Taxing Service Partners to Achieve Horizontal Equity

Henry Ordower
TAXING SERVICE PARTNERS TO ACHIEVE HORIZONTAL EQUITY*

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I. INTRODUCTION

Since the decision in *Diamond v. Commissioner*,¹ the extensive literature addressing the taxability of partners who receive partnership interests in exchange for services has focused on instances involving the receipt of interests in partnership profits.² Since commentators agree that current taxation is appropriate and generally concur that the correct measure of value is liquidation value,³ the commentators have largely ignored these seemingly less interesting issues flowing from the tax consequences to the partner who acquires an interest in partnership capital in exchange for services.⁴

This Article will demonstrate that the issues concerning the tax treatment of capital and profits interests received for services are fundamentally identical. Resolution of the valuation issue with respect to a capital interest will help to determine the correct tax treatment of a profits interest as well. The ability or inability of a taxpayer to escape current taxation on the value of a profits interest received for services depends upon the manner in which the court evaluates the property (the partnership interest) received rather than upon other factors. To illustrate, in their recent decisions in *Campbell v. Commissioner*,⁵ both the Tax Court and the Eighth Circuit reject the taxpayer’s arguments against current taxability, while reaching disparate conclusions with respect to valuation. Unfortunately, the issue of valuation of a profits interest is rarely as simple for the

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¹36 T.C. 530 (1971), rev’d, 492 F.2d 286 (7th Cir. 1971). *Diamond* involved a taxpayer who received an interest in partnership profits in exchange for his services to the partnership and almost immediately sold that interest to a third party reporting the gain over his zero basis as short-term capital gain. The government successfully argued that the interest was compensation for services, ordinary income, equal to the amount for which the interest sold.


³See infra text accompanying note 15.

⁴A leading partnership taxation treatise addresses both capital and profits interests, but emphasizes the profits interest. 1 WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (2d ed. 1990) ch. 5. Another leading treatise devotes more equal time to the capital interest issue. 1 ARTHUR B. WELLS ET AL., *PARTNERSHIP TAXATION* ch. 45 (4th ed. 1991). The tax treatment of the receipt of a capital interest for services remains uncertain, particularly with regard to the issue of valuation of the interest.

⁵39 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162 (1990), aff’d in part, rev’d in part, 943 F.2d 815 (8th Cir. 1991).
courts as it was in *Diamond*. Since Diamond resold the interest immediately, resale value was easy to ascertain—it was the amount he received for his profits interest. Accordingly, the Tax Court held and the Seventh Circuit affirmed that the value of the interest was its resale value. That amount was in turn income from services. Lacking an immediate resale upon which to base its valuation of the interest in profits, the Eighth Circuit, in *Campbell*, held that the profits interests Campbell received had no fair market value when received and, thus, were not includable in his income. While the court did not choose liquidation value expressly, the result and rationale the court applied are the same as would have obtained had the court applied constructive liquidation value, determined at the moment of receipt of the interest. If the partnership liquidated following receipt of the interest, Campbell would receive nothing since the partnership had no profits as yet. Moreover, the partnership might never have profits, so it would be unfair to tax Campbell on the present worth of projected profits. The valuation issue thus is no different from that involved when the partner receives a capital interest, rather than a profits interest, for services. Extrapolating to the *Campbell* holding's ultimate effect, Campbell will be subject to tax on his share of partnership profits only as they arise. Those profits will have the same character in his hands as in the hands of the partnership. If Campbell sells his partnership interest, the gain, subject to the special rules for substantially appreciated inventory and unrealized receivables, would be capital, while his receipt of service income would have been ordinary. *Diamond* involved precisely that issue:

