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The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest

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I. Introduction

If a person receives property as payment for services, whether for past or future services, the receipt typically constitutes gross income to the recipient.[1] If a person performs services for a partnership or agrees to perform future services, and if the person receives a partnership interest as compensation for the past or future services, one might expect that receipt to cause the new partner to recognize gross income in an amount equal to the fair market value of the partnership interest. After all, if a corporation compensated someone for services rendered or to be rendered by transferring the corporation's own stock to that person, the receipt of the stock would be included in the recipient's gross income.[2] One might question whether there is any reason to treat a partnership interest differently. In fact, the actual tax treatment of the receipt of partnership interests has had a checkered history, and there are valid reasons for excluding those interests from income in certain circumstances.

There is a significant difference in the manner in which corporations and partnerships are viewed by the tax law. A corporation is treated as a separate entity from its shareholders. The treatment of partnerships is more nuanced. For some purposes, a partnership is treated as a separate entity, and for some purposes it is treated as a fictional identity representing an aggregate of interests that the partners have in the assets held in the partnership.[3] This blended characterization of a partnership as an entity or an aggregate of interests is a factor making it difficult to determine the proper treatment of a transfer of a partnership interest for services.

A partnership interest that is transferred in payment for past or future services to the partnership is sometimes referred to as a "compensatory partnership interest."[4] When a partnership transfers a compensatory

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[1] *See* I.R.C. § 83(a). If the property interest is forfeitable, the recognition of income will be deferred until the property interest vests unless the taxpayer elects to have it taxed earlier. I.R.C. § 83(a), (b).

[2] *See* Reg. § 1.351-1(a)(2), Ex. (3).

[3] *See* WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 1.02 (2008).

[4] *See* Prop. Reg. § 1.721-1(b)(3), 70 Fed. Reg. 29,675 (2005). As used herein, the term "compensatory partnership interest" does not refer to a partnership interest received for services that were provided to a partner as contrasted to services provided to the partnership itself.

partnership interest, there not only is a question of whether that interest is includable in the recipient's income; there also is a question as to the manner in which the value of the interest is to be determined if it is included. Those two issues are the focus of this Article. Another issue, which this Article does discuss, is whether the transfer of a compensatory partnership interest that is taxable to the service provider will also cause the partnership to be treated as having constructively sold to the service provider, in exchange for his services, a portion of each of the assets it holds.

The tax treatment of a compensatory partnership profits interest has been the topic of considerable commentary recently in connection with the receipt of such interests, often referred to as "carried interests," by managers of private equity funds.[5] Private equity funds typically are conducted as limited partnerships.[6] It is a controversial question as to whether the current tax treatment of those carried interests in private equity funds is bad and should be changed.[7]

This Article does not address the question of how the profits interest of a manager of a private equity fund should be taxed. Rather, the focus of this Article is on the more general question of how the receipt of a compensatory partnership interest should be taxed. However, the analysis and conclusions of this Article are relevant to the resolution of the questions concerning the taxation of a manager of a private equity fund.

Partnership interests can be divided into two broad categories: a partnership capital interest and a partnership profits interest. Part II of this Article sets forth the history of the tax treatment of the receipt for services of those two types of partnership interests. The Article will first define those two terms and the categories they represent.

A partnership capital interest is one in which the partner has the right to receive a share of the liquidating distributions that would be made if the partnership sold all of its assets for cash equal to their fair market value and

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[5] *See, e.g.*, Chris Sanchirico, *The Tax Advantages to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. Chi. L. Rev. 1071 (2008).

[6] Private equity funds are ventures in which a depressed business is purchased; and then, if all goes well, its value is greatly increased by the infusion of additional capital and the entrepreneurial skill provided by the manager. After the value is increased, the business is liquidated for a profit. In exchange for his services, the manager receives a fee plus a percentage interest in the partnership's profits—typically a 20% interest. The manager will be the general partner. The manager's interest is limited to 20% of the profits that the partnership earns (including gain from the appreciation of its assets). On liquidation of the business, the manager will receive his percentage of the partnership's gain as a liquidating distribution. The tax consequence to the manager is that he will not have income when he receives his partnership interest and will recognize a capital gain for his share of the partnership's gain on the disposition of the business (or on most of that gain). Objections have been raised as to the failure to tax the manager on the receipt of his partnership interest and on his obtaining capital gain treatment for the cash he received from the partnership, but the latter has been the principal object of the complaints. *See id.* at 1075.

[7] *See id.* at 1075–76.

then immediately liquidated.[8] The determination of whether a partner's interest is a capital interest generally is made at the time that the partner receives the partnership interest.[9] In other words, a partnership capital interest is one in which the partner obtains the right to some of the existing capital that the partnership possesses at the time that the partner acquires his partnership interest. This method of distinguishing a capital interest from a profits interest is sometimes referred to as the "liquidation method."[10] In addition to distinguishing capital and profits interests, the liquidation method has also been used to determine the value of a partnership interest,[11] but other methods of valuation have been employed.[12] The question of the extent to which it is proper to use the liquidation method for valuation purposes and several alternative methods that can be employed in some circumstances are discussed in Parts II and III.

A partnership interest that is not a partnership capital interest is a partnership profits interest.[13] The recipient of a partnership profits interest obtains no rights in the partnership's existing capital, but is limited to a right to share in future profits of the partnership.

Part III of this Article considers the question of what treatment should be applied to the transfer of a compensatory partnership interest. In that connection, the Article describes circumstances in which there is a principled reason not to tax the recipient of a compensatory partnership profits interest. Part III also discusses the manner in which a taxable compensatory partnership interest, whether a capital interest or a profits interest, should be valued. Part IV discusses the question of whether a taxable transfer of a compensatory partnership capital interest causes a constructive sale of part of the partnership's assets. Part V sets forth the Article's conclusions.

II. The History of the Tax Treatment of the Receipt of a Compensatory Partnership Interest

A. *The Receipt of a Compensatory Partnership Capital Interest*

The tax treatment of the recipient of a compensatory partnership capital interest has been fairly consistent throughout the years. The recipient of that

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[8] Rev. Proc. 1993-27, 1993-2 C.B. 343. A capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership. Reg. § 1.704-1(e)(1)(v).

[9] Rev. Proc. 1993-27, 1993-2 C.B. 343.

[10] *See* McKee et al., *supra* note 3, ¶ 5.03[1].

[11] *Id.*; *see, e.g.*, Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749, 1756, T.C.M. (P-H) ¶ 84,232, at 902 (1984).

[12] *See, e.g.*, Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939, 954 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983).

[13] Rev. Proc. 1993-27, 1993-2 C.B. 343.

interest has had to include the fair market value of the interest in income.[14] However, two questions concerning the treatment of that transaction were not resolved consistently: (1) when the partnership capital interest should be valued and taxed to the recipient, and (2) how the partnership capital interest should be valued.

1. *The Timing for Recognition of Income*

As to when the capital interest should be taxable, prior to 1969, the timing depended upon whether the services in question were performed for the partnership or for other partners. If performed for the partnership, the service provider's receipt of the capital interest was (and still is) treated as a "guaranteed payment" under section 707(c).[15] The timing for a distributee's recognition of income for a distribution that is treated as a guaranteed payment is determined by the taxable year of the partnership in which the payment is deductible or treated as a capital expenditure.[16] On the other hand, if the services were performed for a partner (as contrasted to services performed for the partnership), the transaction is treated as a payment from that other partner to the service provider.[17] The service provider would recognize income in the taxable year in which he constructively received the payment from the other partner.[18]

The time to value the receipt of a partnership interest and for its inclusion in the service provider's income was altered by the adoption of section 83 in 1969. Section 83 provides that when "property" is transferred to a person for services, the fair market value of the property (valued by ignoring restrictions on the property that will lapse) is included in the income of the person who performed the services on the earliest date on which the property is not subject to a substantial risk of forfeiture or when the property becomes transferable.[19] In other words, subject to an election described below, the property is included in the recipient's income in the recipient's taxable year in which his interest in the property vests. This rule will apply regardless of whether the services were provided to the partnership or to a partner, and so the timing of the recognition of income will be the same in both situations.[20] Section 83 overrides the timing rule for recognition of income that otherwise would apply to a guaranteed payment.[21]

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[14] Reg. § 1.721-1(b)(1); *see also* United States v. Frazell, 335 F.2d 487, 489 (5th Cir. 1964).

[15] Reg. § 1.721-1(b)(2). A guaranteed payment is a payment from the partnership to a partner for services or for the use of capital if the payment is not determined by reference to the partnership's income. I.R.C. § 707(c).

[16] Reg. § 1.707-1(c).

[17] *See* McDougal v. Commissioner, 62 T.C. 720, 728 (1974), *acq.* 1975-2 C.B. 1.

[18] *See id.*

[19] *See* I.R.C. § 83(a). To be "transferable," the transfer of the property must cut off any risks of forfeiture. I.R.C. § 83(c)(2).

[20] *See* I.R.C. § 83(a).

[21] Prop. Reg. § 1.707-1(c), 70 Fed. Reg. 29,675 (2005).

Questions have arisen as to whether a compensatory partnership profits interest constitutes property to which section 83 applies.[22] This Article will address that question in Part II.B in connection with the discussion of profits interests. As we will see, it is reasonably certain that a partnership profits interest is property for purposes of section 83. It is even more certain that section 83 applies to compensatory partnership capital interests.[23] The proposed amendment to Regulation section 1.83-3(e) that was promulgated in 2005 expressly states that "property includes a partnership interest."[24] Also, the proposed amendment to Regulation section 1.721-1(b)(1) that was also promulgated in 2005 states, "the transfer of a partnership interest in connection with the performance of services . . . constitutes a transfer of property to which § 83 and the regulations thereunder apply."[25] While those proposed amendments to the regulations might influence a court, they have not yet been finalized.

Consequently, when a partnership interest, whether a capital or profits interest, is received for services, it is taken into account by the recipient when it vests unless the recipient makes an election under section 83(b). As we shall see, the application of section 83 to the transfer of a compensatory partnership interest does not necessarily mean that the transfer will cause the recipient to incur a tax liability. Under section 83(h), to the extent that the transfer of a partnership interest is treated as income to the service provider, the partnership will be allowed either a deduction or an increase in its basis in property it owns.[26]

2. *A Section 83(b) Election*

Section 83(b) permits a person who receives property for services to elect to take the property into income in the year of his receipt even though the property is subject to a substantial risk of forfeiture.[27] If that election is made, the property is valued without regard to any restrictions on the property that will lapse at some time in the future.[28] Under section 83(h), the partnership will be allowed either a deduction or an increase in its basis in some property

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[22] *See, e.g.*, WILLIS ET AL., PARTNERSHIP TAXATION ¶ 4.05[1] (2008).

[23] While one of the principal treatises on partnership taxation questioned the desirability of applying section 83 to compensatory partnership interests, the treatise nevertheless concluded that "[a]s a practical matter, however, it is probable that § 83 will be treated as the applicable provision for post-June 30, 1969, transfers." *Id.* ¶ 4.05[3][d]. The other major treatise questioned whether section 83 should apply to the compensatory transfer of partnership profits interests but ultimately concluded that it will apply to all compensatory transfers of partnership interests. *See* MCKEE ET AL., *supra* note 3, ¶¶ 5.02[1], 5.08[2][a].

[24] *See* Prop. Reg. § 1.83-3(e), 70 Fed. Reg. 29,675 (2005).

[25] *See* Prop. Reg. § 1.721-1(b)(1), 70 Fed. Reg. 29,675 (2005).

[26] *See* I.R.C. § 83(h). If a payment for the services performed by the service provider constitutes a capital expenditure, then the payment must be capitalized by adding it to the basis of the partnership property for which the services were provided. Reg. § 1.83-6(a)(4).

[27] I.R.C. § 83(b).

[28] I.R.C. § 83(b)(1)(A).

it owns equal to the amount that the service provider recognized as income when he made the section 83(b) election.[29] If the section 83(b) election is made, and if the property is subsequently forfeited, the recipient is not allowed to deduct his loss on the forfeiture, except for a loss due to payments made by the recipient as partial consideration for the acquisition of the property.[30] On a forfeiture of the partnership interest, the partnership must include in income the amount of any deduction or increase in basis it obtained under section 83(h) at the time that the service provider made the section 83(b) election.[31]

Consequently, the receipt of a partnership interest for services will be valued and taxed to the recipient either when it vests or on the earlier date of receipt if the recipient makes an election under section 83(b).[32]

If a section 83(b) election is made, the service provider will be treated as a partner of the partnership from the date that he acquires his partnership interest.[33] Consequently, partnership tax items can be specially allocated to the service provider under section 704(b) if those allocations have substantial economic effect or are in accordance with the service provider's "interest in the partnership."[34] If special allocations to the service provider partner do not have substantial economic effect and are not in accordance with the service provider's interest in the partnership, the partnership's tax items are allocated to the service provider according to the latter's "interest in the partnership."[35] Until the service provider's interest actually vests, there is a possibility that it will be forfeited, which would terminate the service provider's capital account.[36] After a forfeiture, no distribution of partnership property will be made to the service provider because his capital account and interest in the partnership will have been terminated. Because of this possibility, the service provider's capital account will not necessarily determine the amount he will receive from the partnership, and an allocation of partnership tax items to the service provider partner while his interest is still subject to forfeiture, therefore, cannot have "substantial economic effect."[37] In 2005, Treasury promulgated a proposed amendment to the regulations under section 704. Proposed Regulation section 1.704-1(b)(4)(xii)(a) expressly states that an allocation to a service provider partner in such a case does not have economic

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[29] I.R.C. § 83(h).

[30] Reg. § 1.83-2(a).

[31] Reg. § 1.83-6(c).

[32] As we shall see, there are a number of circumstances where the receipt of a partnership profits interest for services will not cause the recipient to incur any income tax liability.

[33] Prop. Reg. § 1.761-1(b), 70 Fed. Reg. 29,675 (2005).

[34] Reg. § 1.704-1(b)(1)(i).

[35] I.R.C. § 704(b). In that case, it will be no easy matter to determine what the service provider's interest in the partnership might be.

[36] A partner's capital account is the bookkeeping account of what the partner is entitled to receive from the partnership on its liquidation. Reg. § 1.704-1(b)(2)(ii).

[37] *See* Reg. § 1.704-1(b)(2).

effect.[38]

3. *Forfeiture Allocations*

However, the proposed regulation does provide a means for the parties to give effect to special allocations made under section 704(b) to a service provider partner so that those allocations will be valid. A special allocation will be deemed to conform to the service provider partner's interest in the partnership if the partnership agreement provides for a means of reversing the allocation of partnership tax items that were made to the service provider prior to the forfeiture of his partnership interest (other than allocations of income to the service provider partner to the extent that the income actually was distributed to him).[39] Proposed Regulation section 1.704-1(b)(4)(xii) provides that if the parties adopt a "forfeiture allocations" system, a special allocation of the partnership's tax items to the service provider will be deemed to be in accordance with his interest in the partnership, and so the special allocations of tax items will be valid.[40] The "forfeiture allocations" system requires that, on a forfeiture of the service provider's partnership interest, partnership tax items (*i.e.*, gross income and gross deductions or losses) be allocated to the service provider partner to reverse the partnership allocations that had previously been made to him.[41] However, allocations of income are reversed only to the extent that the allocated income exceeds the difference between the aggregate amount that had been distributed to the service provider and the amount that the service provider had paid for the receipt of the partnership interest.[42] For example, if undistributed income had been allocated to the service provider prior to the forfeiture, an offsetting amount of deduction would be allocated to him on the forfeiture of his partnership interest. Offsetting allocations can only be made for tax items that the partnership possesses at the time of the forfeiture.[43] So, if a partnership lacked a sufficient amount of deductions to offset the income that had previously been allocated to the service provider, no more than the amount of deduction that the partnership possesses can be allocated to him. Treasury is considering whether to remove that limitation and allow notational allocations to be made, but it has not yet done so.[44]

This Article will return to the "forfeiture allocations" system later in Part II in connection with the discussion of the safe harbor that the 2005 proposed amendments to the regulations provide for using the liquidation method of

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[38] *See* Preamble to Prop. Reg. §§ 1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, 1.761-1, 70 Fed. Reg. 29,675 (2005) [hereinafter Preamble].

[39] Prop. Reg. § 1.704-1(b)(4)(xii)(b), 70 Fed. Reg. 29,675 (2005).

[40] Prop. Reg. § 1.704-1(b)(4)(xii), 70 Fed. Reg. 29,675 (2005). This provision does not apply if, at the time that the section 83(b) election was made, there was a plan that it would be forfeited. Prop. Reg. § 1.704-1(b)(4)(xii)(e), 70 Fed. Reg. 29,675 (2005).

[41] Prop. Reg. § 1.704-1(b)(4)(xii)(c), 70 Fed. Reg. 29,675 (2005).

[42] *See id.*

[43] *See id.*

[44] *See* Preamble, *supra* note 38.

valuation for a compensatory partnership interest.

