OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

DOM:FS:

November 2, 1998

UILC: 61.05.03; 83.03.02; 451.01.00; 641.00.00; 643.03.00; 662.01.00
Number: **199907003**
Release Date: 2/19/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated July 1, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Law Firm =
Decedent =
State =
Partnership C =
Partnership B =
Corporation =
Year 1: =
Year 2: =
Year 3: =

Year 4:	=
Year 5:	=
Year 6:	=
$x1:	=
$x2:	=
e%:	=
f%:	=
g%:	=
h%:	=

ISSUES:

1. Whether there was a transformation in the kind of interest acquired by Law Firm between Year 2 and Year 3 or Year 4?

2. Does the answer to Issue 1 affect our current litigating position?

3. Whether State law, in conjunction with the terms of the Contingency Fee Agreement, indicates that the heirs of the Decedent's estate could not have assigned an interest in the Decedent's estate in Year 2?

4.

CONCLUSIONS

1. Upon the resolution of the litigation in Year 3 or Year 4, Law Firm's interest was transformed from that of a mere promise to pay compensation in a contingency fee agreement to a beneficial ownership interest in the Decedent's estate.

2. Our position that Law Firm acquired a beneficial ownership in the Decedent's estate upon resolution of the litigation does not affect our litigating position. The Law Firm attorneys are not beneficiaries for purposes of Subchapter J with respect to characterizing amounts received from the estate, because the distributions relate back to Law Firm's underlying claim for compensation for services. Accordingly, the Internal Revenue Code

section 61/Subchapter J argument should treat the receipt of distributions to the attorneys in excess of their estate basis as section 61 income.

3. Although we agree that the heirs could not have assigned an interest in the Decedent's estate in Year 2, we believe that a transfer of a beneficial ownership interest for section 83 purposes occurred in Year 3 or Year 4 when the litigation was completed.

4.

FACTS

The facts of this case are more fully set forth in our Field Service Advice of April 1995. However, the following is a brief summary of the dispositive facts.

Partnership C is a partnership comprised of a "class of heirs" (hereinafter referred to as "heirs") of Decedent and members of Law Firm (including their beneficiaries) who represented the heirs in prosecution and defense of the heirs' claims. Prior to becoming a partnership, the parties effectuated their arrangement through a "community of interest," (herein called "Community Interest") executed in Year 2. According to the terms of the agreement, the heirs transferred all beneficial interest in their claims to Decedent's estate and Law Firm transferred the value of past and future legal services for the prosecution and defense of the heirs' claims. According to the terms of the agreement, all income, gains, expenses, and losses would be allocated e% to the heirs and f% to Law Firm's attorneys. This agreement contains the following provisions:

1. Section 1.03 provides that it is recognized by both the heirs and Law Firm that the claims of the heirs are, so far as can presently be determined, essentially nonliquid in character and that any contingent fee arrangement will, as a matter of economic necessity to all parties, have to be structured as follows.

2. Section 2.01.(2) provides that the purpose of this agreement is to provide the most mutually practicable economic arrangement for the prosecution and defense of the claims of the heirs and in view of the number

of parties involved, it is mutually agreed that such purpose will be greatly facilitated by creating a Community Interest and transferring to such Community Interest all beneficial interest in the claims of the heirs and the value of Law Firm's past and future legal services and its future advances of amounts required to pay the expenses incurred in the prosecution and defense of such claims.

3. Sections 2.03.(1) and (2) provide that each heir does hereby transfer and assign to the Community Interest as a contribution, all of his or her right, title and interest, exclusive of any right of service or any claim for compensation therefor as a fiduciary of the estate of Decedent as an heir-at-law of Decedent and as beneficiary of any will of Decedent.

4. According to section 2.07, if at any time the attorneys of Law Firm should decide not to participate in any further prosecution or defense of the claims it shall upon written notice relinquish any and all claim to any interest in the Community Interest assets, except for its right for a return of its out-of-pocket expenses.

5. Section 4.01. provides that income and expenses and gains (including net asset appreciation, if any, unreflected in the Community Interest books and account) and losses derived or sustained in furtherance of the Community Interest shall be allocated f% to Law Firm and e% among the heirs in the proportion set forth in Exhibit A of the agreement.

