Tax Treatment of Meals and Lodging Furnished to a Partner

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TAX TREATMENT OF MEALS AND LODGING FURNISHED TO A PARTNER

Two recent cases, Commissioner v. Doak\(^1\) and Commissioner v. Moran,\(^2\) decided under the 1939 Internal Revenue Code have involved the tax treatment of meals and lodging furnished to a partner by a partnership.

The facts and reasoning of the cases are essentially the same: Taxpayers, husband and wife, operated a hotel as partners. In the management of the business they found it necessary to maintain a residence at the hotel and eat their meals there. They deducted the value of these items from the partnership gross income as a business expense in arriving at net income. Both courts reversed the Tax Court\(^3\) and disallowed the deduction as a personal nondeductible expense.\(^4\) Both decisions seem to adopt this reasoning: a partner cannot be considered an employee of a partnership; the meals and lodging cannot be compensation to the partner; therefore, their value cannot be deducted by the partnership as compensation paid to an employee.\(^5\) An important concession made by both courts is that if the partnership was treated as a separate taxable entity and the partners as employees then such costs might be deductible.

The turning point of the cases then, is whether or not these meals and lodging can be considered compensation. Whether or not they can be compensation depends upon the legal concept of a partnership. A partnership has sometimes been treated as an aggregate of individual co-owners of property used for a common purpose; at other times a partnership has been regarded as a single business entity.\(^6\) Depending upon which theory is followed a court can come to completely dif-

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\(^1\) 234 F. 2d 704 (4th Cir. 1956).
\(^2\) 235 F. 2d 959 (8th Cir. 1956). The Doak and Moran cases were approved and followed by the Tenth Circuit in U.S. v. Briggs, 1956 P-H Fed. Taxes, Par. 73,034 (1956).
\(^5\) Int. Rev. Code § 23 (a) (1) (A) (1939): “In computing net income—there shall be allowed as deductions: In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity . . . .” The 1954 Code section is substantially the same. See Int. Rev. Code § 162 (a) (1954).
fferent conclusions as would the courts in both the *Doak*\(^7\) and *Moran*\(^8\) cases had they applied an "entity" theory and held the partners as employees of the partnership. By holding that a partner cannot be an employee of a partnership, the courts in these cases adopted the "aggregate" approach holding that a partner was merely working for himself and could not therefore compensate himself.

I. PRIOR TO INTERNAL REVENUE CODE OF 1954

An analogous situation to the case of meals and lodging furnished a partner is where the partnership agreement provides that a partner is to receive a fixed "salary" as compensation for services in addition to his distributive share of partnership profits.

The early case of *Estate of S. U. Tilton*\(^9\) in 1927 took the position that such agreements to pay fixed "salaries" to partners were nothing more than a method for distributing the partnership profits. The court stated:

"A partner devoting his time and energies to the business of the firm is in fact working for himself and can not be considered as an employee of the firm in the sense that he is in the service of another. It follows, therefore, that he can not be paid a salary by the firm out of earnings in the sense of compensation for services rendered to an employer. In effect any allowances drawn by a partner from partnership assets are payments which he makes to himself and no man can be his own employer or employee."

One year later in 1928, *Karl Pauli v. Commissioner*\(^11\) followed the *Tilton* case\(^12\) in holding that a payment of $6,000 to a partner entered on the partnership books as "salary" was in reality advance payment of firm profits and not compensation to the partner.

As a result of these two cases, the Tax Court appeared to establish the application of the "aggregate" theory when a "salary" was attempted to be paid a partner.

The problem of how these distributions were to be treated by the recipient if the partnership had no profits was decided in *Lloyd v. Commissioner*\(^13\). They were to be treated as a return of capital: taxable to the extent that it represented capital of his partners and nontaxable to the extent that it represented a return of his own capital.

A number of Treasury Department rulings\(^14\) all citing the *Tilton*\(^15\)

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\(^7\) Supra, note 1.
\(^8\) Supra, note 2.
\(^9\) 8 B. T. A. 914 (1927).
\(^10\) Ibid. at 917.
\(^11\) 11 B. T. A. 784 (1928).
\(^12\) Supra, note 9.
\(^13\) 15 B. T. A. 82 (1929).
\(^15\) Supra, note 9.
case as authority, held that such "salaries" were merely methods of distributing partnership profits and could not be true salaries no matter what the partnership agreement specified since a partner could not be a partnership's employee.