4. *Qualification as a Partner*

One reason for concern as to whether section 83 applies to the transfer of a compensatory partnership interest is that if property that is subject to section 83(a) is not vested when acquired, then unless an election is made under section 83(b), the property is deemed to belong to the transferor rather than to the service provider.[45] If that treatment applies to the recipient of a nonvested compensatory partnership interest, and if no election is made under section 83(b), the service provider will not qualify as a partner unless and until the partnership interest vests. If that is so, all partnership distributions of property to the service provider will be treated as compensation for services, and all of the partnership's tax items will have to be allocated to the other partners.[46] That result is contrary to what seems to the author to be the congressional intention that the service provider be treated as an actual partner.

In Revenue Procedure 2001-43, the Service ruled that if certain conditions are satisfied, the determination of whether a nonvested compensatory partnership interest is a profits interest is to be made at the time that the interest was acquired rather than when it vests, even if section 83(b) is not elected.[47] One of the conditions for qualifying for that treatment is that:

> The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest.[48]

Thus, that Revenue Procedure contemplates that the service provider can be treated as a partner even though the partnership interest is not vested and no election was made under section 83(b). While that treatment is contrary to the regulation under section 83, it is consistent with what the author believes to be the apparent congressional purpose to have the service provider qualify as a partner for so long as he holds the partnership interest. Although the Revenue Procedure relates to a profits interest, there is no reason that the same approach should not apply to a nonvested capital interest.

However, Revenue Procedure 2001-43 will be obsolete when and if the amendments to the regulations under section 83 that were promulgated in 2005 become final and the Revenue Procedure that is proposed to replace Revenue Procedure 2001-43 and Revenue Procedure 93-27 expressly provides that the recipient of a nonvested compensatory partnership interest will not be treated as a partner until the interest vests, unless a section 83(b) election is

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[45] *See* Reg. § 1.83-1(a).
[46] Reg. § 1.83-1(a)(1).
[47] Rev. Proc. 2001-43, 2001-2 C.B. 191.
[48] *Id.*

made.[49] Additionally, the proposed amendment to Regulation section 1.761-1(b), which was promulgated on May 24, 2005, states that the recipient of a nonvested partnership interest is not a partner until the interest vests, unless the recipient makes an election under section 83(b).[50] Consequently, once those regulatory amendments are finally adopted, no allocation of partnership tax items can be made to a person whose partnership interest is not vested unless the section 83(b) election is made.[51] Perhaps the reason for that treatment is that unless a section 83(b) election is made, if a service provider is treated as a partner and if his interest is forfeited, there is no requirement that there be a reversal of the allocations of partnership tax items that were made to the service provider before his interest was forfeited.

One prominent treatise has suggested that even though a service provider's interest may be forfeitable, his interest in the partnership's profits and losses for a current year are vested at the end of that year, since the service provider will have fulfilled his obligation to provide services for that year, and so the service partner should be treated as a partner to whom that year's tax items can be allocated.[52] The authors of the treatise note that that "analysis borders on the absurd, but it helps to illustrate the incompatibility between § 83 and Subchapter K."[53] While that approach would justify the treatment accorded in Revenue Procedure 2001-43, it is irreconcilable with Regulation section 1.83-1(a). The regulation treats transferred nonvested property as belonging to the transferor and expressly states that any income from that property that is received by the service provider is treated as additional compensation to the service provider rather than being characterized as income from the property.[54] So, if the property produced capital gain income that was paid to the service provider, it would be treated as ordinary income to the service provider. The transferor of the property would recognize capital gain income and likely would qualify for a deduction for the compensation deemed to have been paid to the service provider.[55] The regulation does not sever the right to the property's income from the right to the property itself. To the contrary, the regulation treats both the right to the property and the right to the income it produces as nonvested interests.[56] Nevertheless, the treatise's analysis highlights how the terms of section 83 sometimes do not conform to the aims of the partnership tax provisions.

5. *Valuation*

Another question is how to value a partnership capital interest that is taxable

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[49] *See* Notice 2005-43, 2005-1 C.B. 1221; *see also* Preamble, *supra* note 38.
[50] *See* Prop. Reg. § 1.761-1(b), 70 Fed. Reg. 29,675 (2005).
[51] *See* Preamble, *supra* note 38.
[52] *See* WILLIS ET AL., *supra* note 22, ¶ 4.06[8][c].
[53] *See id.*
[54] *See* Reg. § 1.83-1(a).
[55] *See* WILLIS ET AL., *supra* note 22, ¶ 4.06[8][d].
[56] *See* Reg. § 1.83-1(a).

under section 83. One possibility is to use the liquidation method that was described above—to determine the amount that the partner who acquired the partnership interest would receive if all of the partnership's assets were sold immediately for their value and the proceeds distributed among the partners according to their interests in the partnership. The authors of one of the prominent treatises on partnership taxation are critical of the use of the liquidation method for valuation purposes, although they agree that it is appropriate for distinguishing a profits interest from a capital interest.[57] In that treatise, the authors note that the liquidation method sometimes provides too high a valuation for the partnership interest and sometimes provides one that is too low.[58] They note that, while the liquidation method generates a figure that represents what the partner would receive on liquidation of the partnership, it ignores the fact that the partnership is likely not to liquidate immediately.[59] Rather, it is likely that the partnership will continue in existence, in which case the right to share in partnership profits has value (or a negative impact) that is not reflected in the liquidation valuation.[60] For example, if the service provider is entitled to receive a share of partnership capital on liquidation but is barred from sharing in the partnership's income to the same extent, the liquidation method would exaggerate the value of his partnership interest, which should be discounted for the limitations on his participation in partnership profits. Since the service provider usually will not have the power unilaterally to force the liquidation of the partnership, the value of his liquidation rights should be discounted.[61]

If the liquidation method is discarded, the valuation of a partnership interest may be administratively burdensome. One may have to decide how to discount the service provider's right to liquidation proceeds. If the other partners have the power to terminate the partnership and thereby terminate the service provider's interest in future profits, one has to determine how to discount the value of his right to share in partnership income in light of that vulnerability to termination.[62] As we shall see, there are circumstances where the valuation of a partnership capital interest is not difficult.

The use of the liquidation method of valuation for a partnership capital interest will result in a figure equal to the current value of the percentage of the partnership's assets in which the service provider has an interest. This method would be appropriate if there is no reason to discount the service provider's right to liquidation proceeds. If a compensatory partnership capital interest

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[57] *See* McKee et al., *supra* note 3, ¶ 5.03[1].

[58] *See id.*

[59] *See id.*

[60] *See id.*

[61] *See id.*

[62] If there are contractual arrangements among the partners obligating the other partners not to terminate the service provider's interest, that would eliminate the vulnerability to termination factor; so, the interest would be far easier to value. It seems that contractual restrictions of that nature are not customary.

that a service provider receives provides the service provider with rights to the same percentage of capital and income, then the question of a discount does not arise, since the discount of the value at liquidation will equal the value of the service provider's income interest. In other words, there would be no reason to discount the service provider's right to receive partnership property on liquidation of his partnership interest since it is reasonable to calculate the rate for that discount by using the actual rate of income earned by the property. The value of the combination of a right to partnership income and a right to partnership capital on liquidation will equal the value of the partnership's capital at the time that the service provider received the partnership capital interest. The liquidation method will arrive at that value.

A valuation will be speculative if the service provider's portion of partnership income is subject to review and redetermination every year, which is the case for some service partnerships. In that situation, the value of the right to income may have to be ignored as being too speculative to calculate. The value of the partnership capital interest should be discounted to reflect the time that will pass before the service provider will receive that capital. Since typically it cannot be predicted what amount of time will pass before the liquidation of the service provider's interest takes place, one can only speculate as to what is the proper amount of discount. Consequently, it might be better to ignore the discount feature and use the liquidation method. While the liquidation method will not produce a precisely accurate figure, it is a reasonable compromise of the conflict between obtaining a precisely accurate figure and the administrative difficulty of arriving at that figure.

As to the service provider's right to share in income, regardless of whether the other partners have the power to terminate that right, if the service provider is required to provide future services to the partnership, there is a strong principled reason not to take his interest in the partnership's future income from services into account. This Article will discuss that principle in Part III in connection with the discussion of the taxation of a partnership profits interest.

Notwithstanding the above described obstacles to valuing a compensatory partnership capital interest if the liquidation method is not used, several other methods of valuation have been used by courts and are appropriate in some cases. If the value of the services provided by the service provider can readily be determined, the courts can use the principle that an arm's length exchange is presumed to be one of equal values.[63] The value of the compensatory partnership interest can be "presumed to be equal to the value

[63] *See* United States v. Davis, 370 U.S. 65, 72 (1962); Phila. Park Amusement Co. v. United States, 126 F. Supp. 184, 189 (Ct. Cl. 1954).

of the" services that were provided.[64] Another method that was used in several cases was to utilize the amount paid by investors for comparable units in the same partnership to value the compensatory partnership capital interest that the service provider received.[65]

When the transfer of a compensatory partnership capital interest is taken into a service provider's income, the partnership will qualify for a deduction of the same amount that constituted income to the service provider, unless a payment for those services would constitute a capital expenditure or otherwise would not be deductible under sections 162 or 212.[66] If allowable, the deduction is taken in the taxable year of the partnership that ends within or with the taxable year of the service provider in which the income is recognized.[67]

6. *Constructive Sale of Partnership Assets*

Should the transfer of a compensatory partnership capital interest to a service provider be treated as a constructive sale by the partnership to the service provider of a percentage of each of the partnership's assets, followed by a contribution of that percentage of the assets from the service provider to the partnership in exchange for the partnership interest? If so treated, that would cause the partnership to recognize gain or loss on a portion of each of its assets and would change the partnership's basis in that portion of its assets. Consider the following example that illustrates how that constructive sale would operate.

Ex. As of March 5, Year One, P, a cash method partnership, held the following assets with the indicated bases and fair market values:

Asset	Basis	Value
Accounts Receivable	$0	$60,000
Inventory	$40,000	$120,000
Furniture	$20,000	$8,000

P had no liabilities and had no other assets. On that date, P had three equal partners: A, B, and C. P was engaged in the retail hardware business. P offered

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[64] That method was employed by the Tax Court in several cases and was approved by the Tenth Circuit Court of Appeals. *See* Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939, 954 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983); *see also* Larson v. Commissioner, 55 T.C.M. (CCH) 1637, 1638, T.C.M. (P-H) ¶ 88,387, at 1915 (1988). In *Larson*, the Tax Court used both that method and another method where both methods arrived at the same valuation. *See* 55 T.C.M. (CCH) at 1638, T.C.M. (P-H) ¶ 88,387 at 1915.

[65] *See* Johnston v. Commissioner, 69 T.C.M. (CCH) 2283, 2290, 1995 T.C.M. (RIA) ¶ 95,140, at 95–96; *Larson*, 55 T.C.M. (CCH) at 1639, T.C.M. (P-H) ¶ 88,387 at 1916. In *Larson*, the court used the value of the services performed to value the compensatory partnership interest, but the court also noted that the amount paid per unit by the investors was equal to the value per unit that the court found for the compensatory partnership interest. *See* 55 T.C.M. (CCH) at 1638, 1639, T.C.M. (P-H) ¶ 88,387 at 1915–16.

[66] I.R.C. § 83(h); Reg. § 1.83-6.

[67] Reg. § 1.83-6.

D, who was its manager, a one-fourth capital interest in the partnership as payment for his future services as manager. The value of the one-fourth partnership capital interest was determined to be equal to $47,000. D accepted the offer and became a partner on that date. D's partnership interest was vested.

The transfer of the partnership interest caused D to recognize $47,000 of gross income.[68] Under sections 83(h) and 162, P was allowed a deduction of $47,000 for making that guaranteed payment to D. If P was deemed to have made its $47,000 payment to D by transferring a one-fourth interest in each of its three assets, that would constitute a sale by P for fair market value of a one-fourth interest in each asset. P would recognize ordinary income of $15,000 on the constructive sale of one-fourth of its accounts receivable, ordinary income of $20,000 on the constructive sale of one-fourth of its inventory, and a section 1231 loss of $3,000 on its constructive sale of one-fourth of the furniture. Those gains and losses would be allocated equally among A, B, and C.

D would have a basis in each of his one-fourth interests in P's assets equal to the value of that interest; and so D's aggregate basis in the three properties would equal $47,000. D would then be treated as contributing his one-fourth interest in each of the assets to P in exchange for a one-fourth interest in the partnership. Under section 721, neither D nor P would recognize a gain or loss on that exchange. P's basis in the one-fourth interest in each of the three properties that it is treated as having acquired from D would equal the basis that D had in those properties (*i.e.*, the basis in each one-fourth interest would equal the value of that interest). D's basis in his partnership capital interest would equal his aggregate basis in the properties he was deemed to have transferred to P, and that would give D a basis of $47,000 in his partnership interest.

After the constructive sale to D and contribution to the partnership, P would have a basis in each of its assets as indicated below.

Asset	Basis
3/4 of Accounts Receivable	$0
1/4 of Accounts Receivable	$15,000
3/4 of Inventory	$30,000
1/4 of Inventory	$30,000
3/4 of Furniture	$15,000
1/4 of Furniture	$2,000

The question of whether the transfer of a compensatory partnership capital interest should cause the partnership to recognize gain or loss on a constructive sale of a portion of its assets is controversial. That issue is discussed in Part IV of this Article.

[68] *See* I.R.C. § 83(a).

In 2005, Treasury promulgated proposed amendments to the regulations concerning the treatment of compensatory partnership interests.[69] One of those proposed amendments provides that a partnership will not recognize a gain or loss on transferring a compensatory partnership interest to a partner or on the vesting of a compensatory partnership interest.[70] If the proposed amendment is finally adopted, there will be no constructive sales of a portion of the partnership's internal assets. It is not clear whether the Service will adhere to the proposed amendment prior to that amendment's adoption as a final regulation, but it seems plausible that it will. The merits of precluding a constructive sale of the partnership's assets are discussed in Part IV.

7. *Services Provided to a Partner*

If services were provided for a partner rather than for the partnership itself, then the transaction should be construed as a payment to the service provider from that partner. This transaction will cause ordinary income to the service provider, a possible deduction for the partner, and the partner's recognition of gain or loss for the partner's property in kind that was deemed paid to the service provider for his services. Since the compensation received by the service provider is a partnership interest, what property will the partner be deemed to have paid to the service provider? If the transaction arises in connection with a newly formed partnership, the payment to the service provider is deemed to be a portion of the property nominally contributed by the partner to the partnership. The service provider will have a basis in that portion of the property equal to its fair market value, and then the service provider will be deemed to have contributed his portion of the property to the partnership in exchange for the partnership interest he acquired. The Tax Court's decision in *McDougal v. Commissioner* applies that approach.[71]

The *McDougal* situation can also arise when an existing partnership transfers a partnership interest to a service provider who provided the services to a partner rather than to the partnership.[72] How should the *McDougal* approach be applied in that case? While there is no authoritative answer to that question, there are two alternative solutions that are plausible.

One possibility is to treat the transaction as if the partnership first distributed

[69] *See* Preamble, *supra* note 38.

[70] *See* Prop. Reg. § 1.721-1(b)(2), 70 Fed. Reg. 29,675 (2005). In the Preamble to the proposed amendments to the regulations, the Service stated that it is still studying the question of whether a partnership should recognize gain or loss on transferring a partnership interest as payment for something other than services, such as payment for interest or rent. *See* Preamble, *supra* note 38.

[71] *See* 62 T.C. 720, 727–28 (1974), *acq.* 1975-2 C.B. 1.

[72] The *McDougal* situation is distinguishable from a situation where one partner contributes services or property to the partnership and there is a related distribution of property by the partnership to that partner (or another partner), in which case the transaction can be recast as a disguised sale of services or property either to the partnership or to another partner. *See* I.R.C. § 707(a)(2); Reg. § 1.721-1(a). The rule applied to this latter situation is a specific application of the substance versus form doctrine.

the partnership interest to the partner, which distribution is not taxable to the partner under section 731(a)(1). Under section 732(a), the partner's basis in the distributed partnership interest would equal the partnership's basis in that interest, which appears to be zero. The partner would then be deemed to have transferred the constructively acquired partnership interest to the service provider in exchange for the latter's services. The service provider would have ordinary income in an amount equal to the value of the partnership interest. The partner would have a gain on the exchange equal to the value of the service partner's services since the partner will have a zero basis in the constructively transferred partnership interest. The partner's gain will be a capital gain under section 741 except to the extent that section 751 applies. The service provider's basis in his partnership interest will equal the fair market value of that interest.

