclude from gross income the value of certain meals and lodging furnished by his employer, provides as follows:

> Sec. 119. MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF THE EMPLOYER.
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> There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—
> (1) in the case of meals, the meals are furnished on the business premises of the employer, or
> (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.
> In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.[8]

Prior to 1954 there was no statutory provision comparable to Section 119, however, the "convenience of the employer" exclusion has been expressed in Treasury Regulations and Rulings since 1919.[9]

In the cases arising under the 1939 Code it was the position of four

5. *See* 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.01 (1957).
6. Armstrong v. Phinney, 394 F.2d 661, 663 (5th Cir. 1968).
7. *See* Commissioner v. Doak, 234 F.2d 704 (4th Cir. 1956); Commissioner v. Moran, 236 F.2d 595 (8th Cir. 1956); United States v. Briggs, 238 F.2d 63 (10th Cir. 1956); Commissioner v. Robinson, 273 F.2d 503 (3d Cir. 1959). *But see* the dissenting opinions in the *Robinson* and *Doak* cases, and also the lower court opinions which were reversed in all four cases: Robinson v. Commissioner, 31 T.C. 65 (1958); Briggs v. United States, 56-1 U.S.T.C. Para. 9164 (D.C. Colo. 1956) (not officially reported); Moran v. Commissioner, 14 T.C.M. 813 (1955); Doak v. Commissioner, 24 T.C. 569 (1955).
8. INT. REV. CODE § 119.
9. *See* Treas. Reg. 45, Art. 33 (1919); Treas. Reg. 118, § 39.22(a)-(3) (1939).

courts of appeals,[10] in accord with the published position of the Commissioner of Internal Revenue,[11] that since the type of personal or living expenses involved must be incurred by everyone, regardless of business requirements, the exclusionary rule in question, expressly limited to employees,[12] could not be extended to partners or proprietors. The basis for this position was the "aggregate" theory of the partnership; that is, the "convenience of the employer" exclusion was held to pertain only to a situation where the employer and the employee are separate taxable entities. It has "no relevancy where the one furnishing meals and lodging is the same taxpayer receiving them."[13]

In 1954 the partnership provisions of the Code underwent a major revision. Under the 1954 Code, as was true with its predecessor, the basic notion of the partnership as merely an information reporter rather than a taxable entity remains intact.[14] However, express recognition was also given by Congress to the "entity" concept of the partnership in several specific areas,[15] one of which involves transactions between a partner and the partnership. Section 707 of the Code adopts an "entity" theory of the partnership by providing that as a general proposition, a transaction between a partner and the partnership is to be regarded as occurring between the partnership and a third person, where the partner engages in the transaction other than in his capacity as a member of such partnership.

III. Recent Departure—*Armstrong v. Phinney*

The Code does not attempt to define the scope of Section 707, nor does it explain the relationship between that section and other sections of the Code. A recent decision, however, has relied upon Section 707 as authority for departing from the prior concept that a partner cannot be an employee of his partnership for purposes of the Section 119 exclusion. In *Armstrong v. Phinney*,[16] the Fifth Circuit Court of Appeals dealt with the question of whether the "convenience of the employer" exclusion is available to a managing partner of a partnership engaged in the business of cattle ranching, where the partner's meals and lodging were furnished

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10. *See* cases cited *supra* note 7.
11. Rev. Rul. 80, 1953-1 Cum. Bull. 62.
12. *See* Int. Rev. Code § 119.
13. Commissioner v. Moran, 236 F.2d 595, 598 (8th Cir. 1956).
14. This fact is clearly stated in both 1954 Code Committee Reports:

> Because of the vital need for clarification, your committee has undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws. . . .
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> . . .
>
> In general, the proposed statutory treatment retains the existing scheme of regarding the partnership as merely an income-reporting, and not a taxable, entity. . . .

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 65 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954).

