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Hill Farrer & Burrill, 67 T.C. 411 (1976)

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Profit Sharing—NEW DEFINITION OF A PARTNERSHIP "PROFITS INTEREST" DISQUALIFIES AN OTHERWISE QUALIFIED PROFIT SHARING PLAN—*Hill Farrer & Burrill*, 67 T.C. 411 (1976).

Hill Farrer & Burrill[1] involved a general partnership of nineteen members engaged in the practice of law. All partners contributed substantially equal amounts to the capital of the partnership and shared in partnership assets in proportion to their respective contributions. Profits from legal services were divided among the partners in three stages. First, twenty percent of a client's fees for services (less proportional overhead) was allocated to the partner or associate responsible for producing the client, or to the partner or associate whose original client in turn referred a new client to the partnership. The partnership agreement specified that these twenty percent interests—which would be paid to the partner or his successors in interest for five years following the partner's permanent retirement from the practice of law, total disability, or death—were assignable. Second, two-thirds of the remaining profits were allocated among the partners in accordance with the ratio by which their legal services contributed to the total partnership profit during the year. Third, the final one-third of profits was allocated among the nineteen partners according to the ratio of their capital contributions.[2] The partnership maintained separate drawing accounts to which each partner's share of profits was credited and all drawings were charged.[3]

The partnership sought to qualify its profit sharing plan under section 401(a) of the Internal Revenue Code of 1954.[4] Qualified plans have several tax advantages: employer's contributions are currently deductible, the fund's income is exempt from federal income taxation, and distributions to a beneficiary are not taxed until received or available.[5] Under certain circumstances these distributions may

1. 67 T.C. 411 (1976), *appeal by the partnership pending (9th Cir.)*, [1978] 4 FED. TAXES (P-H) ¶ 19,266(7). Judge Featherstone's opinion was reviewed by the court. Judge Tannenwald concurred in a separate opinion in which Judges Irwin and Wilbur agreed. Judge Goffe wrote a dissenting opinion in which Judges Drennan, Sterrett, and Wiles agreed.

The petitioner will hereinafter be referred to as "the partnership."

2. *Id.* at 413-14. Partnership profits from sources other than fees for legal services rendered, including gains or losses on the sale of capital assets, or other losses, were allocated among the 19 partners in proportion to their cash capital contribution, except that losses from maintaining branch offices were deducted from total firm profits rather than directly allocated among the partners. *Id.* at 413.

3. *Id.* at 413.

4. INT. REV. CODE OF 1954, *as amended* [hereinafter I.R.C.].

5. *Id.* §§ 402(a)(1), 403(a)(1).

be treated as capital gain.[6] Also, to the extent attributable to employer contributions, death benefits payable to a deceased employee's successors in interest, other than the decedent's estate, are excluded from estate taxation.[7]

Tighter rules govern the qualification of plans benefiting "owner-employees," persons who own more than ten percent of a business. Congress enacted these "tighter rules . . . in order to prevent retirement plans of owner-employees from becoming purely income-averaging devices and to insure that contributions made for their employees . . . [did] not inure to the benefit of owner-employees."[8] The Tax Court in *Hill* reviewed these additional restrictions:

> [T]he trustee must be a bank or other approved person; coverage must be extended to all full-time, nonseasonal employees with 3 or more years of services; such employees' rights are to be nonforfeitable upon contribution to the plan; a definite formula for determining employer contributions must be provided; and annual contributions on behalf of an owner-employee are limited. Distributions are not to be made to an owner-employee before he reaches the age of 59 ½ years except in case of disability, and distributions to an owner-employee are to be made no later than the taxable year in which he reaches the age of 70 ½.
>
> In the case of a plan providing benefits for employees some or all of whom are owner-employees who control the business, restrictions are placed upon transactions between the trust and such owner-employees. These restrictions pertain to loans, compensation for personal services, preferential services, and property transactions . . . .[9]

The partnership conceded that if its plan failed to qualify under the less stringent requirements of section 401(a), the plan would not qualify under the foregoing additional requirements for plans covering owner-employees.[10] The Service ruled that the Hill partnership's

6. *Id.* §§ 402(a)(2), 403(a)(2).