An alternative approach is to treat the partnership as making a constructive distribution of a portion of the partnership's property to the partner, which distribution will not be taxable to the partner under section 731(a)(1), followed by the partner's transfer of that constructively distributed portion of partnership property to the service provider as payment for the latter's services. Under section 732(a), the partner's basis in the constructively distributed portion of partnership property will equal the basis that the partnership had in that portion of its assets, subject to the limitation that the aggregate basis of the partner in the constructively distributed assets cannot exceed the partner's outside basis in his partnership interest.[73] Under section 733, the partner's outside basis in his partnership interest will be reduced (but not below zero) by the amount of basis that the partner takes in the constructively distributed property.[74] The partner will recognize gain or loss on each item of property constructively transferred to the service provider, and the service provider will recognize ordinary income on the constructive receipt of those properties. The service provider will then be treated as transferring the constructively received properties to the partnership in exchange for the partnership interest. Under section 721, neither the service provider nor the partnership will recognize a gain or loss on that exchange. The partnership will have a basis in the constructively contributed property equal to each item's fair market value, since that was the basis that the service provider had in each item. Under section 722, the service provider will have a basis in his partnership interest equal to his basis in the constructively transferred properties, and so his basis in his partnership interest will equal the fair market value of that interest.[75]

It is worth noting that, for reasons that will be explained later, the Treasury has made it clear that its position that a partnership does not recognize a gain or loss on transferring a compensatory partnership interest does not apply to a partner who is deemed to have made a transfer of property in a

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[73] I.R.C. § 732(a).
[74] I.R.C. § 733.
[75] *See* I.R.C. § 722.

McDougal type situation.[76] While several commentators have concluded that a partnership should recognize gain or loss on transferring a compensatory partnership interest,[77] there are no cases applying that approach, and some commentators have reached the opposite conclusion.[78] The only case applying a constructive transfer of assets with resulting gain or loss is the *McDougal* case, in which the constructive transfer was made by a partner (as contrasted to the partnership) who thereby recognized the gain.[79] As shown later in this Article, the reasons for not imposing gain or loss recognition on a partnership have no application to a partner's recognition in a *McDougal* type situation, and that is the apparent reason that Treasury excluded *McDougal* type situations from its determination that a partnership does not recognize a gain or loss.

B. *The Receipt of a Compensatory Partnership Profits Interest*

Prior to the Tax Court's 1971 decision in *Diamond v. Commissioner*,[80] it was widely assumed that the transfer of a compensatory profits interest did not cause the recipient to recognize income. There is a strong inference to that effect in Regulation section 1.721-1(b). While no court had previously passed on that issue, there was a dictum in a footnote in a 1965 Tax Court decision stating that the regulation provides that the receipt of a partnership interest in future profits does not cause any tax liability.[81] The tax bar's confidence in the nontaxability of profits interests was rudely shaken when the Tax Court decided the *Diamond* case, and the bar became even more concerned when the Seventh Circuit affirmed the Tax Court.[82]

1. *The Diamond and Campbell Decisions*

Diamond involved a peculiar situation. In return for past services, the taxpayer received a partnership interest providing a right to share in future profits from a newly formed real estate joint venture. The taxpayer had no right to share in profits until after the other partner to the venture recouped his cash investment. About three weeks after receiving his partnership interest, the taxpayer sold his partnership interest to a third party for $40,000. The Tax Court and the Seventh Circuit held that the taxpayer's receipt of the

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[76] *See* Preamble, *supra* note 38.

[77] *See, e.g.*, McKee et al., *supra* note 3, ¶ 5.08[2][b]; Willis et al., *supra* note 22, ¶ 4.05[5][a]; Martin J. McMahon Jr., *Recognition of Gain by a P'ship Issuing an Equity Interest for Services: The Proposed Regulations Get It Wrong*, 109 Tax Notes (TA) 1161, 1162 (Nov. 28, 2005).

[78] *See, e.g.*, Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships 136 (3d ed. 2006); Douglas A. Kahn, *Is the Report of Lazarus's Death Premature? A Reply to Cameron and Postlewaite*, 7 Fla. Tax Rev. 411, 431–434 (2006); Alan Gunn, *Partnership Interest for Services: Partnership Gain and Loss?*, 47 Tax Notes (TA) 699, 700 (May 7, 1990).

[79] McDougal v. Commissioner, 62 T.C. 720 (1974).

[80] 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

[81] Hale v. Commissioner, 24 T.C.M. (CCH) 1497, 1502 n.3, T.C.M. (P-H) ¶ 65,274, at (1965).

[82] *See Diamond*, 56 T.C. at 546, *aff'd*, 492 F.2d 286 (7th Cir. 1974).

partnership interest was income to him, and the courts determined that the value of that partnership interest was equal to the amount for which the taxpayer sold it only three weeks after acquiring it (*i.e.*, $40,000).[83] The facts in *Diamond* were unusual in that the prompt sale of the partnership interest was evidence of its value. The Seventh Circuit noted that, in many cases, the value of a partnership profits interest would be too speculative to place a figure on it.[84] An inference that could be drawn from the Seventh Circuit's opinion is that a partnership profits interest will be taxable only when it has a reasonably ascertainable market value.

Commentators have raised several concerns over the tax consequences that flow from taxing a profits interest. As we will see, however, only one of those concerns has any merit.

The one concern that has merit is that, in many cases, it will be extremely difficult to value such an interest, especially since the service partner's interest in future profits can be terminated at will by the other partners.[85] Valuation will not be a problem if the liquidation method is used, but then the profits interest will not be taxable because it will have a zero value.

A second concern that has been raised is that if a service provider is taxed on the present value of his right to share in future profits, he will be taxed again when the profits are earned.[86] That double taxation of the same item will be mitigated when the partner's interest is liquidated and he recognizes a loss because of the additional basis he acquired in his partnership interest when the two items were included in his income,[87] but the time value of money concept shows that the eventual deduction of a loss does not eliminate all of the harm that the double taxation causes. However, the double taxation of the service provider is not as troublesome as it might appear at first glance. There is nothing unusual about imposing a double tax on a compensatory transfer of property, and it is not that objectionable.

The value of a partnership profits interest is the present value of a portion of the future income that the partnership will earn. But, that is true of the value of all property—the value of any item of property is the present value of the future income that it is capable of producing. If a service provider receives property as compensation for his past services, he will be taxed on the value of that property (*i.e.*, on the present value of its future income stream) and will be taxed again when the income is earned. Unless his basis in the property can be amortized, he will incur double taxation in exactly the same way that applies to the receipt of a compensatory partnership profits interest. Consider the following example:

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[83] Diamond v. Commissioner, 492 F.2d 286, 291 (7th Cir. 1974); *Diamond*, 56 T.C. at 544.

[84] *See Diamond*, 492 F.2d at 290.

[85] *See, e.g.*, WILLIS ET AL., *supra* note 22, ¶¶ 4.06[4], [7][c]; *Diamond*, 492 F.2d at 290.

[86] WILLIS ET AL., *supra* note 22, ¶¶ 4.06[4], [7][c]. Another aspect of that problem noted in the treatise is that the other partners will receive a double deduction.

[87] I.R.C. § 705(a)(1)(A).

Example. To compensate G for services performed, X Corporation gives G its own stock having a value of $10,000. That value reflects the present value of future income that it is anticipated the stock will produce. G will recognize $10,000 of gross income and will have a basis of $10,000 in the X stock. G is not permitted to amortize and deduct that basis. G will be taxed again when he receives dividends on the stock even though he was already taxed on the present value of those dividends.

Thus, there is little reason for concern over the double taxation of a compensatory partnership profits interest when the service provider does not provide future services to the partnership. Such double taxation is inherent in an income tax system. As we will see later in this Article, there is reason to object to double taxation when the service provider is required to provide future services to retain his profits interest. But, the source of that objection is that there is no justification for taxing the service provider's receipt of a profits interest in that case, and double taxation is merely a consequence of that wrongful taxation.

The fears that the *Diamond* decision generated subsided for a period of time because of the events that followed that case. The Service gave several signals indicating that it would not treat a compensatory partnership profits interest as a taxable event.[88] While the Service did seek to tax a partnership profits interest in several cases, the courts found that the interests had a zero value.[89] To arrive at that zero valuation, the courts used the liquidation method to determine the value of the partnership interest.[90]

The bar's confidence was shaken again when the Tax Court decided the *Campbell* case in 1990.[91] In that case, the taxpayer had performed services in connection with a real estate syndication. The taxpayer sold partnership interests in the enterprise to investors. As part of his compensation, the taxpayer was given a limited partner's interest in the profits and losses of the partnership, which interest was subordinated to the interests of the other partners. The Tax Court held that section 83 applied to cause the taxpayer's receipt of the profits interest to be included in income.[92] The court rejected the liquidation method for valuing the profits interest. Instead, the court relied on projections of cash flow and tax benefits that were set forth in the prospectus for the syndication.

The Court of Appeals for the Eighth Circuit reversed the Tax Court's

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[88] *See* G.C.M. 36,346 (July 23, 1977); *see also* Nat'l Oil Co. v. Commissioner, 52 T.C.M. (CCH) 1223, 1228, T.C.M. (P-H) ¶ 86,596, at 2786 (1986) (the Commissioner conceded that a profits interest is not taxable).

[89] *See, e.g.*, St. John v. United States, 84-1 U.S.T.C. ¶ 9158, at 83,198, 53 A.F.T.R.2d 718, 721 (C.D. Ill. 1983); Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749, 1758, T.C.M. (P-H) ¶ 84,232, at 905 (1984).

[90] *See, e.g.*, *St. John*, 84-1 U.S.T.C. ¶ 9158 at 83,198, 53 A.F.T.R.2d at 721.

[91] Campbell v. Commissioner, 59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162 (1990), *rev'd in part*, 943 F.2d 815 (8th Cir. 1991).

[92] 59 T.C.M. (CCH) at 249, T.C.M. (P-H) ¶ 90,162 at 731.

decision in *Campbell*.[93] The Eighth Circuit held that the value of the partnership profits interest in that case was too speculative to put any figure on it.[94] Accordingly, the court held that the profits interest in that case had no value.[95] The court left open the possibility that a partnership profits interest would be taxable if it could be valued.[96]

2. *The 1993 Adoption of Exclusion from Income*

In 1993, the Service clarified its position on the taxation of profits interests by issuing Revenue Procedure 1993-27.[97] The Service stated that if a person receives a partnership profits interest "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner," the Service will not treat that transfer as a taxable event for either the service provider or the partnership.[98] The exclusion from income applies only if the services were performed by the service provider in his capacity of being a partner or in anticipation of becoming a partner.[99] Moreover, the Service described three situations in which the Revenue Procedure does not apply. Those three situations are:

> (1) if the profits interest relates to a substantially certain and predictable stream of income from partnership assets,
>
> (2) if the partner disposes of the profits interest within two years of acquiring it, or
>
> (3) if the profits interest is a limited partnership interest in a "publicly traded partnership."[100]

The Revenue Procedure does not state how the Service will treat the receipt of a profits interest that falls within one of those three exceptions, but the obvious inference is that such profits interests will be taxed. That issue is discussed in Part III.

Revenue Procedure 1993-27 was modified by Revenue Procedure 2001-43.[101] The 2001 Revenue Procedure states that the determination of whether a nonvested compensatory partnership interest is a profits interest is made at the time of the receipt of that interest rather than when it vests. This timing provision will apply even though no election is made under section 83(b).[102] One of the conditions for qualifying for that provision is that the service provider and the partnership must agree that the service provider will be

[93] *See* Campbell v. Commissioner, 943 F.2d 815, 823 (8th Cir. 1991).
[94] *Id.*
[95] *Id.*
[96] *Id.* at 822–23.
[97] Rev. Proc. 1993-27, 1993-2 C.B. 343.
[98] *Id.*
[99] *See id.*
[100] *Id.* A publicly traded partnership is defined in section 7704(b).
[101] Rev. Proc. 2001-43, 2001-2 C.B. 191.
[102] *See id.*

treated as the owner of the partnership interest from the time that he acquired it and that the partnership will allocate to the service provider his share of the partnership's tax items.[103] The obvious inference of that ruling is that the parties can agree to treat the service provider as a partner, notwithstanding the contrary provision of section 83 and even though no section 83(b) election has been made.

3. *The 2005 Proposed Amendments*

Those two Revenue Procedures provide a safe harbor in which a compensatory partnership profits interest will not be taxable. In 2005, Treasury threw a monkey wrench into the stabilization of this issue that the Revenue Procedures had provided. In that year, Treasury promulgated a number of proposed amendments to the regulations concerning the treatment of a partnership's transfer of an equity interest as payment for services.[104]

In the Preamble to those proposed amendments, Treasury stated that section 83 will apply to a transfer of a compensatory partnership interest, regardless of whether that interest is a capital interest or a profits interest.[105] Treasury stated that it "do[es] not believe that there is a substantial basis for distinguishing" between partnership capital interests and partnership profits interests and so will provide the same treatment to both.[106]

Since the proposed amendments to the regulations will tax profits interests under section 83, how are those interests to be valued? If the liquidation method can be employed, a profits interest will always have a zero value. Proposed Regulation section 1.83-3(l), which was promulgated on March 24, 2005, provides a "safe harbor" in which the value of a compensatory partnership interest, whether a profits interest or a capital interest, can be determined by using the liquidation method.[107] To qualify, the partnership has to elect to adopt the safe harbor, and all the partners have to agree.[108] Additional requirements are set forth in Notice 2005-43.[109] As previously explained, the liquidation method of valuing a partnership interest is based on the amount of cash that the partner would receive if all of the partnership's assets (including goodwill and other intangibles) were sold for their fair market value and then distributed in liquidation.[110] The value of a compensatory partnership profits interest will be zero if the liquidation method is elected.

Notice 2005-43 sets forth a proposed Revenue Procedure that will be promulgated when Proposed Regulation section 1.83-3(l) becomes final.[111]

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[103] *See id.*

[104] *See* Preamble, *supra* note 38.

[105] *Id.*

[106] *Id.*

[107] Prop. Reg. § 1.83-3(l)(1), 70 Fed. Reg. 29,675 (2005).

[108] *Id.*

[109] Notice 2005-43, 2005-1 C.B. 1221.

[110] *Id.*

[111] *Id.*

Upon the finalization of that proposed regulation and the promulgation of the proposed Revenue Procedure, Revenue Procedure 1993-27 and Revenue Procedure 2001-43 will become obsolete. Until that occurs, however, taxpayers cannot utilize the safe harbor, "but taxpayers may continue to rely upon current law, including Rev. Proc. 93-27 . . . and Rev. Proc. 2001-43."[112]

To qualify for the safe harbor, the partnership agreement must contain provisions that are legally binding on all the partners, stating that the partnership is authorized and directed to elect the safe harbor and that the partnership and each of its partners (including subsequent parties who receive a compensatory partnership interest) agree to comply with all requirements of the safe harbor with respect to compensatory partnership interests that are transferred while the election remains effective.[113] If the partnership agreement does not provide such legally binding terms, this requirement can be satisfied by having each partner execute a document containing similar provisions.[114]

If a service provider makes a section 83(b) election to take a nonvested compensatory partnership interest into income, one requirement of electing the safe harbor provision to qualify for the liquidation method of valuation is that the partnership must adopt the forfeiture allocations requirement described in Proposed Regulation section 1.704-1(b)(4)(xii).[115] In the event that the service provider's partnership interest is forfeited, the forfeiture allocations requirement is designed to reverse partnership allocations of tax items that were made to the service provider partner before his interest was forfeited.[116] The operation of the forfeiture allocations provision is described earlier in this Part II.[117]

As previously noted, if the recipient of a compensatory nonvested partnership interest makes a section 83(b) election to recognize income on the receipt of the partnership interest, the partnership cannot make section 704(b) special allocations of the partnership's tax items to that partner because the partner will not collect his capital account if his interest is forfeited. Because of that uncertainty of collection, an attempted special allocation would lack substantial economic effect. However, Proposed Regulation section 1.704(b)(4)(xii) permits a valid section 704(b) special allocation to be made if the partnership adopts the forfeiture allocations requirement.[118]

If the recipient of a compensatory nonvested partnership interest does not elect section 83(b), that person will not be treated as a partner for income tax

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[112] *Id.*

[113] Prop. Reg. § 1.83-3(l)(1)(ii), 70 Fed. Reg. 29,675 (2005). Also, with its tax return, the partnership is required to file a statement, the terms of which are described in the proposed regulation, that is executed by a partner who has responsibility for the partnership's income tax reporting. *See* Prop. Reg. § 1.83-3(l)(1)(i), 70 Fed. Reg. 29,675 (2005).

[114] Prop. Reg. § 1.83-3(l)(1)(iii), 70 Fed. Reg. 29,675 (2005).

[115] Notice 2005-43, 2005-1 C.B. 1221.

[116] *See* Prop. Reg. § 1.704-1(b)(4)(xii)(b), 70 Fed. Reg. 29,675 (2005).

[117] *See supra* text accompanying notes 40–44.

