Rev. Rul. 81-301

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Rev. Rul. 81-301

ISSUE

Is an allocation based on a percentage of gross income paid to an advisor general partner subject to section 707(a) of the Internal Revenue Code, under the circumstances described below?

FACTS

ABC is a partnership formed in accordance with the Uniform Limited Partnership Act of a state and is registered with the Securities and Exchange Commission as an open-end diversified management company pursuant to the Investment Company Act of 1940, as amended. Under the partnership agreement, ABC's assets must consist only of municipal bonds, certain readily-marketable temporary investments, and cash. The agreement provides for two classes of general partners: (1) "director general partners" (directors) who are individuals and (2) one "adviser general partner" (adviser) that is a corporate investment adviser registered as such in accordance with the Investment Advisers Act of 1940, 15 U.S.C.A., section 80b-5 (1971).

Under the partnership agreement, the directors are compensated and have complete and exclusive control over the management, conduct, and operation of ABC's activities. The directors are authorized to appoint agents and employees to perform duties on behalf of ABC and these agents may be, but need not be, general partners. Under the partnership agreement, the adviser has no rights, powers, or authority as a general partner, except that, subject to the supervision of the directors, the adviser is authorized to manage the investment and reinvestment of ABC's assets. The adviser is responsible for payment of any expenses incurred in the performance of its investment advisory duties, including

those for office space and facilities, equipment, and any of its personnel used to service and administer ABC's investments. The adviser is not personally liable to the other partners for any losses incurred in the investment and reinvestment of ABC's assets.

The nature of the adviser's services are substantially the same as those it renders as an independent contractor or agent for persons other than ABC and, under the agreement, the adviser is not precluded from engaging in such transactions with others.

Each general partner, including the adviser general partner, is required to contribute sufficient cash to ABC to acquire at least a one percent interest in the partnership. The agreement requires an allocation of 10 percent of ABC's daily gross income to the adviser. After reduction by the compensation allocable to the directors and the adviser, ABC's items of income, gain, loss, deduction, and credit are divided according to the percentage interests held by each partner.

The adviser's right to 10 percent of ABC's daily gross income for managing ABC's investment must be approved at least annually by a majority vote of the directors or a majority vote of all the partnership interests. Furthermore, the directors may remove the adviser as investment manager at any time on 60 days written notice to the adviser. The adviser can terminate its investment manager status by giving 60 days written notice to the directors. The agreement provides that the adviser will no longer be a general partner after removal or withdrawal as investment manager, but will continue to participate as a limited partner in the income, gains, losses, deductions, and credits attributable to the percentage interest that it holds.

LAW AND ANALYSIS

Section 61(a)(1) of the Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived, including compensation for services, including fees, commissions, and similar items.

Section 702(a) of the Code provides that in determining the income tax of a partner each partner must take into account separately such partner's distributive share of the partnership's items of income, gain, loss, deduction, or credit.

Section 707(a) of the Code provides that if a partner engages in a transaction with a partnership other than as a member of such partnership, the transaction shall, except as otherwise provided in section 707, be considered as occurring between the partnership and one who is not a partner.

Section 1.707-1(a) of the Income Tax Regulations provides that a partner who engages in a transaction with a partnership other than in the capacity as a partner shall be treated as if not a member of the partnership with respect to such transaction. Such transactions include the rendering of services by the partner to the partnership. In all cases, the substance of the transaction will govern rather than its form.

Section 707(c) of the Code provides that to the extent determined without regard to the income of the partnership, payments to a partner for services shall be considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) and, subject to section 263, for purposes of section 162(a).

Although the adviser is identified in the agreement as an "adviser general partner," the adviser provides similar services to others as part of its regular trade or business, and its management of the investment and reinvestment of ABC's assets is supervised by the directors. Also it can be relieved of its duties and right to compensation at any time (with 60 days notice) by a majority vote of the directors. Further, the adviser pays its own expenses and is not personally liable to the other partners for any losses incurred in the investment and reinvestment of ABC's assets. The services performed by the adviser are, in substance, not performed in the capacity of a general partner, but are performed in the capacity of a person who is not a partner.

The 10 percent daily gross income allocation paid to the adviser is paid to the adviser in its capacity other than as a partner. Therefore, the gross income allocation is not a part of the adviser's distributive share of partnership income under section 702(a) of the Code or a guaranteed payment under section 707(c).

HOLDING

The 10 percent daily gross income allocation paid to the adviser is subject to section 707(a) of the Code and taxable to the adviser under section 61 as compensation for services

rendered. The amount paid is deductible by the partnership under section 162, subject to the provisions of section 265.

Compare Rev. Rul. 81-300, page 143, this Bulletin, for an example of when section 707(c) of the Code applies to services rendered by a partner for a partnership.