The application of the "aggregate" theory sometimes produced exceedingly unrealistic results. If a partner had been an employee of the partnership prior to his becoming a member of the partnership and rendered precisely the same service after becoming a partner as he had before and received the same amount of money for the performance of the service, the money suddenly was no longer compensation to him but distribution of profits.\textsuperscript{16}

If these 'salaries' did not represent compensation to the partner under the "aggregate" theory but distribution of partnership profits it necessarily followed, if the theory was applied consistently, that no deduction would be allowed by the partnership as a business expense. Two Treasury rulings\textsuperscript{17} and a Tax Court decision in 1929\textsuperscript{18} refused to allow the partnership deductions for these "salaries."

This string of decisions all applying the "aggregate theory was ignored by the Tax Court in a 1950 decision: Lief J. Sverdrup v. Commissioner.\textsuperscript{19} This case involved an engineering partnership which had procured government construction contracts to be performed outside the United States. Petitioner, a member of the partnership, spent six months outside the United States supervising construction of airfields etc. He was paid $5,000 by the partnership as compensation for these services, in addition to his distributive share of partnership profits. The Tax Court applied an "entity" theory, completely ignoring the precedent against its application, and held that the $5,000 was compensation to petitioner:

"This sum was not a part of the income of the partnership of which he was a member but was paid to him as an individual for services rendered to his joint venture. Accordingly, it is not to be considered as his distributive share of income. . . ."\textsuperscript{20}

With the "salary" cases as background, the first case involving meals and lodging was Papineau v. Commissioner\textsuperscript{21} decided one year subsequent to the Sverdrup case.\textsuperscript{22} The Papineau case\textsuperscript{23} involved essentially the same facts as the Doak and Moran decisions\textsuperscript{24} and was

\textsuperscript{16} Tweedy v. Commissioner, 47 B. T. A. 341 (1942).
\textsuperscript{18} Lloyd v. Commissioner, see note 13.
\textsuperscript{19} 14 T. C. 859 (1950).
\textsuperscript{20} Ibid. at 866.
\textsuperscript{21} 16 T. C. 130 (1951).
\textsuperscript{22} Supra, note 19.
\textsuperscript{23} Supra, note 21.
\textsuperscript{24} Supra, notes 1 and 2.
relied on by the Tax Court in allowing the deduction in those cases. The Tax Court in the Papineau case allowed the deduction of the meals and lodging from the partnership income although it stated:

"Partners can not be employees for the purpose of salaries and their "salaries" are not deductible expenses of the business; neither are the meals and lodging of a managing partner compensation for his services, the reason being that one can not employ or compensate himself." The court seemed to apply the "aggregate" theory drawing the analogy between "salaries" and meals and lodging, holding that neither could be compensation because a partner could not be an employee of the partnership. But the court nevertheless allowed the partnership a deduction, stating:

"His meals and lodging are a part of the ordinary and necessary expenses of operating. They are still ordinary and necessary expenses of operating even though this officer is the owner or one of a group of owners." It is difficult to reconcile the Papineau case and the Doak, Moran and "salary" cases on the "aggregate" theory. These decisions, with the exception of the Sverdrup case, applied the "aggregate" theory in holding that a partner cannot be an employee of the partnership; therefore the meals and lodging or "salary" could not be compensation. Yet the Papineau decision allows the deduction by the partnership as an ordinary and necessary business expense. It is difficult to see on what theory the court can justify the granting of this deduction since it states that the meals and lodging are not compensation. The language of the Code section allows the deduction for "salaries or other compensation for personal services" which would presumably include services rendered by an independent contractor. But under the "aggregate" theory a partner could not be an independent contractor rendering service to the partnership any more than he can be an employee. Under the theory he would still be working for himself and therefore could not compensate himself either as an employee or independent contractor. Although the Code section allows a deduction for business expenses other than compensation for services such as rent, heat etc., it is difficult to categorize this deduction as some type of expense other than compensation for services.