[118] *See* Prop. Reg. § 1.704(b)(4)(xii), 70 Fed. Reg. 29,675 (2005).

purposes until the partnership interest vests. Note that if that person were permitted to be treated as a partner, there would be no requirement that the forfeiture allocations requirement be adopted. Perhaps the reason that the proposed 2005 regulatory provisions do not treat a service provider as a partner if he receives a compensatory nonvested partnership interest and does not make a section 83(b) election is that, in the event of a forfeiture, there would then be no requirement of a reversal of the tax items that had been allocated to the service partner before his interest was forfeited. To allow that person to retain the benefit of the tax items that were allocated to him even though he was never taxed on the receipt of the nonvested partnership interest appears overly generous.

There are three situations in which the safe harbor election is not available. They are:

(1) if the compensatory partnership interest relates to a "substantially certain and predictable stream of income from partnership assets,"

(2) if the compensatory partnership interest was "transferred in anticipation of a subsequent disposition," or

(3) if the compensatory partnership interest is an interest in a "publicly traded partnership."[119]

In the case of certain dispositions of a compensatory partnership interest within two years of receipt, there is a rebuttable presumption that the interest was transferred to the service provider "in anticipation of a subsequent disposition."[120]

The three exclusions from the safe harbor election are similar to the ones that apply to Revenue Procedure 1993-27.[121] But, what will be the tax treatment if the safe harbor is not elected or if it does not apply? The proposed regulation makes a compensatory partnership profits interest taxable, and so how should it be valued if the safe harbor does not apply? A possible inference from the proposed regulation and Notice 2005-43 is that the liquidation method cannot be used in that case, but the use of the term "safe harbor" in both Proposed Regulation section 1.83-3(l) and in Notice 2005-43 suggests that use of the liquidation method is not limited to partnerships that make the safe harbor election.[122] That leaves open the question as to what are the circumstances in which the liquidation method can be used for a partnership that has not made the safe harbor election. In those cases in which the liquidation method is prohibited, how should the valuation be made? Those issues are discussed in Part III.

As noted above, unless and until the proposed amendments to the regulations

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[119] Notice 2005-43, 2005-1 C.B. 1221.

[120] *Id.*

[121] *See supra* text accompanying note 100.

[122] *See* Prop. Reg. § 1.83-3(l), 70 Fed. Reg. 29,675 (2005); Notice 2005-43, 2005-1 C.B. 1221.

under section 83 are finalized, the existing law, including Revenue Procedures 1993-27 and 2001-43, continue to be applicable. Part III will consider how a profits interest that is taxable under current law is to be valued.

4. *Partnership Profits Interest as Section 83(a) Property*

The question arose whether a partnership profits interest is "property" within the meaning of section 83(a). The regulations state in Regulation section 1.83-3(e) that "'property' includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future."[123] The apparent purpose of the regulation's "unfunded and unsecured promise to pay" exception is to preclude inclusion in income of an employer's unfunded promise to pay compensation to an employee. Some commentators suggested that a profits interest is merely an unfunded promise to pay money and so is not subject to section 83.[124] While this issue has not expressly been examined by a court, the Tax Court has applied section 83 to the receipt of a compensatory partnership profits interest,[125] and most commentators and Treasury have concluded that section 83 does apply to a profits interest.[126] While there are some similarities between a partnership profits interest and an employer's unfunded promise to pay compensation to an employee, which is the circumstance at which the regulation's statement about an "unfunded and unsecured promise to pay" is aimed, there are significant differences. So, many have concluded that the "unfunded and unsecured promise to pay" exclusion should not apply to partnership profits interests.[127] The proposed amendment to Regulation section 1.83-3(e) that was promulgated in 2005 expressly states that "property includes a partnership interest."[128] In addition, the proposed amendment to Regulation section 1.721-1(b)(1) that also was promulgated in 2005 states, "[t]he transfer of a partnership interest . . . in connection with the performance of services constitutes a transfer of property to which section 83 and the regulations thereunder apply."[129] The Preamble to the 2005 proposed amendments states that section 83 applies to compensatory partnership interests.[130] However, those proposed amendments and Notice 2005-43 will not be effective unless and until they are finalized.

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[123] Reg. § 1.83-3(e).

[124] *See* James D. Lockhart, *IRS Concedes Tax Treatment of a Partnership Profits Interest Received For Services*, 10 J. PARTNERSHIP TAX'N 283, 295 (1994).

[125] *See* Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 249, T.C.M. (P-H) ¶ 90,162, at 731 (1990) (applying section 83 to the receipt of a compensatory partnership profits interest). While the Tax Court's decision was reversed on appeal, the reversal was based on a valuation issue. *See* Campbell v. Commissioner, 943 F.2d 815, 823 (8th Cir. 1991).

[126] *See, e.g.*, MCKEE ET AL., *supra* note 3, ¶ 5.08[2][a].

[127] *See, e.g.*, *id.* ¶ 5.02[1]. Note, however, that the authors of this treatise conclude that a partnership interest should not be treated as property for section 83 purposes for other reasons.

[128] Prop. Reg. § 1.83-3(e), 70 Fed. Reg. 29,675 (2005).

[129] Prop. Reg. § 1.721-1(b)(1), 70 Fed. Reg. 29,675 (2005).

[130] *See* Preamble, *supra* note 38.

III. *Proper Taxation and Valuation of Compensatory Partnership Interests*

A. *Partnership Profits Interest*

This Article first considers whether the receipt of a compensatory partnership profits interest should be taxable and, if so, under what circumstances. There are many different types of activities conducted by partnerships, and the treatment of a compensatory partnership profits interest might differ depending upon the manner in which the partnership earns its income and whether the service provider is required to provide future services to the partnership. One issue is whether the receipt of a compensatory partnership profits interest should be a taxable event, but even if it is, there is also a question of whether the proper valuation of that interest should be zero, in which case it will not cause the recipient to incur any tax liability.

1. *A Service Partnership in Which No or Little Income Is Created by Capital*

The clearest situation in which receipt of a compensatory partnership profits interest should not be taxable is where the partnership's business consists of providing services, and capital plays little or no role in producing the partnership's income. Indeed, the Service has never sought to tax the receipt of a compensatory profits partnership interest in that circumstance, and it is unlikely that it will ever seek to do so. Nevertheless, this Article will examine the policy reasons that a compensatory partnership profits interest should not be taxed in that circumstance. An understanding of those policy reasons is helpful in determining how other types of compensatory partnership interests should be treated.

Professional activities such as law, medicine, accounting, engineering, and architecture are examples of service businesses in which capital does not play a significant role in the production of partnership income, but there also are nonprofessional service businesses. For example, a firm that provides home care for disabled individuals is a service business, as is a firm that provides temporary clerical employees.

To the extent that a service partnership has capital of some size, typically either the new service partner will be required to contribute an amount equal to his share of that capital, or he will be precluded from sharing in the partnership's capital that exists at the time of his entry as a partner. In either event, the compensatory portion of the partnership interest of that new partner constitutes a partnership profits interest since all of its value in excess of the new partner's contribution is attributable to that interest's share of the partnership's future profits from services. Even if a new partner is given an interest in a service partnership's capital without requiring him to contribute to the partnership, the new partner's interest is only partly a capital interest. The principal value of his interest is from the right to share in future partnership income, and so the largest portion of his interest is a partnership profits interest to which the analysis in this Part III.A is applicable.

If a person is given a compensatory partnership profits interest in a service partnership, it will be given to that person either entirely for future services to the partnership or for both past and future services. In either case, the new partner almost certainly will be expected to provide future services to the partnership and will not be allowed to continue as a partner if he ceases to provide services. Even if a new partner's partnership interest is not expressly made forfeitable if he does not continue to provide services, the reality is that the other partners will not be willing to carry a partner for very long if that partner is not producing income for the partnership. That realistic risk of forfeiture must be considered in valuing the partnership interest and may cause the interest to be characterized as nonvested.

In some service partnerships, each partner's percentage interest in profits is redetermined every year depending upon an evaluation of how the partner performed in the preceding year. The partnership may elect a committee to make those redeterminations. The fact that a partner's interest in such a partnership is subject to change every year not only makes the receipt of that interest especially difficult to value, it likely makes the interest nonvested for purposes of section 83.

Because of the reality that a partner's interest in a service partnership would almost certainly be terminated if he ceases to perform services, a service provider's interest might be treated as nonvested for purposes of section 83. If it were so treated, and if the 2005 proposed amendments to the regulations under section 83 are finally adopted, then the service provider will not be treated as a partner unless a section 83(b) election is made.[131] To protect against that possibility, the service provider should make a section 83(b) election. As we shall see, the section 83(b) election will not cause the service provider to recognize any income.[132]

Treasury might wish to reconsider the position it took in its 2005 proposed regulatory amendments preventing a service provider who receives a nonvested compensatory partnership interest and who does not make a section 83(b) election from being treated as a partner until the interest vests.[133] If that rule is applied to the formation of a new service partnership in which each new "partner's" interest in the partnership will be terminated if he ceases to perform services, then none of the parties could qualify as a partner unless a section 83(b) election were made, and so the entity could not qualify as a partnership for tax purposes since none of its members would qualify as a partner.

The addition of a new service partner to an existing service partnership is similar to the formation of a new service partnership by several persons, none of whom thereby obtains an interest in capital contributed by the other parties. In the latter case, each person receives a partnership profits interest in

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[131] *See supra* text accompanying notes 49–51.

[132] A section 83(b) election can be made even though the net value of the property transferred to the service provider is zero and so will not cause any amount to be included in income. *See* Reg. § 1.83-2(a).

[133] *See* Preamble, *supra* note 38.

anticipation of the services he will subsequently perform for the enterprise. The parties do not recognize income on forming that partnership. Each party is participating in a pooling of several persons' services to engage in a venture together. It is beneficial to society not to discourage a pooling of labor arrangement by taxing the formation of the partnership. While there is no statutory provision excluding from income each partner's receipt of a partnership profits interest for services,[134] there has never been any suggestion that the receipt would be taxable in the case of a newly formed service partnership.

If a service partnership that already exists adds a new service partner who will share only in future income, it is merely expanding the pool of services that the partnership represents. There is no difference in substance between the addition of a new service partner and the association of several persons to form a new service partnership. In the former case, there may be a history of partnership income that provides a source for predicting the income that the new partner will enjoy from the association. But, that may also be true in the case of the formation of a new service partnership. Each of the parties forming the new partnership might have a history of income production that could provide a source for predicting the income that the partnership will produce. The tax policy reasons for not taxing parties on forming a new service partnership operate with equal force to prevent recognition of income when a new service partner joins a service partnership and obtains a partnership profits interest in the enterprise.

If an individual joins a service corporation that does not have a significant amount of capital, and the individual receives stock of the corporation in anticipation of the services he will provide in the future, the individual will be taxed on the value of the stock he received. The stock may have little or speculative value, but the receipt would be a taxable transaction. Why should the addition of a new service partner not be given the same treatment? The answer lies in the very different manner in which those entities are treated by the tax law.

A corporation is a separate entity from its shareholders. So, the income that a new shareholder will generate for the corporation is treated as income of the corporation and not of the shareholder who produced it. Also, absent a contractual agreement, the other shareholders do not possess the power to cancel the new shareholder's stock. In contrast, a partnership's treatment is a blend of entity and aggregate characterizations. For many purposes, the partnership is regarded as merely a representative of the aggregate of the individual interests of its partners in the assets held by the partnership.[135] It is that aggregate of interests characterization that makes a compelling case for not taxing the service partner's receipt of the profits interest. Especially

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[134] Section 721 applies only to the receipt of a partnership interest in exchange for property; it does not apply to the receipt of a partnership interest for services. *See* I.R.C. § 721.

[135] *See* McKEE ET AL., *supra* note 3, ¶ 1.02.

because of the pass-through of partnership tax items to its partners, the income of the partnership can be viewed realistically as the income of the partners to whom it is allocated.[136] Therefore, there is much less reason to tax a new service partner on his entry into the partnership. While there also are good reasons not to tax a new service shareholder on his receipt of corporate stock, the entity characterization of the corporation points towards treating it as a taxable transaction.

The value of a profits interest that a new partner receives in a service partnership is the present value of that partner's share of the anticipated future profits of the partnership that are estimated will be produced. Those future profits will be the product of services performed by both the old partners and the new partner, plus the income that the partnership earns from the excess of income produced by its employees over their salaries.

Unless the circumstances are very unusual, the old partners would not have brought the new partner into the partnership if they thought that the dollar amount of their share of the partnership's future income would be less than they would have received if they did not admit him.[137] In other words, the assumption is that the synergy of the services of the new partner and the old partners will produce income that is greater than the sum of what they would have earned separately, and the increased income will provide both the old partners and the new partner with more than they would have received if they did not pool their labor.

If a new partner in a service partnership were to be taxed on the receipt of a compensatory partnership profits interest, he would be taxed on the present value of the income that he himself will produce in the future. In those partnerships where each partner's percentage interest in profits is subject to an annual review, it is even clearer that a partner will not receive more income than he produces. There is no circumstance in tax law where a person is taxed on the present value of his capacity to produce future income. When a person receives a degree, such as an MBA or a J.D., that very degree provides the recipient with increased earning power. But, the receipt of the degree is not considered a taxable event. Similarly, the fact that several persons have agreed to pool their labor to produce a larger amount of income from the synergy of their combined efforts should not cause them to recognize income. Instead,

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[136] *See* I.R.C. § 702

[137] It is barely conceivable that a service partnership in which capital plays no significant role would give a partnership profits interest to a service provider for past services and require him to perform little or no future services. That would seem to be extraordinary and occur so rarely that its possibility can be disregarded. In effect, the other partners would be giving the service provider an interest for an indefinite period in the income that the other partners will earn in the future from their labor. Note that, contrary to the service partnership's situation, in the case of a partnership in which capital has a significant role, it is plausible that the partnership would give a profits interest to a person for past services and not require any further services of him. In the latter case, the transfer constitutes a compensatory transfer of a property interest as contrasted to a transfer of a right to share in the product of the transferor's future labor.

each person will be taxed only on the actual income he or she acquires in the future and will be taxed when that income is earned.

The above described reasons for not taxing the service provider on his receipt of a partnership profits interest are based on a more fundamental concept than is the so called "sweat equity" issue. The sweat equity issue is whether a tax on the unrealized appreciation in value of a taxpayer's asset due to the labor expended by the taxpayer in improving the asset would conflict with the general rule excluding imputed income from taxation. The sweat equity issue has been raised in connection with the question of how a manager of a private equity fund should be taxed.[138] In contrast, a tax on the receipt of a partnership profits interest would not be a tax on imputed income (*i.e.*, it would not be a tax on appreciation resulting from the service provider's labor). Rather, it would be a tax on the enhancement of the service provider's capacity to earn income from his labor in the future.

If a service provider receives a profits interest in partnership capital, additional factors need to be considered. A profits interest in partnership capital typically includes an interest in the gain recognized from the subsequent appreciation of the value of that capital. At this juncture of this Article, the discussion deals with a partnership in which capital is not a significant item. The proper treatment of a partnership profits interest where the partnership possesses significant capital is discussed in Parts III.A.2 and 3.

It is only where a tax on the receipt of a compensatory partnership profits interest in a service partnership would be a tax on the present value of future income that the taxpayer himself will produce that there is reason to object to the double taxation consequence that was noted earlier in this Article.[139] As noted previously, if the service provider is taxed on the receipt of the partnership interest and then taxed a second time when the future income is earned, he will be doubly taxed on what amounts to the same income.[140] However, the double taxation of a compensatory transfer of property not only is not unique, it is a common occurrence in an income tax system. For example, as demonstrated in Part II of this Article, the same double taxation occurs when a corporation uses its own stock to compensate an employee for past services. Double taxation is not per se objectionable if the service provider does not contribute to the production of the future income so that he effectively is taxed on his own potential for earning income.

Is it likely that the service provider will receive more income from the partnership than the amount that he himself produces? If the partnership has

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[138] *See* Sanchirico, *supra* note 5, at 1079.

[139] *See supra* text accompanying note 87.

[140] As previously noted, the double inclusion in the service provider's income will increase the service provider's basis in his partnership interest under section 705(a)(1)(A). That could result in the service provider's having a loss when his interest in the partnership is liquidated. But, that loss deduction could take place many years after he recognized the income, and so it merely mitigates the injury from the double taxation and does not eliminate it. The time value of money concept works against the service provider in this instance.

employees who also are performing services for clients, the service provider will share in the income that the partnership receives from the employees' services net of their salaries and expenses. Is it proper to tax the service provider on the present value of his share of that future partnership income? The net income produced for the partnership by its employees may have been increased because of the participation of the service provider. That is, his share of that income may reflect the additional work that was created for the employees as a consequence of his clientele and reputation. It will be difficult, if not impossible, to estimate at the time the service provider becomes a partner whether and to what extent his share of employee produced income will be a byproduct of his goodwill and workload. The difficulty in attempting an evaluation of that nature makes it too speculative to take into account. Putting it differently, the service provider will benefit from participating in the goodwill that the partnership already possesses (and that goodwill includes their labor pool), but the service provider brings his own goodwill to the table and enhances the existing goodwill of the partnership through the conduct of his services. There is good reason then not to charge the service provider with income because of the partnership's goodwill.