7. *Id.* § 2039(c).

8. S. Rep. No. 992, 87th Cong., 1st Sess. 2 (1961), 1962-3 C.B. 303, 304.

9. 67 T.C. at 416 (footnotes omitted). For a discussion of the mechanics of qualifying a plan, see Dahlgren, Dauenhauer, & Palmquist, *Qualifying Retirement Plans Under ERISA*, 11 Gonz. L. Rev. 838 (1976); Tilton & McNabb, *Complying With the IRS's New Guidelines for Determinations of Qualified Plans*, 44 J. Tax. 24 (1976).

10. 67 T.C. at 412. For an examination of the hazards of disqualification, see Moore, *Problems in Nonqualified Deferred Compensation*, 25 Tax Exec. 108 (1973); Simmons, *Dangers of Disqualification of Qualified Plans*, 1975-1 N.Y.U. 33d Inst. on Fed. Tax. 507. *See also* Bachelder, *Tax and Accounting Aspects of Costs of Nonqualified Compensation Plans*, 1972-1 N.Y.U. 30th Inst. on Fed. Tax. 443; Jones, *Comparative Analysis of Qualified and*

plan was not qualified because "at all relevant times, at least one partner . . . actually received a distribution of firm profits which exceeded 10 percent of total firm profits"[11] and thus the plan covered owner-employees within the meaning of section 401(c)(3), which provides:

> For purposes of this section—
>
> (3) Owner-employee—The term "owner-employee" means an employee who—
>
> . . . .
>
> (B) in the case of a partnership is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.
>
> To the extent provided in regulations prescribed by the Secretary or his delegate, such term also means an individual who has been an owner-employee within the meaning of the preceding sentence.[12]

The partnership argued that the mere receipt of more than ten percent of the partnership's profits is not ownership. Ownership, it said, is determined by the partnership agreement, which bases a partner's share of profits on this productivity.[13] Since no partner had an absolute advance contractual right to receive more than a ten percent profits interest, no partner owned more than a ten percent interest in the partnership. The sole owner-employee example in the section 401 regulations allows that "an individual who owns only 2 percent of the profits interest but 11 percent of the capital interest of a partnership is an owner-employee."[14]

The partnership also asserted that a distribution based on productivity is not capital in nature, but an interest in partnership profits is a capital asset.[15] Because the distribution was of ordinary income and not of a capital asset, it could not be a partnership interest.

The Tax Court rejected the partnership's definition of "owns":

Deferred Compensation Plans: Non-Equity Type Deferred Compensation Arrangements (Qualified Pension and Profit-Sharing Plans and Non-Qualified Deferred Compensation Plans and Contracts), 1974-1 N.Y.U. 32D INST. ON FED. TAX. 957.

11. 67 T.C. at 415. The Service conceded that no partner owned more than 10% of the capital interest in the partnership.

12. I.R.C. § 401(c)(3).

13. 67 T.C. at 415. *See* Treas. Reg. § 1.401-10(d) (1963): "A partner's interest in the profits and the capital of the partnership shall be determined by the partnership agreement."

14. Treas. Reg. § 1.401-10(d) (1963).

15. 67 T.C. at 418-19; *see* I.R.C. § 741.