6. Section 7.01. provides that upon liquidation of the Community Interest payments will be made in the following amount and order:

> a. A distribution is first made to Law Firm of its unreimbursed out-of-pocket expenses. To the extent the out-of-pocket expenses exceed the value of the remaining Community Interest assets, the heirs agree to contribute cash to the Community Interest so that Law Firm can be paid in full;
>
> b. After the out-of-pocket expenses are paid to Law Firm, a distribution of $x1 (or all of the then remaining Community Interest assets if their value is less than $x1) is made to the heirs in the proportion specified in Exhibit A.

c. After the payments are made under a. and b. above, there shall next be distributed the amount necessary for the payment of and to zero out the capital accounts of the parties.

d. After distribution of the above, any Community Interest assets remaining shall be distributed so that Law Firm receives f% of the value thereof and the heirs receive the balance.

The Decedent's estate litigation was resolved in Year 3 or Year 4. Pursuant to a
settlement agreement between the groups of heirs which was executed in Year 1, the heirs received g% of the estate.

The attorneys of Law Firm did not include the value they received in the estate either at the time the Community Interest was formed or at the time the Decedent's estate litigation was resolved in Year 3 or Year 4.

The Community Interest was initially referred to by the parties to the agreements as Partnership B, later renamed Partnership C. Partnership returns have been filed since the Year 2 tax year. The agreement was amended in Year 5 to authorize Partnership B to manage, preserve, and enhance its share of the assets of the estate.

In Year 4, distributions from the estate to the heirs began. The estate treated Partnership B as if it were an heir, due to the assignment of the heirs' interest to the Community Interest. In Year 6, Law Firm assigned h% of its f% interest in Partnership B to the individual attorneys or their designates who were partners in the firm at the time the Year 2 fee agreement was entered into. In Year 5, the estate distributed to Partnership B approximately $x2 in Corporation stock and Decedent limited partnership interests.

The attorneys treated themselves as beneficiaries of the estate for income tax purposes. Accordingly, they included distributable net income ("DNI") from the estate in income and did not include distributions in excess of DNI in income. The estate was profitable and a large amount of tax was paid at the estate level with respect to income earned each year that was accumulated and not distributed. In addition, there were some distributions of DNI upon which Law Firm and the heirs paid tax, though there was considerably less DNI than accumulated income. Law Firm did not include their share of the Corporation stock and Decedent limited partnership unit distributions in income because it was in excess of the estate's DNI.

In the years at issue, Partnership C reported the distributions in excess of DNI on Schedule M, Reconciliation of Partners' Capital Accounts. These amounts were reported in box (d), Income not included in column (c), plus nontaxable income, and accordingly increased the partners' capital accounts. However, none of these amounts were included in the taxable income of the heirs or the Law Firm attorneys. In addition, the amounts reported in column (d) do not represent the carryover basis the estate had in the assets nor the fair market value of the assets. The amount in column (d) represents the value of the assets as accounted for on the estate's books.

LAW

Pursuant to section 61(a)(1), gross income includes compensation for services, including fees. Section 451(a) generally provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer.

Section 83(a) generally provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom the services were performed, the excess of the fair market value of the property over the amount paid for the property is included in the service provider's gross income in the first taxable year in which the rights of the service provider in the property are transferable or are not subject to a substantial risk of forfeiture.

Pursuant to section 83(c)(1), the rights of a person in property are subject to a substantial risk of forfeiture if the person's rights to full enjoyment of the property are conditioned upon the future performance of substantial services by any individual. Treas. Reg. § 1.83-3(a)(1) provides that for purposes of section 83 and the regulations thereunder, a transfer of property occurs when a person acquires a beneficial ownership interest in such property.

The term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. See Treas. Reg. § 1.83-3(e). A capital interest in a partnership is also included in the term "property". See Rev. Proc. 93-27, 1993-2 C.B. 343, which defines a capital interest as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination, according to Rev. Proc. 93-27, is made at the time of receipt of the partnership interest.