Some relief for the double taxation of income that the service partner himself provides might seem to be available if the partnership were treated as having sold to the service provider the right to a portion of its future income. This treatment would be an application of the contention by some commentators that the transfer of a compensatory partnership interest causes a constructive sale of a portion of the partnership's assets to the service provider followed by a contribution of the constructively acquired property to the partnership in exchange for the partnership interest.[141] In that case, the partnership would have a basis in the right to the portion of its future income that the service provider would be deemed to have contributed to the partnership. There are several reasons why this approach is not likely to be adopted and would be of little help if it were.

First, as previously noted, the 2005 proposed amendments to the regulations concerning transfers of compensatory partnership interests expressly state that a partnership is not deemed to have sold a portion of its internal assets by transferring a compensatory partnership interest.[142] If the proposed amendments are finally adopted, there can be no constructive sale by the partnership and so no acquisition of a basis in the right to receive a portion of the income. Second, the Service has never sought to treat the transfer of a compensatory partnership profits interest as a sale by the partnership of a right to future income and, for the reasons noted below, it is not likely to ever do so even if the 2005 proposed amendments to the regulations are not adopted.

If the transfer were treated as a constructive sale by the partnership of the

[141] *See supra* note 70 and accompanying text.
[142] *See supra* note 70 and accompanying text.

right to a share of its future profits, the partnership would then have ordinary income in an amount equal to the amount of income recognized by the service provider. The partnership would be deemed to have sold its right to future income for the value of the services received (or to be received), and that would fall within the doctrine of anticipation of income, which leads to the partnership's recognizing ordinary income in that amount.[143] That ordinary income would be allocated among the old partners of the partnership and would thereby cancel out any deduction they received for the partnership's payment to the service provider. While the partnership would have a basis in the right to the income that was sold, it is doubtful that the partnership could amortize that basis and deduct it from the income when earned since there is no ascertainable period over which the basis could be amortized. Moreover, even if an amortization deduction were allowed, the service provider is the only one who should benefit from the deduction, but instead, the deduction would be allocated among all of the partners proportionately unless a special allocation under section 704(b) were made to the service provider.[144]

While the tax treatment of partnerships vacillates between an entity and an aggregate approach, distributions from a partnership to a partner are treated as a distribution from an entity unless a specific statutory provision (such as section 751) dictates otherwise. Under section 731(b), a partnership does not recognize gain or loss on making a distribution of property to a partner unless section 751 applies.[145] Section 751 applies only when a distribution causes a change in the partner's interests in both section 751(c) and 751(d) assets on the one hand and the partnership's other assets on the other hand, so that the partner's interest in one type of asset is increased and the partner's interest in the other type of asset is decreased by the same amount.[146] Section 751(c) and 751(d) assets can generally be described as unrealized receivables and inventory when those terms are given a broad definition.

It is noteworthy that the tax law does not treat a partnership as having made a constructive sale of its assets merely because a partnership distribution shifts a partner's interests among capital gain assets or among ordinary income assets; it is only when the partner's interest is shifted from one of those types of assets to the other that a constructive sale takes place, and that rule is designed to prevent the parties from changing potential ordinary income into potential capital gains. That shifting of interests from one type of asset to the other type does not occur when a partnership transfers a compensatory partnership interest to a service provider. Consequently, the policies that dictated the adoption of section 751 have no application to the transfer of a compensatory partnership interest.

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143 *See* Douglas A. Kahn & Jeffrey H. Kahn, Federal Income Tax §§ 20.3000–20.3722 (5th ed. 2005).

144 Reg. § 1.704(b)(1)(i).

145 Reg. § 1.731-1(b).

146 *See* Reg. § 1.751-1(a).

Although section 731(b) does not apply to a partnership's transfer of a compensatory partnership interest since it is given for services rather than as a distribution to a partner, the same policies that caused Congress to treat a partnership distribution as not being a taxable transaction to the partnership apply to the transfer of a compensatory partnership interest. The transfer should be treated as a transfer of an interest in an entity rather than as a transfer of a portion of the assets of the partnership. By way of analogy, albeit an imperfect one, a corporation's distribution of its own stock as payment for services does not cause the corporation to be treated as having sold a portion of its assets to the service provider.[147] Additional reasons not to treat the transfer of a compensatory partnership interest as a constructive sale of the partnership's assets are discussed in Part IV. As noted in Part IV, the polices that underlie section 721, which provides that a partnership does not recognize income when property is contributed to the partnership, also point toward preventing a partnership from recognizing a gain or loss on transferring a compensatory partnership interest.

Apart from the policy considerations that are discussed above and in Part IV, the complications that would ensue from treating the partnership as having sold its right to future income are sufficiently daunting to refrain from going down that path. Moreover, the consequences of that treatment are no less troublesome than double taxation of the service provider would be. In any event, regardless of whether a constructive sale of a portion of the partnership's future income would be a consequence of taxing the service provider, in the case of a service partnership, the proper result is to exclude the compensatory partnership profits interest from the service provider's income for the reasons spelled out above.

The Service has never suggested that it will seek to tax a service provider for receiving an interest in future profits of a service partnership. If the 2005 proposed amendments to the regulations under section 83 are adopted, any possibility of taxation can be avoided by electing the safe harbor to use the liquidation method of valuation for the partnership interest. Even if the proposed amendments are not finally adopted or if the parties fail to make the safe harbor election, the compensatory partnership profits interest should not be taxable. As shown above, the service provider should not be taxed on the present value of his capacity to produce income in the future. Even if that view of the transaction were rejected, there should be no tax imposed because the situation is one in which the liquidation method of valuation should be used even if the safe harbor is not available or elected. The service provider did not receive anything other than the right to a share of future profits that will be produced by the efforts of the service provider himself in conjunction with his other partners. He will receive that future income only for so long as he continues to earn it. The value of a profits interest that can be terminated at will is too speculative to be taxed, and the value is even more speculative

[147] *See* Rev. Rul 1962-217, 1962-2 C.B. 59.

if the partner's percentage interest is subject to an annual review. As noted, it is not plausible that the other partners would allow the service provider to continue for long to share in partnership income that was produced by the labor of the other partners.

2. *A Partnership in Which Both Capital and Labor Produce Significant Income*

What does this analysis tell us about what should be the tax treatment of a service provider receiving a compensatory profits interest in a partnership that conducts a business in which capital is the principal source of the partnership's income or in which both capital and labor are significant elements in the production of the partnership's income? First, let us consider the latter situation.

Based on the preceding discussion, we can conclude that any value of a profits interest that is attributable to the anticipated income derived from the performance of future services should not be included in the service provider's income if the service provider will provide future services for the partnership. This is true regardless of whether the service provider also provided past services to the partnership.

Should the value of the service provider's profit interest be taxable to the extent that the value reflects the income that is anticipated to be produced by the capital that the partnership possesses and the gain that it is anticipated will be recognized from the future appreciation of the capital? Let us assume that the partnership's capital does not provide a substantial certain and predictable stream of income. The latter situation will be examined later in this Article in connection with the discussion of the three exceptions to the availability of the safe harbor for using the liquidation method of valuation and to the availability of Revenue Procedure 1993-27.

If a reasonable estimate can be made of the income that the property will produce, and if there is a contractual arrangement prohibiting the other partners from terminating the partnership for some period of time, the service provider's interest in the partnership's income from capital can be valued and should be taxed to the service partner upon its receipt.[148] An alternative to estimating the rate of return for the partnership's assets is for Treasury to adopt a specified rate of return for all assets and use that rate to calculate the present value of the income stream from the partnership's assets. While there is no policy reason not to tax a service provider's receipt of a profits interest in that circumstance, if the 2005 proposed amendments to the regulations are finalized and if the safe harbor election is made, the liquidation method will

[148] If there are contractual arrangements that effectively prevent the other partners from terminating the service provider's right to income from the partnership's capital, then there is no impediment to valuing the service provider's right to that income from capital, and there is no policy reason not to tax the service provider on that value. However, it does not seem likely that such contractual provisions will be adopted by many partnerships.

be used to provide a zero value to the service provider's interest. The operation of the safe harbor election is overly generous in that case.

On the other hand, in the more likely circumstance that the other partners have no contractual restraint on their power to terminate the partnership at will, the present value of the anticipated income stream from the partnership's capital would have to be discounted to reflect the vulnerability to termination of the service provider's interest. A determination of the amount of that discount will depend upon an evaluation of the likelihood of that termination's taking place and a weighing of the changes over time in the likelihood that the termination will take place. The likelihood of an immediate termination may be very slight but, over time, the risk that the service partner will be cut out may increase. Administratively, it does not seem feasible to make individual determinations of those risks for each case, but a standardized discount for all such cases does not seem appropriate either, since the risks will vary widely from case to case. Given those difficulties and the amount of sheer speculation that an evaluation of the risk entails, there is a strong policy justification for not including the compensatory partnership interest in the service provider's income unless its value can be ascertained through other means discussed below. The value of that partnership interest typically will be so speculative that it should be considered to be zero. In other words, this is a situation where it is appropriate to use the liquidation method to value the profits interest. Even if the proposed amendments to the regulations are finalized and a partnership fails to make the safe harbor election, the valuation should be made by using the liquidation method. Later, this Article discusses how a service provider's interest should be valued if one of the three exceptions to the use of the safe harbor election applies.

One possible means of valuing a compensatory partnership interest in this circumstance may be available if the services for which the service provider is being compensated are exclusively (or perhaps primarily) past services. If the value of those past services can be determined, then the value of the compensatory partnership interest can be deemed to be equal to the value of those services, on the principle that an exchange between people at arm's length is deemed to be of equal values. However, for several reasons, if a significant element of the services for which the partnership interest was transferred is future services, this approach is inappropriate. First, it will be very difficult, and perhaps impossible, to value services which might be performed in the future. Second, when future services are part of the bargain, it is likely that the partnership's income from services will be an important element of the income in which the service provider will share. The service provider should not be taxed on his right to that portion of the partnership's income since his own services will contribute to the production of that income. It is not possible to determine how much of the value of the service provider's services is attributable to the right to the partnership's future income from labor and how much is attributable to the right to income from capital, unless one can value the right to the income from capital. Because of the vulnerability to termination, it may not be feasible to determine the value of the right to income from capital; indeed, it is the difficulty in making that determination that leads to an attempt to value the services contributed by the service provider as a device for valuing the compensatory partnership interest.

If comparable interests in the partnership were sold to third parties, the amount paid by those parties could be used to value the compensatory partnership interest. But, we are positing a partnership interest that can be terminated by the other partners at will. It is unlikely that a terminable partnership interest could be sold to third parties, except for an interest subject to a buyout provision. If a partnership interest that is subject to a buyout is marketed to third parties, the price paid for the interest would reflect a discount for the vulnerability to having the partnership interest bought out. That method of valuation is reasonable if the service provider is not required to provide future services. However, if the service provider is required to provide future services, he should not be taxed on the value of the compensatory partnership interest that is attributable to future income from labor and, as noted above, it is not feasible to allocate the interest's value between the right to income from labor and the right to income from capital.

A compensatory profits interest typically includes the right to share in any gain subsequently recognized from the appreciation of the partnership's capital that occurs after the service provider acquired the partnership interest. If the partnership has a significant amount of capital, the potential for appreciation can be a significant item. Should the service provider's right to share in that potential appreciation be valued and included in the value of the compensatory partnership profits interest that the service provider acquired? Any appreciation of the partnership's assets will be derived from two sources: either it will be attributable to market forces, or it will be attributable to the services performed by the partners, or both. As to the potential for appreciation that is due to the partners' labor, that potential should be excluded from the value of the service provider's compensatory partnership interest, since his own future labor will contribute to that appreciation. The service provider should not be taxed on the present value of anticipated appreciation that will be the product of his own labor. As to the possibility of appreciation due to market forces, that possibility is too speculative to take into account. There is as great a risk that the property will decline in value as there is that it will appreciate in value. Consequently, the prospect of future appreciation of capital should be excluded from the valuation of the service provider's compensatory partnership interest. The use of the liquidation method will prevent the prospect of appreciation from affecting the valuation of the partnership interest.

While it seems implausible that a service partnership would give a compensatory partnership profits interest to a person who will not provide future services to the enterprise, it is plausible that a partnership for which a significant part (or all) of its income is produced by capital would transfer a partnership profits interest as compensation solely for past services. Indeed, that was the situation that arose in the *Diamond* case.[149] Should the service provider be taxed on the partnership profits interest in that situation? As noted above, the only plausible reason for not taxing a service provider in that situation is due to the problem of valuing the interest. If the interest can readily be valued, there is no policy reason not to tax the service provider on that value and the proposed safe harbor's insulation of that interest from taxation is too generous.

But, as noted above, when the service provider's profits interest is subject to termination at the will of the other partners, there is good reason to employ the liquidation method in valuing that interest unless another reasonable method of valuation is available. The liquidation method will provide a zero valuation for the profits interest and will not cause any tax liability. In this author's view, the liquidation method should be employed here even if the 2005 proposed amendments are finally adopted and the partnership fails to elect the safe harbor. In other words, this is a situation in which the liquidation method should be applied whether or not the safe harbor is applicable. However, if another valuation method is available (*e.g.*, if the value of the services provided by the service provider can be determined, or if comparable partnership interests have been sold to investors), then that other method should be utilized.

3. *A Partnership Whose Income Is Derived Primarily from Capital*

If virtually all of a partnership's income is attributable to capital, the question of how to tax the receipt of a compensatory partnership profits interest in such a partnership is subject to the same analysis that is set forth above for the taxation and valuation of a profits interest in a partnership in which both capital and labor produce income. In general, if the profits interest can be valued, there is no policy reason not to tax it. To the extent that the 2005 proposed amendments to the regulations permit an election to use the liquidation method in valuing a compensatory partnership profits interest in that circumstance, they are too generous.

B. *The Service's Exceptions to the Exclusion of the Receipt of a Partnership Profits Interest from Income and from the Safe Harbor Election*

Let us now turn to the situations described in the three exceptions to the exclusion from income that apply to Revenue Procedure 1993-27 and to the safe harbor election that Notice 2005-43 implements. The three exceptions in each of those documents are similar to the ones in the other document.

149 Diamond v. Commissioner, 56 T.C. 530, 535–538 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

1. *The Partnership Profits Interest Is Disposed of Within Two Years After the Service Provider Acquired It*[150]

This exception tracks the situation that was the subject of the *Diamond* case.[151] If the service provider sells the partnership interest shortly after receiving it, that is strong evidence that the profits interest had more than a zero value at the time of the sale. If the sale is in close proximity to the receipt of the profits interest, it is reasonable to assume that the interest had the same value at the time that the service provider acquired it. While there could be a difference in value at the earlier date, it is not likely to be large if little time has elapsed between the receipt of the interest and its sale. Note that a service provider generally will not be able to sell an interest in a service partnership in which little income is derived from capital, but even if he were able to sell that interest, he should not be taxed on the receipt of the compensatory partnership profits interest since most of the value of that interest will be attributable to the right to income that the service provider will produce through his own labor.

Diamond involved a partnership in which capital was the principal source of the partnership's income, and the service provider in that case had performed past services and had no obligation to provide future services. As already noted, it is highly unlikely that a partnership whose principal source of income is from services would give a profits interest for past services to someone who will not provide future services.[152] If the retention of the profits interest depends upon the service provider's continuing to provide services to the partnership, it does not seem plausible that he could sell that right for any significant amount. Consequently, if a service provider can sell his profits interest for a meaningful sum shortly after receiving it, that suggests that the service provider's interest pertains to a right to capital or to the income derived from capital or to both. As shown above, the only policy reason not to tax the right to income from capital is the valuation problem, and that problem is alleviated when a sale takes place soon after the transfer of the profits interest to the service provider.

In Revenue Procedure 1993-27, a partner's disposition of the compensatory partnership profits interest within two years of receipt removed the receipt from the protection of that ruling.[153] A "disposition" may be too broad a category for this purpose. A sale or exchange of the profits interest establishes a presumptive value for it. How does a gift or bequest of the profits interest help resolve the valuation problem? One possible answer is that the exception will be invoked for nonsale dispositions only in cases where there is no problem in valuing the profits interest. Also, the property may have to be valued for estate tax or gift tax purposes, and that valuation could be adopted

[150] Rev. Proc. 1993-27, 1993-2 C.B. 343.
[151] *Diamond*, 56 T.C. at 544.
[152] *Id.* at 535–38.
[153] Rev. Proc. 1993-27, 1993-2 C.B. 343.

as the value that the compensatory partnership interest had at the time that the service provider acquired it.