> [W]e do not agree . . . that this word contemplates necessarily "a contractual agreement, fixing, in advance the percentages of the partnership profits to be awarded each partner." . . . Its meaning in a statute is affected by the context and the legislative purpose of the provision in which it is used.[16]

The Tax Court found that under the partnership agreement, each partner had a contractual right to receive his distributive share as calculated under the fixed, agreed-to formula.[17] It held further that any partner could transfer or bequeath "his contractual rights in partnership profits, whatever the amount thereof might be. That constitutes ownership of an interest in those profits . . . ."[18] The Tax Court rejected the partnership's capital asset assertion.[19]

Although the Service has not promulgated regulations defining who "has been an owner-employee" as mandated by section 401(c)(3), the Tax Court stated that the language "indicates a congressional intent that the partner's ownership rights be measured at the end of the business year."[20] Consequently, since a partner had received more than ten percent of the profits of the partnership pursuant to a contractual formula, that partner was an "owner-employee" within the meaning of section 401(c)(3), and the plan did not qualify under section 401(a).

The dissent stressed that the section 401 regulations defining owner-employee "do not set forth any test as to *when* an individual *has been* an owner-employee nor do the regulations explain what is meant by 'owning' an interest in the capital or profits."[21] The dissent pointed out that the section 401 regulations based ownership in terms of the partnership agreement, but "[t]he majority looks outside the partnership agreement to see what . . . partners have received . . . ."[22] The dissent also identified the uncertain nature of partners' shares under the partnership agreement and criticized

16. 67 T.C. at 419 (citation omitted).

17. *Id.* at 420.

18. *Id.*

19. *Id.* The court stated:

> Where the consideration received by the taxpayer for the sale of a partnership interest was a "present substitute for what would have been ordinary earned income in the hands of the assigning taxpayer, if the assignment or transfer had not been made," the courts have treated the sale as an assignment of future income. United States v. Woolsey, 326 F.2d 287, 291 [13 AFTR 2d 311] (5th Cir. 1963); Roth v. Commissioner, 321 F.2d 607, 610-611 [12 AFTR 2d 5392] (9th Cir. 1963), affg. 38 T.C. 171 (1962); Frank A. Logan, 51 T.C. 482, 485-486 (1968).

Id. at 419.

20. *Id.* at 420.

21. *Id.* at 422 (emphasis in original).

22. *Id.*

the majority for equating "1 year's 'distributive share' with 'profits interests.'"[23] Finally, the dissent underscored the impracticality of the majority's ownership test vis-a-vis its stated purpose to eliminate abuses:

> [I]f the owner-employee cannot be identified until the end of the year when the accounting is completed and such owner-employee may or may not be an owner-employee in the subsequent taxable year, how can it be determined who is going to commit the abusive acts that the definition of owner-employee was designed to correct?[24]

That Congress anticipated that profit sharing plans covering owner-employees would "present greater opportunities for abuse" was recognized by the Tax Court in *Hill.*[25] But the court linked this intent directly to the language of section 401(c)(3), which *permissively* invites the Service to define "who has been an owner-employee."[26] The Tax Court overlooked language, expressed within the same subdivision of the Senate Report it cited, referring only to "a partner who does not own more than a 10-percent interest in the business (and thus is not an owner-employee) . . . ."[27] Likewise, neither the House nor the Conference Report discusses this language. This suggests that Congress delegated to the Service the discretion to define who has owned more than ten percent of either the capital or the profits interest in a partnership. The Service has refrained from exercising this discretion.

The profits interest concept is critical in the disallowance of "special allocations." A partnership may allocate items of income, gain, loss, deduction, or credit; but if the allocation does not have "substantial economic effect," then "the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership . . . ."[28] For example, if in real estate partnership *AB*

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23. *Id.* at 424. The dissent stated:

> [The agreement] prevents any partner from *owning* a fixed percentage of the net profits of the partnership for any given year because each partner's share of the profits necessarily rests upon three variables; i.e., the new clients brought to the firm by such partner, the total income earned by the partnership and the expenses paid by the partnership for the year involved.

Id. at 423-24 (emphasis in original).

24. *Id.* at 426.

25. 67 T.C. at 417, *quoting* H.R. REP. No. 378, 87th Cong., 1st Sess. (1961), 1962-3 C.B. 261, 262; S. REP. No. 992, *supra* note 8, at 1962-3 C.B. 305.