If, in exchange for services, a taxpayer using the cash receipts and disbursements method of accounting receives a mere promise from the service recipient to pay compensation in the future, the compensation is included in gross income when it is actually (or constructively) paid. See sections 61(a)(1) and 451(a), and Rev. Rul. 60-31, 1960-1 C.B. 174. Conversely, if, in exchange for services, the taxpayer receives property (which may take the form of a secured promise to pay compensation in the future), the fair market value of the property is included when it is "transferred" and becomes "vested." See sections 83(a) and 83(c) and Treas. Reg. § 1.83-3(b).

Section 643 sets forth definitions for purposes of sections 641-668 (Subparts A-D of Part I of Subchapter J). Section 643(a) defines DNI as the taxable income of an estate or trust computed with certain modifications (for example, exclusion of certain capital gains). Section 643(c) provides that the term "beneficiary" includes heir, legatee, and devisee.

Section 662(a) generally provides that the beneficiary of an estate or trust must include in income any such amounts to the extent of the beneficiary's proportionate share of DNI. Income that is treated as distributed flows through and is taxed to the beneficiaries, while retained or accumulated income is taxed at the estate level. Future distributions of these amounts are tax-free to the beneficiaries who receive them. Section 662(b) provides that the character of DNI distributions to the beneficiary will be the same as in the hands of the estate.

ISSUE 1

ANALYSIS

At the outset, we note that your reading of the August 1996 Field Service Advice may have led you to conclude that our position is that property was transferred to Law Firm in Year 2. However, this is not our position. In Year 2, the Community Interest represented a mere promise to pay compensation in a contingency fee agreement. At the time the parties entered into the agreement, Law Firm was required to perform services, i.e., services for the prosecution and defense of the heirs' claims to the estate. The Law Firm's interest in the estate did not vest until these services were no longer required. This event happened in Year 3 or Year 4 when the litigation was

completed. When the litigation was completed, the interest received in the estate litigation was transferred for purposes of section 83.

We conclude that upon the resolution of the litigation in Year 3 or Year 4, Law Firm's interest was transformed from that of a mere promise to pay compensation in a contingency fee agreement to a beneficial ownership interest in an estate.

ISSUE 2

ANALYSIS

Our position that Law Firm eventually acquired a beneficial interest in the estate when the litigation was resolved does not affect our litigating position. Although Law Firm eventually acquired an interest in the estate, the Law Firm attorneys are not beneficiaries for purposes of the DNI and accumulation distribution rules of subchapter J based upon the relation back doctrine and cases interpreting this doctrine.

Our analysis of the relation back doctrine and Arrowsmith v. Commissioner, 344 U.S. 6 (1952), and Getty v. Commissioner, 913 F.2d 1486 (9th Cir. 1990), revg. 91 T.C. 160 (1988), is more fully set forth in our April 1995 Field Service Advice. Based upon the rationale of the Supreme Court in Arrowsmith, and based upon the Ninth Circuit's analysis in Getty, we believe that the Law Firm attorneys should not be treated as beneficiaries with respect to distributions received by Partnership C on their behalf, because the estate distributions received relate back to the agreement with the heirs. In addition, cases interpreting the term "beneficiary" also support not characterizing the Law Firm attorneys as beneficiaries for purposes of characterizing the distributions they receive from the estate. (See the analysis provided in our prior Field Service Advice, and our discussion of Sletteland v. Commissioner, 43 T.C. 602 (1965); Nemser v. Commissioner, 66 T.C. 780 (1976); In re Nissen's Estate, 345 F.2d 230 (4th Cir. 1965); and Wolder v. Commissioner, 493 F.2d 608 (2d Cir), cert. denied, 419 U.S. 828 (1974).)

To the extent distributions exceeded the Law Firm attorneys' bases in their interests in the estate, the attorneys should have taxable income under section 61. This conclusion applies to accumulation distributions as well as distributions of DNI.

ISSUE 3

ANALYSIS

We have reviewed State case law in conjunction with the terms of the Contingency Fee Agreement, and, while we agree that the heirs could not have assigned an interest in the Decedent's estate in Year 2, we believe that a transfer of a beneficial ownership interest for section 83 purposes occurred in Year 3 or Year 4 when the litigation was completed.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

ISSUE 4

ANALYSIS

1

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