15. *See* J. Chommie, Federal Income Taxation 356 (1968).
16. Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).

by the partnership. In reversing the district court's action of granting summary judgment for the government, the court ruled that in enacting Section 707(a), Congress had rejected the "aggregate" theory of partnerships in favor of the "entity" theory in "cases where a partner sells property to or performs services for the partnership,"[17] and in the light of the provisions of Section 707, the government was "not entitled to a judgment as a matter of law."[18]

In arriving at its decision, the court noted that under the provisions of Section 707, a partner who performs services for the partnership is treated as an "outsider" or as "one who is not a partner," when he is not acting in his capacity as a partner.[19] After having recognized this express limitation on the scope of the section, however, the court made no attempt to discuss when a partner who performs services for his partnership is acting within its provisions. Rather, the court merely went on to conclude that while the Code did not explain the relationship between Section 707 and the other sections of the Code,

> we have found nothing to indicate that Congress intended that this section is not to relate to Section 119. Consequently, it is now possible for a partner to stand in any one of a number of relationships with his partnership, including those of creditor-debtor, vendor-vendee, and *employer-employee*.[20]

From the reasoning employed in this case, one is led to the logical conclusion that in the view of the court, the taxpayer fell within the purview of Section 707(a) solely because he was rendering services to his partnership. This, in effect, is a holding that every partner who performs services for his partnership (other than in return for guaranteed payments)[21] is automatically acting in a capacity other than a partner within the meaning of Section 707(a).

This apparent holding in *Armstrong* is important for several reasons. Aside from the fact that such a construction of Section 707 represents a fundamental departure from established principles of partnership law,[22] the number of partners similarly situated with the taxpayer in the *Armstrong* case will obviously make for substantial administrative ramifications. Also, there is the distinct possibility that a court employing the same reasoning as the Fifth Circuit Court of Appeals will have little difficulty in making available to the partner-employee all of those tax benefits accompanying the status of "employee" that heretofore have been denied him. The question for consideration, then, is whether by

17. *Id.* at 663.
18. *Id.* at 664.
19. *Id.* at 663.
20. *Id.* at 663-664 (emphasis supplied).
21. The problem of "guaranteed payments" is dealt with in Section 707(c).
22. To wit: that a partner cannot be an employee of his partnership for any purpose, including the Section 119 exclusion. *See* discussion *infra* at page 784.

enacting Section 707(a) Congress intended to provide statutory recognition for the type of relationship involved in the *Armstrong* case.

IV. Section 707(a)

A. *Partner Acting in Capacity as a Partner*

The court in *Armstrong* was quite correct in observing that in 1954 Congress

> rejected the "aggregate theory" in favor of the "entity theory" in cases where "a partner sells property to, or performs services for the partnership."[23]

However, as is clearly stated in both the Code and the Regulations, this result will be forthcoming only if the partner is engaging in any of these transactions with his partnership "other than in his capacity as a member of such partnership."[24] That is, "Section 707(a) is not applicable to transactions which involve the partner in his role as partner."[25] Accordingly, in order to properly apply Section 707(a), it becomes necessary to distinguish transactions in which a partner is not acting in his capacity as a member of the partnership from those in which he is so acting.[26] While the Code does not consider the problem separately it is submitted that the proper rules to be utilized lie in the considerations that follow.

B. *Specific Considerations*

Whether a partnership's business consists of the performance of services for clients or the selling of goods to customers, the general partner will very often perform services for the partnership as a normal and integral part of the business of the partnership. For example, *X*, a partner in the *XYZ* accounting firm, is clearly acting in his capacity as a partner when, in accordance with the partnership agreement, he earns income for his partnership by auditing the books of one of his firm's clients. Indeed, the same is true of any partner, who, pursuant to his partnership agreement, performs the various activities which constitute the business of the partnership. Restated, a partner who contributes to the business activities of the partnership by performing functions that are an integral part of the normal conduct of the partnership business would appear to be acting in his capacity as a partner.[27] While such

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23. Armstrong v. Phinney, 394 F.2d 661, 663 (5th Cir. 1968).

24. *See* § 707(a), Treas. Reg. § 1.707.1 (1956).

25. *See* 6 Mertens, Law of Federal Income Taxation § 35.24 (1957).

26. *Id.*

27. There may be instances, however, where a partner will perform services for his partnership in the capacity of a non-partner. Suppose that partner *X* contracts with *XYZ* to build a new set of bookshelves for the firm's conference room. In this case, he would be acting other than as a member of the partnership.

activities may fall within Section 707(c),[28] they are not covered under Section 707(a). If, on the other hand, the interpretation that the Fifth Circuit has apparently given to the section is what Congress really intended, one would expect to find some mention of it in the legislative history. Yet, as the court in *Armstrong* pointed out,[29] this is not the case. In fact, the contrary appears to be true. The Conference Report on H.R. 8300 points out quite clearly that the use of the "entity" approach in the treatment of transactions between a partner and a partnership cannot be considered a recognition by Congress of the validity of considering the partnership as an entity in all situations.[30]