26. I.R.C. § 401(c)(3).

27. S. REP. No. 992, *supra* note 8.

28. I.R.C. §§ 702 and 704(b)(2); Treas. Reg. § 1.704-1(b)(2) (1964).

all depreciation deductions are allocated to partner *A*, but the partners have made equal contributions to and have otherwise equal interests in the partnership, under section 704 the depreciation deductions will be reallocated in accordance with the partners' general sharing ratio, or fifty percent to *A* and fifty percent to *B*.[29] Another important circumstance involves section 708: a partnership is considered as terminated if "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits."[30] As recently as 1976, Congress considered defining partners' partnership interests, but has not done so.[31]

While the structure of a law firm such as the Hill partnership neither permits nor encourages an allocation formula which would always avoid the Tax Court's definition of "owns," similar partnerships may yet be able to avoid the definition. The section 401 regulations state that a "guaranteed payment (as described in section 707(c)) is not considered a distributive share of partnership income" for the purpose of determining whether a partner is an owner-employee.[32] Guaranteed payments under section 707(c) are payments made "without regard to the income of the partnership" to a partner not acting in a capacity as a partner. Because guaranteed payments are treated as ordinary income and as if made to an employee, it is appropriate that they are not considered as a partner's profits interest. Under the section 721 regulations the receipt of a partnership interest "for services rendered to the partnership . . . is a guaranteed payment for services under section 707(c) . . . ."[33] Partners in *Hill* received their profits interest in return for services; thus, under the section 721 regulations the receipt was a guaranteed payment. As such, under the section 401 regulations it was not a partnership interest for the purpose of section

29. *See* Stanley C. Orrisch, 55 T.C. 395 (1970), *aff'd per curiam*, 31 A.F.T.R.2d 73-1069 (9th Cir. 1973); Weidner, *Partnership Allocations and Tax Reform*, 5 FLA. ST. U.L. REV. 1, 15-23 (1977).

30. I.R.C. § 708(b)(1)(B).

31. The House suggested the following permanent allocation method in proposing the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520:

> A partnership will ordinarily be considered to have a "permanent method" of allocating taxable income or loss if (1) it has consistently applied such method over a number of years, and (2) it meets both the business purpose and significant tax avoidance tests provided under the amended section 704(b).

H.R. REP. No. 94-658, 94th Cong., 1st Sess. 125, 127 (1975). *See* Weidner, *supra* note 29, at 57-58 n.211.

The Senate dropped this proposal in scrapping the House test of special allocations. *Id.* at 55-63.

32. Treas. Reg. § 401-10(d) (1963).

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

401(c)(3)(B).[34]

Valuation may provide yet another way to avoid the Tax Court's definition of owner-employee. In *Vestal v. United States,*[35] the taxpayer received an interest in partnership capital in return for services. Vestal failed to pay income tax upon receiving the interest. After the statute of limitations had run, the partnership sold its assets at a substantial gain and Vestal sought to treat the amount he realized as capital gain.[36] He argued successfully before the district court that his basis in the partnership interest was the amount he should have included in his income when the interest was transferred, and that subsequent appreciation was properly recognized as capital gain.[37] But on appeal the Service prevailed. The Eighth Circuit determined that although the interest Vestal received had value, its receipt was not necessarily a taxable event:

> 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.[38]

What, then, is the value of a *Hill*-type executory contingent contract-profits sharing interest which includes a partner's right to receive twenty percent (less proportional overhead) of the fees from clients he recruits? The Tax Court in *Hill* held that "[t]his policy allowing a partner to share in all fees paid by a client he has obtained gives him a continuing right from year to year to a portion of the firm's profits."[39] But a more credible answer to the value question was suggested by the Board of Tax Appeals in *Humphrey Barton.*[40] Barton attempted to avoid taxation on money distributed to him by his partnership. He alleged that the distribution represented a nontaxable return of his capital contribution to the part-

34. In *Hill*, the calculation of a partner's profits interest would be based solely on the final one-third of profits allocated according to the ratio of the 19 partners' capital accounts. The interest amounts to approximately a one-nineteenth share per partner, well below the 10% limitation.