Even in the case of a sale of the profits interest, is two years too long a period to attribute the selling price to the value of the profits interest at the time of its receipt? Any time period that is chosen will be arbitrary, and so there should be no quarrel with whatever choice the Service makes unless it is unreasonably long. While two years may be a longer period than some would choose, it is not an unreasonable selection. However, the longer the amount of time that has elapsed between the receipt and sale of the compensatory partnership interest, the less reliable is the assumption that the selling price equals the value that the partnership interest had when the service provider acquired it. Moreover, the selling price of the interest will reflect the service provider's share of undistributed income that arose after the service provider became a partner, and the price paid for the right to that income bears no reflection on the value that the compensatory partnership interest had when the service partner acquired it. Presumably, if the service provider can prove the amount of his share of undistributed partnership income, that amount (or a discounted amount) will be subtracted from the purchase price in determining the value of the compensatory partnership interest.

In Notice 2005-43, a transfer of a compensatory partnership interest in anticipation of its subsequent disposition is excluded from the safe harbor provision.[154] The Notice creates a presumption that, in certain circumstances, the transfer was made in anticipation of a subsequent disposition, but this presumption can be rebutted.[155] One of the conditions that triggers the presumption is a disposition of the compensatory partnership interest within two years of its receipt, but the Notice provides that the presumption will not apply if the disposition occurred "by reason of death or disability."[156] While the Notice provides more flexibility than does the 1993 Revenue Procedure and excludes certain dispositions, it still covers gifts.[157] However, since the safe harbor election covers both partnership profits and capital interests, there may not be a valuation problem in some of the cases to which the exception applies.

Note that, in the case of a subsequent sale, the service partner will have the same amount of income whether or not he is taxed on the receipt of the partnership profits interest. If he is taxed on that receipt, he will have a basis in the partnership profits interest that is equal to the selling price, and so he will not have any gain on the sale. If he is not taxed on the receipt of the partnership profits interest, he will have a zero basis in that interest, and he will recognize a gain on the sale equal to the selling price. In either case, he will have income equal to the selling price of the partnership profits

[154]Notice 2005-43, 2005-1 C.B. 1221.

[155]*Id.*

[156]*Id.*

[157]*See id.*

interest. Why then, in the case of a subsequent sale of the partnership profits interest, does it matter whether the receipt of that interest is taxed? Unless there can be some difference of consequence in the tax treatment, it would not be worthwhile to fashion an exception to the exclusion from income of the receipt of a partnership profits interest.

One item of difference relates to the timing of the recognition of the income. Under one approach, the income will be recognized when the service provider acquired the partnership profits interest and, under the other approach, he would be taxed when he sold that interest. If the partnership interest was acquired in the same taxable year in which it was sold, a difference in timing would not matter. But, if the two events took place in different taxable years, then the timing of the recognition will matter.

Apart from timing, which sometimes will be of no consequence because the acquisition and the sale will occur in the same taxable year, the question of taxing the receipt of the partnership profits interest in this situation will be significant only if the service partner's gain from the sale of that interest will be treated as capital gain, as contrasted to the ordinary income that he would recognize if the receipt of the partnership profits interest were taxable. Even if the gain on the sale is treated as a capital gain, it will be a short-term capital gain if the partnership interest is sold within one year of the time that the service provider acquired it. Since short-term capital gain receives no preferential income tax rates, is there any difference between the service partner's having a short-term capital gain rather than ordinary income? The answer is that there can be a significant difference if the service provider has capital losses that year. Capital losses of an individual can be deducted, to the extent that the individual has capital gains, and if there is an excess of capital losses, they can be deducted against $3,000 of the individual's ordinary income.[158] An advantage of having the service provider's gain be characterized as a short-term capital gain is to permit the deduction of capital losses that the service provider had that year. Apparently, that was the reason that the taxpayer in *Diamond* sought to be taxed on the short-term capital gain from the sale of his partnership profits interest rather than to have ordinary income on his receipt of that interest.[159] Moreover, if the service partner sells the partnership profits interest more than a year after acquiring it, he could have long-term capital gain on the sale, and preferential tax rates can apply to long-

[158] I.R.C. § 1211(b). A corporation can deduct capital losses only to the extent of its capital gains. I.R.C. § 1211(a).

[159] *See* Diamond v. Commissioner, 56 T.C. 530, 539 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

term gains.[160]

a. Characterization of Gain from the Sale of a Partnership Profits Interest. Will the sale of a compensatory partnership profits interest qualify for capital gains treatment? The sale constitutes a sale of a partnership interest that the service provider owns. The taxation of the gain from the sale of a partnership interest is controlled by section 741, except to the extent that section 751 applies. Section 741 treats the gain to which that section applies as a capital gain, which will be either long-term or short-term depending upon whether the service provider holds the partnership interest for more than one year.[161] Under section 751(a), the amount realized on the sale will be ordinary income to the extent that it is attributable to the service provider's interest in the partnership's unrealized receivables and inventory.[162] As used in that section, "unrealized receivables" and "inventory" have a specially defined meaning which is much broader than normal usage would suggest.[163] Given that under the terms of this exception, the sale will take place a relatively short time after the service provider acquired the profits interest, there is not likely to be much section 751 income attributable to that interest. If there is any, the principal amount would likely be from accounts receivable that were earned after the service provider became a partner, and then only if the partnership reports its income on the cash receipts and disbursements method of accounting. Accordingly, all or most of the gain recognized on the sale of the partnership interest will be capital gain under section 741.

One question arises as to whether section 751 will cause all of the income recognized by the service provider on the sale of his partnership interest to be treated as ordinary income. There are judicial decisions holding that if a partnership has a contractual right to earn income, any value in the sale of a partnership interest that is attributable to that contractual right is ordinary income. The courts treated the value of the contractual right to earn income as an unrealized receivable for purposes of section 751(c).[164] If the gain from a sale of the contractual right to earn income through the performance of services is treated as ordinary income,[165] the value of that right can also be classified as "inventory" within the meaning of section 751(d)(2). The service provider's partnership interest is a right to share in future partnership profits. But, it is only where the partnership itself has a contractual right with third

[160] Section 1(h) provides preferential tax rates to an individual's "net capital gain," which refers to the excess of net long-term capital gain for the year over the net short-term capital loss for that year. *See* I.R.C. § 1222(11). Note that a sale within two years of the receipt of the profits interest can trigger the exceptions to the nonrecognition provision of Revenue Procedure 93-27 and to the 2005 safe harbor provision. *See* Rev. Proc. 1993-27, 1993-2 C.B. 343; Notice 2005-43, 2005-1 C.B. 1221.

[161] I.R.C. § 741.

[162] I.R.C. § 751(a).

[163] *See* I.R.C. § 751(c), (d).

[164] *See* Ledoux v. Commissioner, 77 T.C. 293, 307 (1981), *aff'd per curiam*, 695 F.2d 1320 (11th Cir. 1983), and cases cited therein.

[165] *See* Commissioner v. Ferrer, 304 F.2d 125, 134 (2d Cir. 1962).

parties to earn income that the value of that contractual right would constitute an unrealized receivable of the partnership.

If a partner's right to share in partnership profits were deemed a right to unrealized receivables, then that would virtually eliminate section 741's treatment of the gain from the sale of a partnership interest as a capital gain. Even if a partnership capital interest reflects the value of the income that the partnership's capital can produce, and if the partner's interest in that income were deemed to constitute an interest in an unrealized receivable, there would be little capital gain treatment left. Whatever the merits of the principle that the value of a partnership's contractual right to earn income is an unrealized receivable, it has no application to a partnership profits interest unless the partnership has such a contractual right with third parties, and then only to the extent of the partner's share of the value of that contractual right.

Another basis for characterizing the gain from the sale of the partnership interest as ordinary income could rest on the contention that if the service partner were to have sold his right to partnership profits, the gain from the sale of that right would be treated as ordinary income, and therefore the right to that income should be classified as "inventory" within the meaning of section 751(d)(3).[166] As discussed below in connection with the Third Circuit's decision in the *Lattera* case, contrary to that contention, the gain from a sale by the partner of all of his rights to partnership income would be a capital gain.[167]

Of course, if the author is wrong in determining that a sale of the compensatory partnership interest would produce capital gain income, then there is no reason to have the exception to nonrecognition treatment for the service provider's receipt of that partnership interest. If the sale of the partnership interest produces ordinary income, then the only reason to create an exception to the nonrecognition treatment is that the timing of the income might be altered, and that is not a significant enough difference to warrant creating that exception.

Clearly, assuming that the gain from the sale of a compensatory partnership interest will be treated as a capital gain, there are significant differences in the tax consequences attending the two possible treatments of the receipt of a compensatory partnership profits interest that is sold soon afterwards. What then is the consequence of having this exception to the application of both Revenue Procedure 1993-27 and Notice 2005-43?

If the profits interest that the service provider acquired is in a service partnership in which capital is not a significant factor, and if the service provider is required to provide future services to the partnership, then as indicated above, he should not be taxable on that interest. But because of the subsequent sale, the service provider will not qualify for the exclusion of income from Revenue Procedure 1993-27 or for the safe harbor of Notice

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[166] *See* I.R.C. § 751(d)(3).

[167] *See infra* Part III.B.1.c.

2005-43. Nevertheless, he should not be taxed on the receipt of his interest. The sale of the interest indicates that it has value, presumably because of the belief that the partnership will not be terminated for some time. But, the reason for not taxing the service provider on the receipt of the profits interest does not rest on the difficulty of valuation. Rather, it rests on the principle that a person should not be taxed on an increase in his capacity to produce a greater amount of income. In this author's view, the value of that interest should be determined by using the liquidation method even when the safe harbor election is not available.

The issue raised above may be purely theoretical in that it seems unlikely that a service provider could sell a profits interest of the type described above. There is unlikely to be a buyer who is willing to purchase such an interest with the attendant risk that the seller will continue to earn the expected income. In those circumstances where a buyer would be willing to purchase an interest in the income that the seller will earn in the future because of the stature of the seller, it is unlikely that a person having that income producing potential would be willing to sell a percentage of it. For example, many people would likely be willing to pay something to have a right to a percentage of the earnings that Tiger Woods will have in the next ten years, but the purchase price would be discounted to such an extent that Tiger Woods would not be likely to have any interest in selling that right.

On the other hand, to the extent that the value of a compensatory partnership profits interest is attributable to the anticipated income from partnership capital, then the receipt of the interest should be taxed and the value should be deemed to be equal to the selling price. The only reason not to tax the receipt of a profits interest in capital is the valuation problem caused by the power of the other partners to terminate the profits interest at any time. A prompt sale of the profits interest vitiates that valuation problem.

If the service provider's gain from the sale of the partnership interest did not qualify as a capital gain, there would be little reason to object to excluding the compensatory partnership interest from the service provider's income on its receipt. As noted above, sections 741 and 751 provide capital gain treatment for most, or perhaps all, of the gain from the sale of the partnership interest. Let us consider whether, as a matter of tax policy, the provision for capital gain treatment is appropriate for the sale of a partnership profits interest.

The value of a partnership profits interest is the present value of the partner's share of the partnership's future income. In what way does that distinguish a profits interest from other income producing properties? The value of any property is the present value of the income stream that the property is capable of producing. For example, the value of a commercial building is the present value of the future rent that the building can generate. If the owner sells the building, the purchase price represents the present value of the income stream that the building can produce. Yet, the gain from that sale will be a capital gain or a section 1231 gain, depending upon whether the owner is in the real estate rental business. Is there any reason that the sale of a partnership profits interest should be treated differently? How should a sale of the right to profits that were not connected to a partnership interest be treated?

b. *The* McAllister *decision*. The case most closely allied to the sale of a right to profits is *McAllister v. Commissioner*.[168] In that case, the taxpayer was a widow who had inherited a life income interest in a trust. The taxpayer sold her life income interest to the remainderman of the trust. The Second Circuit had two issues to resolve: (1) should the gain or loss from the sale of the entirety of a life income interest be treated as a capital gain or loss, and (2) in determining her gain or loss, could the taxpayer use the basis that she acquired in her income interest under the antecedent of section 1014. In a majority opinion, the Second Circuit answered both questions in the affirmative. The court held that any gain or loss was a capital gain or loss, and it held that the basis that the taxpayer acquired in her life income interest on her husband's death could be used in determining her gain or loss on the sale.[169] The latter holding on basis was changed by Congress when it passed section 1001(e), disallowing the use of basis on the sale of a term interest if the basis was acquired by sections 1014, 1015 or 1041 (*i.e.*, acquired from a decedent, or by gift, or from a spouse).[170] Congress did not pass any legislation changing that part of the *McAllister* decision that held that capital gains treatment applies, and Treasury has promulgated a ruling adopting the *McAllister* view that the sale of a life income interest qualifies for capital gain treatment.[171] Moreover, the Service has consistently followed the *McAllister* view in numerous subsequent private rulings.[172]

The issue that *McAllister* resolved was whether the sale of the right to income from a trust was subject to the anticipation of income rule requiring ordinary income treatment. The Second Circuit declined to apply that rule.[173]

In several recent cases, courts of appeals have held that when the winner of a lottery that provides an annuity sells the right to subsequent annuity

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[168] 157 F.2d 235 (2d Cir. 1946).

[169] *Id.* at 236.

[170] The basis in the term interest can be used if the sale is part of a transaction in which all of the interests in the property are transferred. I.R.C. § 1001(e)(3). The apparent reason that Congress prevented the use of basis in a disposition of a term interest was to prevent what was perceived to be a double use of that basis. A unified basis in a trust is allocated between the term interest and the remainder interest according to their actuarial values. Reg. §§ 1.1014-5(a), 1.1015-1(b). Thus, the basis that is allocated to a life income beneficiary is reduced each year as she ages, and the basis of the remainderman is increased in the same amount. Ultimately, upon the death of the life income beneficiary, the entire uniform basis will be allocated to the remainderman. So, if the life income beneficiary sells her interest in the trust and was permitted to use her basis to offset the amount realized, that same basis will flow to the remainderman in subsequent years and be available to the remainderman to use again. Congress prevented that doubling of the use of the life income beneficiary's basis by preventing its use on the sale of the income beneficiary's interest unless the remainder interest is sold at the same time, in which event the remainderman cannot ever reuse the basis that the income beneficiary used.

[171] Rev. Rul. 1972-243, 1972-1 C.B. 233.

[172] *See, e.g.*, P.L.R. 2007-39-004 (June 21, 2007).

[173] *McAllister*, 157 F.2d at 236.

payments, the seller recognizes ordinary income.[174] Those cases rested their decisions on the "substitute for ordinary income" doctrine that treats a gain as ordinary if it received in lieu of future income that would be ordinary income when recognized.[175] Let us consider whether the policy underlying the substitute for ordinary income doctrine conflicts with the section 741 statutory provision granting capital gain treatment for all or most of the gain from the sale of the service provider's partnership interest.[176]

c. *The Substitute for Ordinary Income Doctrine and the* Lattera *Decision.* While the substitute for ordinary income principle sounds helpful and is often employed, it actually is of no use in separating capital gain from ordinary income. The value of every asset is the present value of the future income that it is capable of producing. So, the amount realized on the sale of every asset is a substitute for the ordinary income that the owner of the asset could have derived from it. If the substitute for ordinary income principle were applied without restrictions, virtually no sales would produce a capital gain. As the courts in several of the lottery cases noted (the *Lattera* decision is one), the so called substitute for ordinary income principle must be modified so as to restrict its application to only some of the situations in which payment is received in substitution of ordinary income.[177] The modification then becomes the standard for distinguishing ordinary income from capital gain, and the substitution for ordinary income doctrine becomes irrelevant. If no standard for distinction is applied, a court that purports to use the substitute for ordinary income doctrine is actually making an ad hoc decision to treat an item of income as ordinary and is merely reciting the substitute for ordinary income doctrine as a shibboleth to disguise the fact that it is not employing any standard at all.

In *Lattera*, while relying on the substitute for ordinary income doctrine, the Third Circuit correctly observed that the doctrine cannot be applied indiscriminately or it would preclude capital gain treatment in virtually all situations.[178] The court noted that it was not prepared to try to set forth an exclusive list of the standards that could be employed to distinguish capital gains from ordinary income, but it set forth three standards, the satisfaction of any one of which would be sufficient to require ordinary income treatment.[179] The court's discussion of those standards, and its application of one of them,

[174] *See, e.g.*, Prebola v. Commissioner, 482 F.3d 610, 612 (2d Cir. 2007); Lattera v. Commissioner, 437 F.3d 399, 410 (3d Cir. 2006); Watkins v. Commissioner, 447 F.3d 1269, 1273 (10th Cir. 2006); United States v. Maginnis, 356 F.3d 1179, 1187 (9th Cir. 2004).

[175] The landmark expression of that principle is stated in *Hort v. Commissioner*. *See* 313 U.S. 28, 31 (1941).

[176] *See* I.R.C. § 741.

[177] *See, e.g.*, *Lattera*, 437 F.3d at 404.