Armstrong is the first reported case decided under the 1954 Code that has dealt with the interrelationship between the Section 119 exclusion and Section 707.[31] However, one circuit, in the case of *Foster v. United States*,[32] has already indicated that it would rule contra to the holding in *Armstrong* should the opportunity present itself. In *Foster* a partner, while acting within the scope of his normal duties as a member of the partnership, provided management consulting services for a client of the partnership in Saudi Arabia. The partner claimed that the payments he received for his services were covered under Section 707(c) and were therefore excludable under Section 119. The court found that "there was no evidence to support the contention that the payments were to bear no relationship to partnership income,"[33] and, therefore, the payments were not guaranteed within the meaning of Section 707(c). What is significant here, however, is a statement of the court concerning the possible application of Section 707(a). The court said:

> There is no basis for any contention that the plaintiff was not acting in his capacity as partner in Saudi Arabia so as to render applicable Section 707(a) . . . . [34]

C. *Conclusion*

Whether a partner-employee is performing services for his partnership in a capacity other than as a member of the partnership must be de-

28. If a partner receives as compensation for his services a fixed salary that is determined without regard to the income of the partnership, then he would come under the provisions of Section 707(c). *See* discussion of Section 707(c) *infra* at 785.

29. Armstrong v. Phinney, 394 F.2d 661, 663 (5th Cir. 1968).

30. No inference is intended, however, that a partnership is to be considered as a separate entity for purposes of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

H. CONFR. REP. No. 2543, 83d Cong., 2d Sess. 59 (1954).

31. The only other case decided under the 1954 Code that has considered the question of whether a partner could avail himself of the Section 119 exclusion is Wilson v. United States, 376 F.2d 280 (Ct. Cl. 1967), in which it was held that he could not do so. However, the court in *Wilson* did not consider the applicability or the effect of § 707. This fact was noted by the court in *Armstrong*. Armstrong v. Phinney, 394 F.2d at 664, n.9.

32. 221 F. Supp. 291, 295 (S.D.N.Y. 1963), *affirmed on other grounds*, 329 F.2d 717 (2d Cir. 1964). *See also* Foster v. Commissioner, 42 T.C. 974, 978 (1964).

33. Foster v. United States, 221 F. Supp. 291, 295 (S.D.N.Y. 1963).

34. *Id.*

termined according to the facts of each individual case. However, based on the foregoing discussion, it is submitted that under no circumstances should a partner who performs services as a normal incident of his duties as a member of the partnership be considered as falling under the "entity" concept of Section 707(a).

V. Section 707(c)

A. *Unique Interpretation*

The holding in *Armstrong* was grounded upon Section 707(a). However, the court intimated[35] that the identical result could have been reached under subsection (c) of the same section.[36]

Section 707(c) provides that payments for services or for the use of capital, computed without regard to the income of the partnership, shall be treated as if paid to a non-partner.[37] However, Section 707(c) "guaranteed" payments are treated as payments to non-partners "only for the purposes of Section 61(a) (relating to gross income) and Section 162(a) (relating to trade or business expenses)."[38] For purposes of the other provisions of the Code, they are regarded as a partner's distributive share of ordinary income.[39] The effect of this limitation is to prevent a partner from qualifying as an employee for purposes of the Section 105(d) sick pay exclusion, and also to prevent him from qualifying for purposes of contributions to a pension or profit-sharing plan.[40]

Whether or not a payment is "guaranteed" within the meaning of Section 707(c) is primarily a factual inquiry.[41] The test for determining guaranteed payments is whether they are payable without regard to the income of the partnership, and in making this determination, the substance rather than the form of the transaction is to govern.[42]

In the *Armstrong* case, the government had argued that the emoluments received by the taxpayer were determined without regard to the income of the partnership, and that, therefore, Section 707(c) rather than Section 707(a) should govern the outcome of the case and prevent any exclusion from gross income under Section 119.[43] In rejecting the

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35. *See* Armstrong v. Phinney, 394 F.2d 661, 664 n. 10 (5th Cir. 1968).

36. Int. Rev. Code § 707(c) provides as follows:

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

37. *Id.*

38. *Id.*

39. Treas. Reg. § 1.707-1(c).

40. *Id.*

41. F.A. Falconer v. Commissioner, 40 T.C. 1011, 1015 (1963).

42. *Id.*

43. It should be noted in passing that we have considered and rejected the government's contention, first raised on oral argument, that section 707(c) governs this case.