35. 498 F.2d 487 (8th Cir. 1974).

36. *Id.* at 488.

37. The district court opinion is unofficially reported at 73-1 U.S. Tax Cas. ¶ 9260 (W.D. Ark. 1973).

38. 498 F.2d at 493-94. *See* United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), *rev'g* 213 F. Supp. 457 (W.D. La. 1963) (a profits interest in a partnership does not exist until the interest becomes possessory).

39. 67 T.C. at 418.

40. 13 B.T.A. 1184 (1928).

nership—"25 law cases in which he had been retained . . . ."[41] The Board disagreed:

> Even if there is any legal basis sufficient to support the claim of [Barton,] the value of the law cases was contingent and highly speculative and can not be regarded as a capital contribution to the partnership in any amount which the evidence enables us to determine.[42]

If, as in *Barton,* the right to represent clients in present litigation is valueless, the mere right to receive a percentage of a client's fees, if any, must also be presumed to be valueless.

The *Hill* decision holds other ramifications. Fresh doubt is injected into the snare of partnership taxation referred to as the "flip-flop" problem. This problem stems from Treasury Regulation § 1.752-1(e), which provides that a partner shares in a partnership's nonrecourse liabilities in the same proportion as the partner shares in partnership profits. Under sections 752(a) and 722, the partner's basis is increased by this amount. Therefore, if a partner's interest in partnership profits is reduced and the partnership has nonrecourse liabilities, then the partner realizes income in an amount equal to the proportional reduction of his share of nonrecourse liabilities.[43] Under *Hill,* a partner is considered as owning an interest in partnership profits in the amount to which he becomes entitled. That interest will fluctuate, perhaps dramatically, depending upon a partner's performance for a given year. A partner might be working on a contingency fee basis, and one year win a stunning personal injury award. The partner would receive a large share of partnership profits, increasing his profits interest and his proportional share in non-recourse liabilities. Assume that the following year is average for the partner, and no large awards are won. His share of partnership profits is proportionally smaller, reducing his profits interest and proportional share of nonrecourse liabilities. The partner faces the adverse tax consequences of a constructive distribution. Also, the same problem faced the partner's colleagues in the preceding year when the partner won the award, increased his profits interest, and proportionally reduced his colleagues' shares of nonrecourse liabilities.[44]

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41. *Id.* at 1185.
42. *Id.* at 1187.
43. *See* Rev. Rul. 74-40, 1974-1 C.B. 159.
44. *See* 1 A. WILLIS, PARTNERSHIP TAXATION 255-59, 487-88 (1976); Lee, *Constructive Cash Distributions,* 22d WM. & MARY TAX CONF. 129 (1977); Parker & Lee, *Constructive Cash Distributions in a Partnership,* 41 J. TAX. 88 (1974).

Additionally, the Tax Court's definition of ownership may complicate the application of section 83, relating to property transferred in connection with the performance of services. Under section 83, if a person receives property which is nontransferable or subject to a substantial risk of forfeiture, that property is not included in the recipient's income until the transfer becomes complete, unless within thirty days the recipient elects to realize the receipt.[45] "Substantial risk of forfeiture" under section 83 means that a "person's rights to full enjoyment of [the restricted] property are conditioned upon the future performance of substantial services by any individual."[46] The proposed regulations under section 83 provide that until the transfer of restricted property 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 . . . .[47]

Under the *Hill* definition of "owns," the application of section 83 to partnerships would be narrowed.[48] A partner receiving a *Hill*-type partnership interest, although conditioned upon the performance of substantial services, would be treated as owning the partnership interest. The partner would recognize any distributive share of partnership losses and would determine the character of any distributive share of partnership income as if it had been received directly rather than through an entity. The partner would realize loss on the forfeiture of the partnership interest and, upon selling the interest, treat its appreciation as capital gain.[49]

But circumventing section 83 is not without a drawback. Under section 83, a service partner[50] receiving a restricted partnership interest, for example, would not share in the tax losses and deductions venerated by high-bracket investors. As transferors, the investors would be treated as owning the interest until the transfer became

45. *See* I.R.C. § 83(b).