25 Supra, note 3.
26 Supra, note 21 at 132.
27 Ibid., at 313.
28 Supra, note 21.
29 Supra, note 1.
30 Supra, note 2.
31 Supra, note 19.
32 Supra, note 21.
33 Supra, note 5.
34 Ibid.
Part of the reasoning of the *Papineau* case is consistent with the “aggregate” theory, but the ultimate result the court comes to is more logical under the “entity” theory. This theory would designate the partner as an employee; the meals and lodging would be compensation to him. The deduction then would be allowed by the partnership as an ordinary and necessary business expense; compensation for personal services rendered. The prior decisions reasoning on the “aggregate” theory are more consistent in denying the deduction by the partnership.

Subsequent to the *Papineau* case, there have been three decisions which have relied on it in allowing the deduction, two of which have been reversed on appeal. In view of these reversals in the appellate courts and the Commissioner’s nonacquiescence and refusal to follow the decision in its rulings, the case, in the opinion of the writer, must be regarded as an anomaly.

In other appellate decisions prior to the 1954 Code, much like the “salary” cases in their basic facts, where the partner dealt with his partnership as a stranger would deal with it such as rendering service for the partnership, or using the services of the partnership the courts failed to follow either theory consistently.

The Second Circuit in the case of *Benjamin v. Hoey* applying the “aggregate” theory held that where a partner ran personal stock transactions through his partnership and paid it brokerage commissions, 38% of these commissions (that percentage attributable to his interest in the business) which were paid to him as his distributive share of the partnership profits were excludable from his gross income because to that extent he was dealing with himself and what one pays to himself cannot be income.

In *Wegener v. Commissioner* in the Fifth Circuit, the taxpayer

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35 *Supra*, note 21.
36 *Supra*, note 5.
37 *Supra*, notes 1, 2, 13, 17.
38 *Supra*, note 21.
40 *Supra*, notes 1 and 2;
41 The case of *Briggs v. U.S.*, 1956 P-H Fed. Taxes Par. 72,319 (1956), while not mentioning the *Papineau* decision allowed the partnership the deduction and also excluded the value of the meals and lodging from the individual partner’s gross income. The court did not state upon what reasoning these results were based. The case was also reversed on appeal, see *U.S. v. Briggs*, note 2. Because of these reversals, the probability is high that the *Wolfe* case, note 39, also will be reversed.
43 139 F. 2d 945 (2d Cir. 1944).
44 This case has been cited as an example of a hybrid theory; that is, that the partner deals with himself to the extent of his own interest in the partnership and treats the remainder as an exchange with the other partners as an *entire*.
45 See 70 Harv. L. Rev. 379 (1956).
46 119 F. 2d 49 (5th Cir. 1941).
owned a one third interest in a partnership which owned gas and oil leases. He did the drilling of the wells as would an employee or independent contractor, billed his partners for the service and was paid by them. His contention consistent with the “aggregate” theory was that he should not be taxed on one third of the profit received from his partners for the drilling since he owned a third interest in the partnership. The court applying the “entity” theory held that the entire amount was taxable since he acted as any outsider would have in performing the service.

These conflicting theories and lack of consistent application of them by the courts resulted in much confusion and uncertainty necessitating a Code revision if a partnership could act within this area with any expectation of what the tax consequences would be.

**II. Partnership Treatment Under the 1954 Code**

The 1954 Code attempted to resolve this confusion by specifically adopting the “entity” theory in transactions between a partner and partnership.\(^{45}\)

Sec. 707 (a) states the rule that: if the partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall be treated as between the partnership and a stranger. Sec. 707 (c) states that: payments made to a partner for services or for use of capital shall be considered as being made to a stranger for purposes of Sec. 61 (a)\(^{46}\) and Sec. 162 (a).\(^{47}\)

Sec. 707 (c) was aimed at the “salary” cases\(^{48}\) and also to those cases where interest was paid to a partner upon contributions of capital to the partnership.\(^{49}\) Under this section, where a partner receives a salary under the partnership agreement, it will be treated as compensation to him and as a business deduction by the partnership. This would seem to be a more realistic and practical approach than the decisions under the “aggregate” theory prior to the 1954 Code and to be more consistent with the intent of the parties. This section would probably not help in a case involving meals and lodging because it would be hard to classify meals and lodging as a guaranteed payment in view of the wording of the Code section,\(^{50}\) the House Committee Reports,\(^{51}\) and Treasury Regulations.\(^{52}\)

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\(^{46}\) Relating to gross income.