[178] *Id.*

[179] *Id.* at 406.

makes the *Lattera* case worthy of careful consideration.[180]

The facts of *Lattera* were that the taxpayers in that case won a Pennsylvania state lottery having a value of more than $9 million. The winnings were required to be paid in 26 annual installments. After receiving nine of the installments, the taxpayers sold their right to the remaining seventeen installments to a third party for a lump sum. The taxpayers reported the sale price of over $3.372 million as a capital gain, listing their basis in the right to the installment payments as zero. The Third Circuit Court of Appeals sustained the Commissioner's view that the taxpayers' gain was ordinary income.[181]

The first of the three standards that the Third Circuit adopted is a resemblance test.[182] The court listed a number of items that have been treated as capital assets and some that have not, and then looked to see if the right to the installment lottery payments looked more like one of the lists than the other. The court concluded that the right to the installment payments did not bear a resemblance to the items on either of the lists, and so the resemblance test was of no use in that case.[183]

The second test or standard that the Third Circuit court expounded is the well-established principle that if the seller of a right to future income (a carved out interest) retains a residual interest in that income or in the property that produces the income, the seller will recognize ordinary income on the sale.[184] The court treated the carved out principle to be one test for determining whether the substitution of ordinary income rule applies. Since the taxpayers in *Lattera* had sold all of their interest in the lottery payments, the carved out or residual interest rule was not applicable.[185] The court further held, however, that the carved out principle is only one of the circumstances in which the substitution for ordinary income rule applies.[186] The court then fashioned a third test or standard: the earned income standard.

The third standard, like the resemblance test, requires an examination of the character of the property that was sold to determine whether it qualifies as a capital asset.[187] The third standard that the court adopted, and on which

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[180]The *Maginnis* decision also stated standards for restricting the substitute for ordinary income doctrine. *See* United States v. Maginnis, 356 F.3d 1179, 1183 (9th Cir. 2004). But the standards employed in that case were rightly rejected and criticized by the Third Circuit in the *Lattera* decision, and this Article will not repeat that criticism. *See Lattera*, 437 F.3d at 405.

[181]*Lattera*, 437 F.3d at 410.

[182]*Id.* at 406.

[183]*Id.* at 409.

[184]*See id.* at 407; *see also* Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 267–68 (1958).

[185]In some of the lottery sale cases, the carved out interest exception was applicable since the taxpayer in those cases did not sell all of the installment payments to which she was entitled but, instead, retained the right to some of the installments. *See, e.g.*, Davis v. Commissioner, 119 T.C. 1, 3 (2002). Consequently, those cases could easily be decided in favor of the Commissioner. *See, e.g.*, *id.* at 7–8.

[186]*Lattera*, 437 F.3d at 407.

[187]*Id.* at 407–08.

it based its decision, rests on a distinction between "earned income" and the right to earn income.[188] While an earned income distinction is useful if correctly construed, the court's construction and application of that concept makes no sense.

Adopting the analysis employed in a student note, the court concluded that only if the owner of the right to the income must do something further to earn the income can the seller have capital gain treatment.[189] The court determined that if the mere ownership of property gives the owner the right to future income, then the sale of that property will be treated as a sale of earned income, and therefore the gain from that sale will be ordinary income.[190] The court held that the taxpayers' right to the annuity payments in the instant case had been earned when they won the lottery, and so their income from the sale of the right to future payments was ordinary income.[191]

While the court reached the right result in *Lattera*, its reasoning is flawed. The problem with the court's opinion is not that it chose to exclude gain from the sale of the right to earned income from capital gain treatment, but rather it is the manner in which it construed the term "earned income." If the distinction that the court employed were adopted, the sale of bonds or stock would produce ordinary income. As the court itself noted, stocks and bonds typically are capital assets, the sale of which produces a capital gain or loss.[192] The court also noted that "a stock's value is the present discounted value of the company's future profits."[193] On the sale of stock, the purchaser acquires the right to future income (dividends) solely by virtue of owning the stock; he need do nothing further to obtain the dividends. Yet, the court acknowledged that the sale of the stock produces capital gain.[194] The treatment of the sale of capital assets, including stock, which the court acknowledged is correct, cannot be reconciled with the distinction on which the court based its decision.

Moreover, the court recognized that its analysis conflicted with the Second Circuit's decision in *McAllister* on the capital gains issue. The court dismissed *McAllister* in the following language: "We consider *McAllister* to be an aberration, and we do not find it persuasive in our decision in this case."[195] The court failed to note that the Service has ruled that it accepts the *McAllister* holding on capital gain treatment and adopted it.[196] The court cited Professor

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[188] *Id.*

[189] *Id.* at 409. The court derived this standard and its construction of it from a student commentary. *See id.* at 406 n.4 (citing Thomas Sinclair, Note, *Limiting the Substitute-for-Ordinary-Income Doctrine: An Analysis Through Its Most Recent Applications Involving the Sale of Future Lottery Rights*, 56 S.C. L. Rev. 387, 401–03 (2004)).

[190] *Id.* at 409–10.

[191] *Id.* at 410.

[192] *Id.* at 406.

[193] *Id.* at 404.

[194] *Id.* at 406.

[195] *Id.* at 409.

[196] *See* P.L.R. 2007-39-004 (June 21, 2007); Rev. Rul. 1972-243, 1972-1 C.B. 233.

Chirelstein's comment in his excellent book on federal income taxation that the *McAllister* decision was incorrect.[197] Although Professor Chirelstein did make that statement in his book, the court neglected to note that in the next paragraph Professor Chirelstein qualified his position. He noted that, in light of the congressional repudiation of the court's allowing the taxpayer to use her basis in her life income interest, coupled with the failure of Congress to change the capital gain ruling of that case, the holding in *McAllister* for capital gain treatment "presumably" would be followed if the issue arose today.[198]

The Third Circuit also stated that the Tax Court, in a 2004 memorandum opinion, had written off the *McAllister* decision as irrelevant because it was decided prior to some Supreme Court decisions that applied the substitute for ordinary income approach.[199] The Tax Court in *Clopton* did not dispute the holding in *McAllister* that the sale of a life interest in a trust qualifies for capital gain treatment. What the Tax Court said was that the suggestion in *McAllister* that all property that is not excluded from capital asset status by the statutory definition of that term is a capital asset is incorrect and is in conflict with subsequent Supreme Court decisions.[200]

The sale of the lottery payments was correctly held by the Third Circuit and other courts to produce ordinary income. When the taxpayers' lottery number was chosen, the taxpayers became entitled to the installment payments.[201] Why were the taxpayers not taxed at that time on the present value of the right to receive those installment payments? The apparent answer is that the taxpayers, who presumably reported their income on the cash method of accounting, obtained only an unfunded, nonnegotiable promise of the state to pay those installments, and so under the cash method of accounting, they did not recognize income until the payments were made. While there are exceptions, an unfunded, nonnegotiable promise to make payments generally does not qualify as cash or its equivalent.[202] The installment payments represented a kind of deferred income. As one student commentator put it,

[197] *See Lattera*, 437 F.3d at 409 n.5 (citing MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 17.03, at 373 (9th ed. 2002)).

[198] *See* MARVIN CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 17.03, at 388–89 (10th ed. 2005). I disagree with Professor Chirelstein's conclusion that *McAllister* was wrongly decided, but surely he is correct that the view adopted in that case is good law today.

[199] *See Lattera*, 437 F.3d at 409 n.5 (citing Clopton v. Commissioner, 87 T.C.M. (CCH) 1217, 1219–20, 2004 T.C.M. (RIA) ¶ 2004-095, at 614). *Clopton* effectively involved the sale of future lottery payments.

[200] *Clopton*, 87 T.C.M. (CCH) at 1219-20, 2004 T.C.M. (RIA) ¶ 2004-095 at 614.

[201] In the *Lattera* case, the taxpayer did not have a choice of accepting a lump sum in lieu of the installment payments. Her prize was payable only in annual installments. *See* 437 F.3d at 401.

[202] *See* BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 105.3.2 (2d ed. 1992).

the transaction effectively was kept open until the payments were received.[203] The sale of the right to the taxpayer's remaining installment payments can then be seen as a sale of income that was already earned but was deferred. The right to already earned but deferred income is not a capital asset, and the principle that gain from the sale of "earned income" does not qualify for capital gain treatment should be limited to that situation. The application of the earned income standard that the court chose, especially since it indicated that its application of the standard would require ordinary income treatment in a *McAllister* type transaction, is overly broad and would remove items from capital asset characterization that the court itself acknowledges are and should be capital assets.[204]

Consider the difference between the sale of the right to lottery installment payments and the sale of a life income interest. The holder of a life income interest does not have a right to receive a specified amount of dollars. Instead, the holder has the right to income that is earned from the assets that are held in the trust. The trustee can sell those assets and reinvest the proceeds. So, the income of the holder of the life income interest depends upon the yield of the investments made by the trustee. In contrast, the winner of a lottery is entitled to a specified amount of dollars paid over a period of years. In effect, the winning ticket represents a debt of a specified dollar amount that the state owes to the holder of the ticket, to be paid in installments with interest. The value of the winning ticket is the discounted value of those installments, and the discounted value constitutes the aggregate installment payments of the principal debt, exclusive of the interest payable on those installments. In effect, the taxpayer's income is earned and fixed in amount at the time that the winner is determined, but the taxation of the winnings is deferred. The taxation of the holder's income is deferred because of the operation of the relevant accounting method. The holder should not be allowed to utilize the advantage of that deferral of his income to convert it into a capital gain.

It would have been better for the court to limit its exclusion from capital asset characterization to items that represent income that is already earned but is deferred. A sale of the right to income that will be earned in the future, whether from investments or otherwise, is a very different matter, and the treatment of such sales should be left to an examination of the character of each individual situation.

In any event, even if the reasoning of the Third Circuit was adopted, it would not cause a service provider's sale of a profits interest in a service partnership to fail to qualify for capital gain treatment. In that situation, the income to be subsequently earned requires that services be provided in the future. The Third Circuit itself noted in *Lattera* that a law partner's sale of his

[203] *See* Matthew Levine, Case Comment, *Lottery Winnings as Capital Gains*, 114 YALE L.J. 195, 201 (2004). The Third Circuit cited this student commentary in *Lattera*, but the court failed to adopt that view. *See* 437 F.3d at 402.

[204] *See Lattera*, 437 F.3d at 409 n.5.

interest in a partnership is the sale of a capital asset since future services must be provided.[205] There is no policy objection to the application of section 741 to a service provider's sale of a compensatory partnership profits interest to provide capital gain treatment for all or most of the gain. To the extent that any part of the service provider's gain from the sale of the partnership interest should not qualify for capital gain treatment, section 751 will prevent that from occurring and will impose ordinary income treatment.

2. *The Partnership Interest Relates To a Substantially Certain and Predictable Stream of Income from Partnership Assets*

This situation is one in which the profits interest relates to income from capital. Consequently, this is not a situation where the value of the partnership interest is attributable to the present value of the income that will be produced by the service provider's future labor. As previously stated, if an income interest in capital can be readily valued, there is no reason not to tax the receipt of that interest. The presence of a substantially certain and predictable stream of income means that it will be relatively easy to value the right to the income from the partnership's capital. However, if the service provider's interest can be terminated by the other partners at will, then the valuation of that income interest might be too speculative to warrant taxing it. In that case, even though the safe harbor election will not apply to that partnership interest, it should be valued by using the liquidation method, which will provide a zero value for the interest. If, however, the value of the service provider's interest can be ascertained by using another method such as a valuation of the service provider's past services (if no future services are required of him) or if comparable interests in the partnership have been sold to third parties, then those values should be used instead of the liquidation method.

It is quite plausible that a service provider would be given a partnership interest in the profits from capital that cannot be terminated by the other partners. If so, the receipt of such an interest should be taxed. It would be inappropriate to use the liquidation valuation method in that case.

3. *The Partnership Interest Is in a Publicly Traded Partnership*

One of the exceptions to Revenue Procedure 1993-27's exclusion from income of a compensatory partnership profits interest is where the interest is "a limited partnership interest in a 'publicly traded partnership.'"[206] A similar exception is contained in Notice 2005-43 for the application of the safe harbor provision, except that it does not require that the partnership interest be a limited partnership interest.[207] However, there is not likely to be much significance in that difference since an interest in a publicly traded partnership

[205] *Id.* at 408.
[206] *See* Rev. Rul. 1993-27, 1993-2 C.B. 343.
[207] *See* Notice 2005-43, 2005-1 C.B. 1221.

that is sold on the market is likely to be a limited partnership interest. In any event, I will consider how a compensatory partnership interest in a publicly traded partnership should be taxed.

If the compensatory partnership interest is the same as (or very similar to) interests of that partnership that are being publicly traded, there is no difficulty in valuing that compensatory interest. No significant part of the future income in which the service provider will share will be a product of the future labor of the service provider. It is unlikely that an interest in a publicly traded partnership could be terminated by the other partners since a terminable interest would be difficult to market to the public, but even if the interest were subject to termination (through a buyout provision for example), the market price would reflect the proper discount for that termination provision. There is no obstacle to taxing the service provider on the receipt of such a compensatory partnership interest or to valuing the interest. The compensatory partnership interest should be valued at its market price.

C. *A Partnership Capital Interest*

There is no question about the propriety of taxing a service provider's receipt of a compensatory partnership capital interest. The only issue is how that interest should be valued. The 2005 proposed amendments would allow the use of the liquidation method for valuation if the safe harbor election is made. That treatment will be proper in many cases, but there are circumstances where it will provide an inaccurate measurement of value. Regardless of whether that election is made, the liquidation method should be used unless there are circumstances which would make that method inappropriate. For example, if the service provider's share of the partnership's income is less than his right to a share of the liquidating proceeds, then the liquidation method would be inaccurate. Even then, the administrative ease provided by the liquidation method may justify its use.

IV. The Question of the Partnership's Constructive Sale Of Its Assets

The Tax Court's decision in *McDougal v. Commissioner*,[208] was discussed in Part II.A.[209] Briefly stated, the facts of that case are as follows: M and L formed a partnership in which M contributed a race horse and L contributed services for the care and training of the horse, some of which services had been provided prior to the formation of the partnership. The court treated the transaction as a sale of an interest in the horse from M to L before the partnership was formed, followed by a contribution of the horse to the newly created partnership by both M and L.[210] As a result, M had income for the appreciation of the fraction of the horse that was deemed to have been sold to

[208] 62 T.C. 720 (1974), *acq.* 1975-2 C.B. 1.
[209] *See supra* text accompanying notes 71–78.
[210] 62 T.C. at 725.

L in exchange for the latter's services.[211]

A number of commentators concluded that the same approach as that used in *McDougal* should be applied to an existing partnership's transfer of a compensatory partnership interest to a service provider.[212] Under that approach, the partnership would be treated as having sold a fraction of each of its assets and recognized gain or loss on each constructive sale. The manner in which that treatment would operate is illustrated in an example in Part II.A.[213] I have previously discussed the question of whether there should be a constructive sale of the partnership's assets in a 2006 article that I published in the Florida Tax Review.[214] There also is some discussion of this issue in Part III.A.1 of this Article. The commentary that follows is taken largely from the discussion in my 2006 article.[215]

Much of the material below is a response to an article by Professor Martin J. McMahon Jr.[216] I do not wish to appear to be picking on that article, which is quite well written, but I chose to repeat my responses here because I believe that the conjunction of Professor McMahon's points and my responses brings the relevant issues into clear focus.

As previously noted, the 2005 proposed amendments to the regulations concerning the treatment of compensatory partnership interests expressly provide that a partnership will not recognize a gain or loss on transferring a compensatory partnership interest to a service provider or on the vesting of that interest, even if the transfer or vesting of that interest allows the partnership to take a deduction.[217] If the proposed regulations are finally adopted, it will be clear that the partnership does not recognize a gain or loss. But, the policy for excluding that gain or loss has been criticized by at least one commentator.[218] Moreover, the question is still open as to whether the exclusion adopted by the proposed amendments to the regulations will be applied by the Service prior to the final adoption of those amendments. In my view, the position taken by Treasury in the proposed amendments to the regulations is proper, and that position should be applied even prior to the final adoption of the amendments. Let us consider the merits of Treasury's position.

The Preamble that Treasury wrote for that regulation states:

> Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. . . . However, the Treasury Department and

[211] *Id.* at 726.

[212] *See* sources cited *supra* note 77.

[213] *See supra* Part II.A.6.

[214] *See* Kahn, *supra* note 78, at 430–34.

[215] I have even quoted parts of my previous article, but have not used quotation marks to reflect which of the material below is quoted. Since the quoted material was authored by me, I am not depriving anyone of credit for authorship.

[216] *See* McMahon, *supra* note 77.

[217] *See* Prop. Reg. § 1.721-1(b)(2), 70 Fed. Reg. 29,675 (2005).

[218] *See, e.g.*, McMahon, *supra* note 77, at 1161.

> the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721—to defer recognition of gain or loss when persons join together to conduct a business—than would be a rule requiring the partnership to recognize gain on the transfer of those types of interests.[219]

The Preamble makes clear that Treasury and the Service deem the nonrecognition policy of Subchapter K to be more important than the policy of forcing recognition of unrealized appreciation when appreciated property is used to satisfy an obligation, even though the transferor is allowed to deduct the payment. One might question whether the policy for deferral of gain for partnership distributions is of the same magnitude as the policy for nonrecognition on partnership formation, but there seems little reason to treat the former as being of less consequence.