Armstrong v. Phinney, 394 F.2d 661, 664, n. 10 (5th Cir. 1968).

government's contention, the court expressed the view that even if the emoluments furnished the partner were covered under Section 707(c), the outcome would remain unchanged, since coverage for purposes of Section 61(a), to which Section 707(c) is expressly limited, should be construed as incorporating the other sections of Subtitle A of the Code.[44]

This unique interpretation of Section 707(c), suggested by way of dictum in the *Armstrong* case, raises two important points for consideration: (1) are the Section 119 emoluments "guaranteed payments" under Section 707(c); and (2) was the reference in Section 707(c) to Section 61(a) intended to incorporate by reference the remaining sections of Subtitle A?

B. *Guaranteed Payments*

Before Section 707(c) becomes operative, two requirements must be satisfied: (1) the partner must receive a guaranteed payment, and (2) that payment must be determined without regard to the income of the partnership.[45] The problem here is with the first of these two requirements: is the value of meals and lodging furnished to the partner-employee a "guaranteed payment" within the meaning of Section 707(c)?

It seems only logical that in situations where a partner-employee has his meals and lodging taken care of by the partnership, the value of these emoluments is as much a part of the partner's salary as any cash payments he may receive, so that to the extent that his right to receive such compensation is not dependent upon partnership income, it would constitute a guaranteed payment under Section 707(c).[46] But, as a close look at the wording of this section and at its legislative history indicates, another interpretation is also possible.

The use of the phrase "guaranteed payment" indicates literally a fixed or predetermined cash amount, such as a salary or an annuity. In both of the committee reports on Section 707(c) the term "guaranteed salary" is used synonymously with the term "guaranteed payment."[47] Therefore, it becomes arguable that had Congress intended to include the value of meals and lodging within the purview of Section 707(c), the term "guaranteed compensation," "guaranteed income," or a similar more inclusive term than "guaranteed payment" would have been used. Perhaps, then, Section 707(c) was intended to cover only cash payments

44. Under section 707(c) such "payments to a partner for services . . . shall be considered as made to one who is not a member of the partnership . . . for the purpose of section 61(a). . . ." (emphasis added.) Section 61(a) defines gross income as "all income from whatever source derived," but with the proviso "except as otherwise provided in this subtitle.' 26 U.S.C.A. § 61(a). Thus section 61(a) incorporates the other sections of the subtitle including section 119, and requires that the other provisions of the subtitle be considered and utilized in determining gross income. . . . *Id.*

45. *See* INT. REV. CODE § 707(c).

46. *See* F.A. Falconer v. Commissioner, 40 T.C. 1011, 1015-1016 (1963).

47. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954), S. REP. No. 1622, 83d Cong., 2d Sess. (1954).

for salaries and interest on capital, and not such expenditures as the cost of meals and lodging furnished to a partner-employee for the convenience of the partnership.

The court in *Armstrong* did not deal directly with the precise question now under consideration. From its discussion of the sub-section, however, it seems the court considered the value of meals and lodging as falling under the statute.[48] Moreover, a statement made by the court concerning the requirements necessary before the value of these emoluments could fall under Section 707(c) has placed an additional uncertainty upon this problem of characterization. In discussing the interrelationship of Section 707(c) and Section 119, the court said:

> There is no evidence in the record that the emoluments were "determined without regard to the income of the partnership" or that they consisted of "*payments*" rather than lodging and meals furnished in kind. Furthermore, even should evidence be produced on remand showing that these *two requirements* for the application of section 707(c) are present, such evidence would not affect the result in this case.[49]

Precisely what the court meant by this language, which apparently restricts the application of Section 707(c) to "payments" rather than "meals and lodging furnished in kind," is not at all clear. There are conceivably two methods available to the partnership for providing a partner with the value of meals and lodging: (1) The partner-employee can pay for the expenses himself and later be reimbursed by cash payments from the partnership; (2) The meals and lodging can be furnished directly (in kind) by the partnership to the partner. It is unlikely that the court's intention could have been to draw a distinction between these two methods for the purpose of restricting Section 707(c) to the "reimbursement" situation. The reason for this is as follows: Section 119 is almost uniformly considered to apply only where the value of meals and lodging is furnished "in kind."[50] Therefore, it seems doubtful that the court would make an initial determination that Section 119 emoluments are "guaranteed payments," and then restrict the application of Section 707(c) to a situation which would render the initial characterization meaningless.