46. I.R.C. § 83(c)(1). "Whether such services are substantial depends upon the particular facts and circumstances." Prop. Reg. § 1.83-3(c)(1) (1971).

47. Prop. Reg. § 1.83-1(a) (1971).

48. For a discussion of the applicability of I.R.C. § 83 to partnerships, see Cowan, *Receipt of a Partnership Interest for Services*, 1974-2 N.Y.U. 32D INST. ON FED. TAX. 1501, 1527.

49. I.R.C. §§ 702, 731, 741.

50. A service partner receives a partnership interest in exchange for a promise of personal services.

complete. But following the *Hill* definition of "owns," the transferee-service partner would share in the tax sheltering items, defeating "a mechanism that would pass all tax losses from service partners to high-bracket investor-partners."[51]

Finally, ordinary income may be transformed into capital gain under the *Hill* definition of ownership, rekindling the controversy surrounding the now renowned case of *Diamond v. Commissioner.*[52] Diamond received an interest in partnership profits solely in exchange for securing financial backing for a partnership's purchase of real estate. Diamond's partner agreed to pay all costs exceeding the amount of financing, but, until reimbursed for the costs, Diamond's partner was entitled to receive all partnership profits. Losses and postreimbursement profits were allocated sixty percent to Diamond and forty percent to his partner. Shortly after receiving his interest, Diamond sold it and sought to treat the amount realized as capital gain.[53] The Service successfully reclassified Diamond's gain as ordinary income.[54]

Section 721 provides that a partner does not recognize gain or loss upon contributing property to a partnership in exchange for an interest in the partnership. The *Diamond* dispute centered upon a parenthetical in the 721 regulations: "To 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 . . . section 721 does not apply."[55] Diamond asserted that this parenthetical required the application of section 721 to transfers of an interest in partnership profits in exchange for services. Thus, under section 721 no gain or loss is recognized on the transfer. But the Tax Court rejected this reading of the regulations and required Diamond to recognize as ordinary income the value of the profits interest transferred.[56] But the Tax Court also noted that "there may be some kind of equitable justification for giving the parenthetical clause some kind of affirmative operative scope, as perhaps where there is a readjustment of partners' shares to reflect services being performed by one of the partners . . . ."[57]

51. Weidner, Pratt *and Deductions for Payments to Partners,* 12 REAL PROP., PROB. & TR. J. 811 (1977).
52. 492 F.2d 286 (7th Cir. 1974).
53. *Id.* at 286-87.
54. *Id.* at 292.
55. Treas. Reg. § 1.721-1(b)(1) (1960).
56. Sol Diamond, 56 T.C. 530, 545-46 (1971).
57. *Id.* at 546.

Under this dictum in *Diamond,* it follows that if a member of a *Hill*-type partnership receives an interest in partnership profits in exchange for services, no gain or loss will be recognized under section 721; and, on the sale of the interest, under section 741, the partner will receive capital gain treatment.

In summary, the partnership should defeat the Tax Court's definition of profits interest and owner-employee by employing either the guaranteed payment or valuation approach. If *Hill* is affirmed by the Ninth Circuit, then the taxation of partnerships will be saddled with further uncertainty: the constructive distribution issue is fueled; the transformation of ordinary income into capital gain might be achieved under the *Diamond* dictum; and rules for taxation of restricted property may be upset. *Hill*-type profit sharing plans now face a Service attack carrying adverse tax consequences for all involved.

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