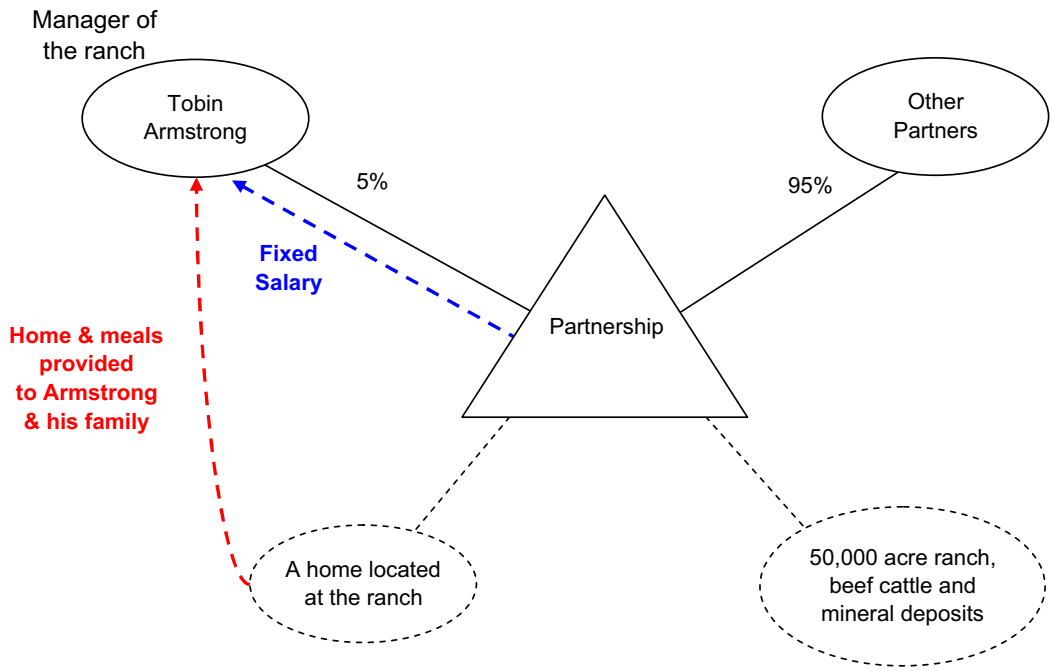
Armstrong v. Phinney
394 F2d 661 (5th Cir. 1968)

Partner Can Be Considered An Employee of the Partnership for the Convenience of Employer Rule

Tobin Armstrong is the manager of the 50,000 acre Armstrong ranch located in Armstrong, Texas. Beef cattle are raised and some of the land contains certain mineral deposits. The ranch is owned by a partnership in which Tobin Armstrong has a five percent interest. In addition to his share of the partnership profits and a fixed salary for his services as manager of the ranch, the partnership provides Tobin Armstrong certain other emoluments which were at issue. The partnership provides a home at the ranch for Tobin Armstrong and his family, most of the groceries, utilities and insurance for the house, maid service and provides for the entertainment of business guests at the ranch. Tobin Armstrong did not include the value of these emoluments in his gross income for the years 1960, 1961 or 1962. The Internal Revenue Service determined that these items should have been included and therefore increased his taxable income by approximately $6,000 for each year involved.



The case law interpreting the 1939 Internal Revenue Code held that a partner could not be an employee of his partnership under any circumstances, and that therefore no partner could take advantage of the "living expense" exclusion promulgated in the regulations and rulings under the 1939 Code. The earlier cases were grounded on the theory, present throughout the 1939 Code, that a partnership and its partners are one inseparable legal unit. However, in 1954 Congress rejected this "aggregate theory" in favor of the "entity theory" in cases where "a partner sells property to, or performs services for the partnership." H. R. Rep. No. 1337, 83d Cong., 2d Sess. 67 (1954). Under the entity approach "the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership." Id. This solution to the problem of the characterization of a partner's dealings with his partnership was codified as section 707(a) of the 1954 Code.

Considering the legislative history and the language of the statute itself, it was manifestly the intention of Congress to provide that in any situation not covered by section 707(b)-(c), where a partner sells to or purchases from the partnership or renders services to the partnership and is not acting in his capacity as a partner, he is considered to be "an outsider" or "one who is not a partner." The terms "outsider" and "one who is not a partner" are not defined by Congress; neither is the relationship between section 707 and other sections of the Code explained. However, the court found nothing to indicate that Congress intended that this section is not to relate to section 119 [dealing with meals or lodging furnished for the convenience of the employer]. 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 employee-employer. Therefore, in this case it was possible for Tobin Armstrong to be an employee of the partnership for purposes of section 119.