In a 2005 article, Professor Martin J. McMahon Jr. contends that Treasury and the Service erred in providing in Proposed Regulation section 1.721-1(b) that a partnership does not recognize gain on making a compensatory transfer of a partnership interest even though the partnership is allowed to deduct (or capitalize) the value of the partnership interest.[220] McMahon argues that the combination of allowing nonrecognition for a portion of the appreciation of the partnership's assets and also allowing a deduction for the full value of the partnership interest provides the other partners with a double tax benefit that results in what he refers to as "tax arbitrage."[221] He predicts that aggressive tax planners will exploit that benefit.[222] McMahon proposes that either the partnership should be required to recognize gain for a portion of the appreciation of its assets, or the amount of deduction allowable to the partnership should be limited to a pro rata portion of the partnership's inside basis in its assets.[223] It would seem that the latter proposal could be adopted only by congressional action.

Even if McMahon's contention of tax arbitrage was correct, and I do not think that it is, it would serve to emphasize how strongly the Treasury adheres to the policy of deferring recognition of gain or loss on transactions between a partnership and its partners to the extent that it is reasonable to do so. Even facing the possibility that its nonrecognition policy could lead to

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[219] Preamble, *supra* note 38. Interestingly, the Preamble states that while the proposed regulation's provision for nonrecognition applies to the compensatory transfer of an interest in an existing partnership, it does not apply to the receipt of a partnership interest in a newly formed partnership. In the latter case, the exchange of property for services is deemed to occur between the parties before the partnership comes into existence, and so the nonrecognition principles of Subchapter K do not apply to that situation. So, the *McDougal* case is still good law for newly formed partnerships. *See id.*

[220] *See* McMahon, *supra* note 77, at 1170.

[221] *See id.* at 1168.

[222] *See id.* at 1169.

[223] *See id.* at 1169–70.

abuses, Treasury and the Service chose not to require recognition of gain or loss. They balanced the competing considerations and deemed the policy for nonrecognition the weightier. To discuss all of the points made by McMahon in his article would expand this piece beyond the scope that I intended. So, I will discuss only two of the points that Professor McMahon made.

Before taking up those two points, I wish to note that I am not alone in concluding that Proposed Regulation section 1.721-1(b)(2) appropriately provides that the partnership does not recognize gain. In a published text on partnership taxation, Professors Laura and Noel Cunningham expressly approved of the nonrecognition treatment that was adopted in the proposed regulation. They stated: "Although some may argue that [nonrecognition] is difficult to justify technically, we believe that the rule is justified from an administrative point of view and is consonant with the underlying policies of § 721."[224]

Their view, like mine, is contrary to the position that Professor McMahon adopted. Let us now turn to the two points of Professor McMahon that I wish to discuss.

In his 2005 article, Professor McMahon states: "In light of the legislative history and statutory structure, section 721 simply cannot be read to provide nonrecognition to a partnership that admits a service provider partner with a capital account that is transferred in exchange for services. Under the current statutes, the transaction must be a recognition event."[225] But, the inapplicability of section 721 is beside the point. In its Preamble to its proposed regulation, Treasury did not claim that section 721 applies to the transaction. What Treasury said was that it was adopting a position that conforms to "the policies underlying section 721."[226] Treasury sought to conform to those polices in applying the guaranteed payment provision to a compensatory transfer of a partnership interest. I suggest that the underlying nonrecognition policy of section 721 to which Treasury referred is merely one aspect of a broader policy to defer gain or loss on transactions between a partnership and its partners.

McMahon suggests that it is inappropriate to grant nonrecognition to the partnership (and thereby to the other partners) when the recipient of the partnership interest may be taxed on the transaction.[227] In other words, he considers it wrong to tax one side of a transaction and grant nonrecognition to the other side. However, it is not unusual for the tax law to provide nonrecognition of income to one side of a transaction while imposing tax consequences on the other side. For example, if a solvent, liquidating subsidiary corporation transfers appreciated property to its parent in satisfaction of a debt owed to the parent, the subsidiary will not recognize gain on the transfer

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[224] CUNNINGHAM & CUNNINGHAM, *supra* note 78, at 136.
[225] McMahon, *supra* note 77, at 1167.
[226] *See supra* text accompanying note 219.
[227] *See* McMahon, *supra* note 77, at 1166.

because of section 337(b). The parent, however, will recognize income if its basis in the debt is less than the debt's face amount. Another example occurred in the Supreme Court's 1962 decision in *United States v. Davis.*[228] In that case, pursuant to a marital separation, the taxpayer transferred appreciated stock to his wife in payment for release of her marital rights. The taxpayer was held to recognize income on that exchange.[229] But, despite the fact that a wife will have little or no basis in her marital rights, the Service never sought to tax a wife on her receipt of property in exchange for the release of those rights, and the Supreme Court indicated its approval of that practice in its opinion in the *Davis* case. In footnote seven of the *Davis* decision, the Court stated, "[u]nder the present administrative practice, the release of marital rights in exchange from property or other consideration is not considered a taxable event as to the wife."[230] While the taxation of a spouse on making such marital transfers was eliminated when Congress adopted section 1041 in 1984, the point is that the Service and the Supreme Court were comfortable with taxing only one side of a transaction.

In addition to section 721, the same policy for nonrecognition of income to the partnership can be seen in section 731(b), which prevents a partnership from recognizing income from making a distribution of property to a partner unless section 751 applies to the distribution.[231] As noted in Part III.A.1, the transfer of a compensatory partnership interest would not invoke the policy for requiring income under section 751, since that provision applies to a distribution only when the partner's interest in one type of asset (sometimes referred to as "section 751 assets") is either increased or decreased and the partner's interest in all the other partnership assets is changed in the opposite direction by the same amount. While section 731(b) is not applicable to a transfer of a compensatory partnership interests since it is made for services rendered rather than as a distribution to a partner, the transfer is made to one who becomes a partner as a consequence of the transfer, and the same policies that dictate not taxing the partnership on making a distribution to a partner apply with equal force to the transfer of a compensatory partnership interest.

Another point that McMahon makes relates to what is sometimes called "tax arbitrage." He notes that by granting a full deduction to the partnership and not requiring it to recognize gain, the amount of the other partners' investment (hereinafter sometimes referred to as the "old partners") that had previously been taxed is reduced by the amount of the deduction.[232] That reduction causes an increase in the old partners' subsequent after-tax rate of return on their remaining previously taxed investment. As McMahon uses the

[228] 370 U.S. 65 (1962), *superceded by statute*, Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

[229] *Id.* at 66.

[230] *Id.* at 73 n.7.

[231] *See* I.R.C. § 731(b).

[232] McMahon, *supra* note 77, at 1168.

term, "already taxed investment" refers to a partner's share of the partnership's inside basis in its assets, provided that cash is included in the figure.[233] Since the aim of McMahon's analysis is to measure the difference that the transaction causes in the old partners' rate of return on their investment (as determined for tax purposes), it would seem that reference to the old partners' outside basis in their partnership interest (or perhaps their outside basis reduced by their share of partnership liabilities) would be more relevant than their share of the partnership's inside basis in its assets. McMahon maintains that the resulting increase in the old partners' after-tax rate of return amounts to tax arbitrage and should be prevented.[234] To determine whether the result reached in the proposed regulation is appropriate, let us consider the following examples that are drawn from illustrations that McMahon provided in his article.[235] Since there are no partnership liabilities in these examples, the old partners' outside basis in their partnership interests will reflect their previously taxed investment.

> Example (1). P partnership has two equal partners, A and B. P's assets consist of cash in the amount of $120, and a widget (a capital asset) with a value of $120 and a basis of zero. The aggregate value of P's assets therefore is $240, and P's aggregate basis in its assets is $120. P earns a before-tax return of 10% on its assets, and so P has income of $24 per year. C performs services for P, in exchange for which P transfers to C a 25% capital interest in the partnership. The value of the partnership interest that C received is $60. P is allowed a $60 deduction for transferring the partnership interest to C, all of which is allocated to A and B. The deduction allocated to A and B will reduce their outside basis in their partnership interests. Under the proposed regulations, P does not recognize any gain. As a result of the transaction, A and B will have a 75% interest in P's assets instead of the 100% interest they previously had. P retains all of its assets and continues to earn $24 per year, of which $18 is allocated to A and B.

This author will concede that the rate of A and B's return (*i.e.*, the rate of return on their outside basis in their partnership interests) will be increased as a result of this transaction, even though the partnership continues to produce

[233] *See id.* The regulations under section 743 use the term "previously taxed capital," but it is highly unlikely that Professor McMahon's term "already taxed investment" has the same meaning. Previously taxed capital is part of a formula that is used to determine the adjustments to be made to a partnership's inside basis in its assets when a partnership interest is transferred and an election under section 754 for adjusting partnership inside basis has been made. A transferee partner's share of previously taxed capital refers to the amount of cash that would be distributed to the transferee partner if the partnership were liquidated after selling all of its assets for cash equal to their fair market value, which figure is then reduced by the partner's share of tax gain that would be allocated to him and increased by the amount of tax loss that would be allocated to him. Reg. § 1.743-1(d)(1).

[234] McMahon, *supra* note 77, at 1168.

[235] *See id.*

the same amount of annual income.[236] But, does that constitute an abuse that needs to be prevented? Contrast Example 1 with the following two examples.

> Example (2). The same facts as those stated in Example (1) except that instead of giving C a partnership interest, P pays C $60 cash for his services. P takes a $60 deduction for making that payment, all of which is allocated to A and B and reduces their outside basis. Immediately after that payment, D, an unrelated party, pays $60 cash to P to purchase a 25% partnership interest. P does not recognize income because of the cash payment to C, nor does it recognize income because of D's payment to P. When all the smoke is cleared, P has $120 of cash and has a widget with a value of $120 and a basis of zero. P's annual income will be $24, of which A and B's share is $18. A and B will have the same outside basis in their partnership interests that they had in Example 1, and their share of the partnership's inside basis will be the same as it was in Example (1). The end result is that P (and A and B) are in the identical economic and tax position that they occupied at the close of Example (1) except that D has been substituted for C as the new 25% partner. Since the economic and tax positions of A, B and P are identical in both Examples, and since the tax treatment described for the parties in Example (2) is incontrovertible, there is no reason to regard the treatment accorded to the parties in Example (1) as abusive or even inappropriate.

Before D made his contribution to P in Example (2), the partnership had $60 in cash and the $120 widget, all of which were allocable to A and B. After D joined the partnership, it had $120 in cash and the widget, and A and B's allocable share of those properties was $90 of cash and $90 of the widget. As a result of D's addition to the partnership, the value of A and B's share of the partnership's cash increased by $30, and the value of their share of the widget decreased by $30. In effect, the addition of D resulted in A and B's selling one-fourth of their interest in the widget for $30 of cash. But Subchapter K prevents P (and therefore A and B) from recognizing gain in this circumstance. This policy of providing nonrecognition, even though there was an effective sale of a portion of the widget for a gain, is the policy on which Treasury and the Service relied when they extended nonrecognition

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236 For example, assume that A and B each had an outside basis of $60 in his partnership interest immediately prior to the transfer of the compensatory partnership interest to C. A and B would each have received $12 annual income (½ of the partnership's $24 of income) before C became a partner. So, A and B would each have been receiving a 20% return on their investment (12/60 = 20%). As a consequence of adding C as a partner and obtaining a partnership deduction of $60 for transferring the partnership interest to C, each partner's outside basis will be reduced by $30; and so each partner will have a basis of $30 in his partnership interest. Each partner will receive annual income of $9 (½ of the $18 income allocated to them both) after C becomes a partner. So the rate of return on their remaining investment of $30 is 30% (9/30 = 30%). So the rate of return on the old partners' investment is increased by 10 percentage points as a consequence of the partnership's transferring the partnership interest to C and obtaining a deduction for that transfer without incurring any gain.

to the facts of Example (1).[237] The consequence of allowing P a deduction for its cash payment to C and not requiring P to recognize income on the admission of D to the partnership provides A and B with the same after-tax rate of return on their previously taxed investment (or on their outside basis in their partnership interests) that they achieved in Example (1).

> Example (3). The same facts as those stated in Example (2) except that after receiving his payment of $60 cash for his services, C pays $60 to P to purchase a 25% partnership interest. If the formal facts are respected, P will have a $60 deduction, and P will not recognize gain on receiving C's $60 contribution. Yet, the economic circumstances of Example (3) are identical to those of Example (1). There is no reason that the tax treatment of the parties should differ.

Of course, the step transaction doctrine could be applied to the facts of Example (3) to ignore the payment of cash to C and the repayment from C to P. If so, the transaction in Example (3) would be recharacterized to describe it as a payment of a 25% partnership interest in P to C for his services. But, why should the step transaction be applied here? The formal facts of Example (3) track the substance of the transaction. If an employer transfers property in kind to an employee as compensation for services, the transaction is treated for tax purposes as if the employer had paid the employee cash equal to the value of the distributed property, followed by the employee's purchase of that property from the employer with the cash that the employee constructively received.[238] True, the taxation of the transaction as if those events had occurred does not necessarily mean that they should be regarded as actually having occurred. But, the reconstruction of the transaction to a cash-out and cash-in structure is helpful to see the true nature of the transaction. Similarly, in the case of a compensatory payment of a partnership interest, the cash-out, cash-in scenario is helpful to grasp the nature of the transaction. When Example (3) is compared to the facts of Example (2), it becomes difficult to see a reason to punish the partnership in Example (3) just because C is the investor instead of D. The economic positions of A and B in Example (3) are identical to their positions in Example (2), and it is A and B who would bear any tax imposed on P for the recognition of gain if the position adopted in the proposed regulation were rejected.

V. Conclusions

The answer to the question of whether, as a matter of policy, the receipt of a compensatory partnership profits interest should be taxable depends upon the type of partnership to which the interest relates and the type of profits interest that the service provider received.

If the interest is in a service partnership in which capital is not a significant

[237] *See supra* text accompanying note 221.
[238] Reg. § 1.83-6(b).

factor in the earning of the partnership's income, the receipt of a partnership interest should not be taxable to the service provider. The interest should simply be excluded from income, and so no valuation issue would arise. If the interest is deemed to be taxable (for example, if the 2005 proposed regulations are finally adopted), then the liquidation method of valuation should be employed regardless of whether the safe harbor election is made. In either event—the exclusion from income or the use of the liquidation method for valuation—the service partner will not incur any tax liability.

If income from the partnership's capital is a significant element of the income to which the service provider is entitled to share, and if the value of the right to that income can be measured with reasonable accuracy, then the value of the receipt of the right to that income should be taxed to the service provider. It would be inappropriate to use the liquidation method of valuation in that case, and the proposed regulations are overly generous in allowing that method to be used. However, if the other partners have the right to terminate the service provider's partnership interest, and if other circumstances do not provide a means of determining the value of that interest, the liquidation method of valuation should be used then, even if the safe harbor election was not made. The partnership interest either should be excluded from the service provider's income, as is provided in the currently applicable revenue procedure, or the liquidation method of valuation should be applied, which would give a zero value to the partnership interest. However, if other methods of valuation are available, then the compensatory partnership profits interest should be taxed. For example, if the value of the services for which the partnership interest was received can be valued, then the value of the partnership interest can be assumed to be equal to the value of those services. If similar partnership interests to the one acquired by the service provider are sold to third parties, the selling price of those interests can be used to value the compensatory partnership profits interest.

The three exceptions that the Revenue Procedure (and the proposed Revenue Procedure for the 2005 proposed amendments) applies to the exclusion of a compensatory profits interest from income (and the exclusion of such an interest from utilizing the safe harbor valuation election) are consistent with tax policy. The receipt of a compensatory partnership profits interest should be taxed in those situations, and with one exception, the liquidation method of valuation should not be used. The one caveat to that observation is that when the income right relates to a stream of income that is substantially certain and predictable, the liquidation method of valuation should be used if the other partners have the right to terminate the service partner's partnership interest and if other methods of valuation are not available.

The receipt of a compensatory partnership capital interest should be taxed to the service provider, and the current law does so. The liquidation method of valuation is reasonable in most cases and has the advantage of administrative simplicity in its application. In some circumstances, the liquidation method will not provide an accurate measurement of value. For example, if the service provider's right to a portion of partnership income is less than his right to a share of liquidation proceeds, the liquidation method will not accurately represent the value of the service provider's interest. Even in that situation, the administrative simplicity provided by the liquidation method may warrant its use.

Finally, the 2005 proposed amendments to the regulations provide that a partnership does not recognize gain or loss on transferring a compensatory partnership capital interest to a service provider even though the partnership may obtain a deduction for making that transfer. This author concurs with the position taken in those proposed regulations and considers them to be consistent with tax policy.