Perhaps by restricting the application of 707(c) to "payments," the court intended to adopt the narrow interpretation of that section as encompassing only fixed cash payments to a partner.[51] However, this also appears unlikely, and for almost the indentical reason as in the previous alternative considered above. To say that only cash payments may qualify under Section 707(c), after having initially decided that the value of

48. *See* Armstrong v. Phinney, 394 F.2d 661, 664, n.10 (5th Cir. 1968).
49. *Id.* (Emphasis supplied.)
50. *See* 2 P.H., FEDERAL TAXES § 8687 (1969).
51. *See* discussion *infra* at 25.

these emoluments are "guaranteed payments," would be to allow form to govern over substance.

C. *Problem of Incorporation*

As has already been pointed out, the Regulations expressly provide that for purposes of provisions of the Code other than Sections 61(a) and 162(a), guaranteed payments are to be treated as distributive shares of partnership income, with the effect of this limitation being to prevent a partner from qualifying for the Section 105(d) sick-pay exclusion and the Section 404 deferred compensation deductions.[52] It would appear, then, that since Section 119 stands in the same general category as Section 105(d)—in that they both provide for exclusions from the gross income of employees—the same result should apply to Section 119.

The court in *Armstrong*, however, reached an opposite conclusion by reasoning that the reference in Section 707(c) to Section 61(a) should be construed as incorporating the other sections of Subtitle A of the Code, including Section 119.[53] In arriving at this result, the court relied entirely upon the words in Section 61(a), "[E]xcept as otherwise provided in this subtitle . . . ."[54] It hardly needs pointing out that if the above expression is to be treated as being included in the reference in Section 707(c) to Section 61(a) then, logically, it should apply with equal weight to all of the provisions of Subtitle A; not only Section 119, but also Sections 105(d) and 404. But, as has already been noted, the latter two Sections are mentioned in the Regulations as specific examples of non-applicable provisions under Section 707(c).[55] If the construction suggested by the *Armstrong* case is correct, then to the extent that they conflict the Regulations must be considered invalid. It is a well-established rule of construction, however, that in interpreting tax statutes, the Regulations are to carry great weight and have the force of law unless clearly in conflict with the terms and purposes of the statute to which they relate.[56] Therefore, unless the legislative history discloses such a "clear conflict," the applicable provisions of the Regulations should play at least some part in interpreting the scope of Section 707(c).

1. LEGISLATIVE HISTORY OF SECTION 707(c)

The original version of Section 707(c) as contained in the 1954 House Bill provided as follows:

> (c) *Guaranteed Salaries.—For purposes of section* 61(a) (1) (relating to the *inclusion* in gross income of compensation

52. *See infra* at 20.
53. Armstrong v. Phinney, 394 F.2d 661, 664, n.10 (5th Cir. 1968).
54. *Id.*
55. Treas. Reg. § 1.707-1(c) (1956).
56. Commissioner v. South Texas Co., 333 U.S. 496, 501 (1948); United States v. Correll, 389 U.S. 299, 305-307 (1967).

> for services, etc.) *and section* 162(a) (1) (relating to the deduction of expenses for a reasonable allowance for salaries, etc.), payments to a partner for services shall, to the extent determined without regard to the income of the partnership, be considered as a salary paid or incurred with respect to one who is not a member of the partnership.[57]

As is readily apparent, this original version contained the same latent ambiguity as does the present revised version now under consideration. In fact, this ambiguity was called to the attention of the Senate Committee on Finance on the Internal Revenue Code of 1954 by a representative of the American Institute of Accountants:

> [I]t should be made clear whether the imputed compensation [under Section 707(c)] is to be treated as such for purposes of the withholding tax, unemployment-compensation tax, social security tax, pension and profit-sharing plans, etc.[58]

With minor revisions, the House version of Section 707(c) was approved by the Senate, and this revised form was subsequently enacted into law. In commenting upon the revisions it made, the Senate Finance Committee's Report explained:

> When a partner . . . performs services for the partnership, the problem arises whether the transaction is to be treated [by adopting the entity approach or the aggregate approach] . . . . Because of its *simplicity* of operation, the "entity" rule has been adopted by the House and your committee.
>
> . . .
>
> Under present law, fixed payments to a partner are not recognized as a 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. As indicated below, your committee makes slight changes. . . .
>
> In the case of guaranteed salary payments your committee followed the House bill but made it clear that such income is to be reported for tax purposes at the end of the partnership year in which it is paid and that this treatment is *only* provided for purposes of the *reporting* of the income by the partner and the deducting of the payments by the partnership. . . .[59]

57. H.R. 8300, 83d Cong., 2d Sess. (1954) (emphasis supplied).

58. *Senate Hearings Before the Committee on Finance on The Internal Revenue Code of 1954*, 83d Cong., 2d Sess. 1322 (1954).