\(^{47}\) Supra, note 5.

\(^{48}\) Supra, note 45 at 68, A226.

\(^{49}\) These interest payments had been previously held to be distribution of partnership profits and nondeductible by the partnership. See Ella Daly King v. Commissioner, 10 B. T. A. 698 (1928); John A. L. Blake v. Commissioner, 9 B. T. A. 651 (1927).

\(^{50}\) INT. REV. CODE § 707 (c).

\(^{51}\) Supra, note 48.

\(^{52}\) Treas. Regs. § 1.707-1 (c).
The House Committee in adopting Sec. 707 (a) stated what transactions should be included within the category of a transaction where the partner is acting other than in his capacity as a partner:

"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 for pay by the partner to the partnership."\(^{55}\)

The Treasury's regulations covering this section generally follow those items contained in the committee reports:

"Such transactions include for example, loans of money or property by the partnership to the partner or by the partner to the partnership, 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 partnership to the partner or by the partner to the partnership."\(^{54}\)

It is to be noted that the words "for pay" in the Committee Report are omitted from the regulation in stating the last category: rendering of services by the partner to the partnership. Under this broad language of the regulation, a case involving meals and lodging furnished a partner would most likely be decided according to the "entity" theory and the partner treated as one not a partner under Sec. 707 (a), i.e. as an employee of the partnership. Under such classification the meals and lodging would represent compensation to the partner.

What would be the tax consequences under the 1954 Code if partners receiving meals and lodging by the partnership are classified as employees under Sec. 707 (a) and the meals and lodging as compensation? Prior to the 1954 Code the Commissioner had a regulation which provided:

"If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees."\(^{55}\)

If the meals and lodging were found to be compensation under this regulation they were includable in the employee's gross income even if furnished for the convenience of the employer. The "convenience of employer" rule was used as an administrative test to be applied only in cases in which the compensatory character of the benefit was not otherwise determinable.\(^{56}\)

\(^{55}\) Supra, note 45 at A226.

\(^{54}\) Treas. Regs. § 1.707-1 (a).

\(^{55}\) Treas. Regs. 118, § 39.22 (a)-3.

Under Sec. 119 of the 1954 Code the "convenience of the employer" rule is the primary test. If the meals and lodging are furnished for the "convenience of the employer" and meet the other qualifications of the section, the employee may exclude them from his gross income even if they represent compensation to him.

Under the former regulation, whenever the meals and lodging were found to be compensatory, the employee would include their value in gross income, and the employer would take a corresponding deduction as a business expense. However under Sec. 119 there is not necessarily a correlation between a deduction by the employer and inclusion by the employee. If the meals and lodging are compensation to the employee and qualify under Sec. 119, their value would be wholly deductible by the employer as a business expense and at the same time be completely excluded from the employee's gross income.

In a situation where partners are furnished meals and lodging and found to be strangers and hence employees in their rendering of service to the partnership under the provisions of Sec. 707 (a), Sec. 119 might operate to exclude the value of the meals and lodging from the partner's gross income. Since the value of the meals and lodging would also be compensation paid out by the partnership, the partnership would also deduct the value as a business expense in arriving at partnership net income.

This combination of Sec. 119 and Sec. 707 (a) would allow the partner a double deduction to the extent that the value of the meals and lodging are deducted from partnership gross income in figuring his distributive share of profits. The fact that in reality the partner and the partnership may be the same person, even if the "entity" theory is used as a legal concept of a partnership, allows Sec. 119 to enable the partner to completely avoid the taxability of the meals and lodging by excluding their value from his gross income, and at the same time to use them to reduce the size of his distributive share of the partnership profits.

III. CONCLUSION

The incorporation of the "entity" theory into the Code by Sec. 707 should impart definiteness and consistency to an area previously marred by conflicting opinions as to which theory was to be applied. The adoption of the "entity" theory in preference to the "aggregate" theory is desirable. The theory is simpler in operation, is more realistic,

58 (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.
59 Supra, note 5.
61 Supra, note 5.
and will conform in most cases to the actual intent of the participating members.

Because of the dual nature of the partnership, the operation of Sec. 119 may create some degree of tax avoidance by the recipient of the meals and lodging, but the general desirability of the "entity theory" should outweigh the small amount of revenue that would be lost.

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