59. S. REP. No. 1622, 83d Cong., 2d Sess. 92 (1954) (emphasis supplied).

Prior to the 1954 Code, certain complications and uncertainties had arisen in connection with the income of a partner and the corresponding business deduction of the partnership, where the partner transacted business with his partnership as an outsider. These problems were due to the fact that a guaranteed salary could be considered either as a distributive share of partnership income or as income earned by the partner as an outsider, depending upon whether the "aggregate" or "entity" theory of the partnership was adopted.[60]

Perhaps, then, as the Senate Committee Report seems to indicate, the "entity" theory of the partnership was provided for in Section 707(c) only because it was simpler than the "aggregate" theory for dealing with the income-computing and timing problems discussed above. Had the Report gone on to provide explicitly that the guaranteed payments in their entirety were to be included in the recipient-partner's gross income, then such an interpretation of Section 707(c) would appear to be conclusive. However, this is not the case. The Report stated that the entity treatment was being provided "only" for the "reporting" of the income by the recipient partner.[61] The use of the word "reporting" opens the door for a construction coinciding with that in the *Armstrong* case, since the word "reporting" can be interpreted as including a predetermination as to whether a given item of income is taxable or non-taxable. A statement contained in the Report of the House Committee on Ways and Means also supports this latter view.[62]

Nowhere in the legislative history of Section 707(c) is the subject of the value of meals and lodging furnished to a partner-employee dealt with directly. Nor is it possible to infer from the Committe Reports with any degree of certainty that the Congressional intent in enacting Section 707(c) was to treat a partner-employee like any other employee for purposes of determining whether a payment is includible in, or excludable from, the partner's gross income. Perhaps, then, all that can be said regarding the reference in Section 707(c) to Section 61(a) is that it is ambiguous.

2. INTERPRETATION OF SECTION 707(c)

If it is true that the statute itself and its supporting history are unclear on the issue of incorporation, then this would seem to be precisely the situation for which the Regulations were designed. Yet, in *Armstrong*,

60. *See* Benjamin v. Hoey, 47 F. Supp. 158 (S.D.N.Y. 1942), *vacated and remanded on other grounds,* 139 F.2d 945 (2d Cir. 1944); Wegener v. Commissioner, 119 F.2d 49 (5th Cir. 1941), *certiorari denied,* 314 U.S. 643 (1941). Stout v. Commissioner, 31 T.C. 1199 (1959).

61. S. REP. No. 1622, 83d Cong., 2d Sess. 92 (1954).

62. The Report states:

> 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. . . . (Emphasis supplied.)

H.R. REP. No. 1337, 83d Cong., 2d Sess. A226 (1954).

the validity of the pertinent provisions of the Regulations was not even considered.

It is submitted that before any court adopts an interpretation of 707(c) that would allow incorporation, the validity of the Regulations must be considered; and unless found to be in clear conflict with the underlying purposes of the statute, they should operate to prevent incorporation.

VI. Conclusion

The different tax treatment accorded essentially similar businesses, depending upon their legal form of organization, has been characterized as "a striking and inequitable feature of the present law."[63] Without going into the criticisms of the existing scheme, suffice it to say that a construction of Section 707 that would remove the present distinctions insofar as the partner-employee is concerned would not serve to remove the existing "inequities." Rather, it would only serve to create new ones. Taxpayers operating their business as a partnership would thereby be given a tax advantage over a similarly situated sole-proprietor who clearly cannot take advantage of provisions such as Section 119. The partner-employee would also gain a tax advantage over the shareholder-employee, since in the latter case both the shareholder-employee and his corporation would still be required to pay income tax. It is submitted that Section 707 was not intended to remove the well-established rule that a partner is not an employee of his own partnership for the purpose of applying the "convenience of the employer" exclusion now codified in Section 119 of the Code.

63. 100 Cong. Rec. 8998 (1954) (remarks of Senator Millikin).