> 8492 F.2d at 291.
> 7The Tax Court in *Campbell* would include currently in the taxpayer's income the present value of the benefits that the taxpayer would receive if the financial projections accompanying the offering materials, pursuant to which interests in the partnerships were syndicated, were realized. 943 F.2d at 822.
> 6The *Campbell* court held that a service partner was currently taxable under section 83 of the 1954 Code on the fair market value of partnership profits interests received for services. This decision sparked renewed interest in the issue of current taxability of the service partner who receives an interest in partnership profits only. See, e.g., Robert C. Ricketts, Section 83 and Service Partners, 21 TAX ADVISER 99 (1990); Terence F. Curtin, New Decision Threatens Tax-Free Formation of Moe Partnerships, 73 J. TAX'N 46 (1990); Alan Gunn, Partnership Interest for Services: Partnership Gain and Loss?, 47 TAX NOTES 699 (May 7, 1990); Mark P. Gergen, Why a Partnership Should Recognize Gain on an Exchange of a Partnership Interest for Services, 47 TAX NOTES 1487 (June 18, 1990); Benedicta Stampe, Note, Revisiting the Controversy over the Taxation of the Receipt of a Partnership Profits Interest for Services: Campbell v. Commissioner, 23 CONN. L. REV. 413 (1991).
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> 8See infra text accompanying note 15. The result, not the rationale, of the decision is also consistent with open transaction reporting. See infra text accompanying notes 88-121.
> 9Campbell, 943 F.2d at 823.
> 10I.R.C. § 702(b).
> 11I.R.C. § 751.
> 12Under section 741, gain or loss from the sale or exchange of a partnership interest is capital. Section 741 is limited by section 751, the collapsible partnership rule. Section 751 classifies gain as gain from the sale or exchange of property other than a capital asset the gain resulting from the required allocation of a portion of the consideration received by the selling partner to the partner's share of the partnership's unrealized receivables, defined in section 751(d), and substantially appreciated inventory items, as defined in section 751(d).

Diamond wished to have short term capital gain rather than that he could absorb his capital losses. This Article addresses principally the problem of valuing services received for services, and demonstrates that the value of that interest, its liquidation value, is economically unacceptable. Value to value a capital interest violates notions of homogeneity, causes similarly situated taxpayers to be taxed dissimilarly. An analysis in valuing profits interest reveals that assigning profits interest issued by the partnership in return for services and that fear of double taxation of the service partner's share of the interest is not ascertainable, the transaction should be called double taxation should continue until the true valuation becomes ascertainable.

II. VALUING AN INTEREST IN PARTNERSHIP

A. Valuation Methods: The Anomaly of Liquidation Value

Most commentators select liquidation value as the asset should be taxed when they receive interests in capital. Liquidation value is the amount the service partner would be liquidated immediately after the service partner's admittance. Zero valuation, of course, is rarely possible when the service partner is not an interest in capital, as opposed to profits, but in and of itself is anomalous. It disregards the economic reality of the transaction. It would not admit a service partner if it contemplated immediate liquidation, it could convert the service partner's contribution of property.

The anomaly of liquidation value manifests itself clearly in the following example:

\[ A, B, \text{ and } C \text{ contribute } $100 \text{ for equal interests in a new partnership after formation, but before anything occurs that might cause a transfer of interest} \]

\[ \text{491 F.2d at 287.} \]

\[ \text{Double taxation generally would continue under section 83. See infra text accompanying notes 88-121.} \]

\[ \text{8See, e.g., 1 WELLS ET AL., supra note 4, § 45.01; CURTIS J. BERG, CASES AND MATERIALS ON PARTNERSHIP TAXATION 175 (1989). I N. 5.02(2), 5.06(1), implicitly endorses but questions the propriety of} \]

\[ \text{5071-1(b)(1) supports this conclusion in that it views the partnership in a partnership for services as the relinquishment by one or more of their respective capital interests.} \]

\[ \text{Similarly, in the case of Mark IV Pictures, Inc. v. Commissioner, T.C.M. (P-H) \# 90,571 (1990), aff'd, 969 F.2d 669 (8th Cir. 1992), the} \]

\[ \text{value in determining the value of a capital interest received for services is on valuation without questioning the propriety of liquidation value.} \]

\[ \text{Notwithstanding the fact that the capital interests of the other partners of the partnership actually increase as a result of the transaction, the other partners in fact do not relinquish part of their right to return of capital in a partnership and following note 29.} \]

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Since Diamond resolved the interest immediately, to ascertain—it was the amount he received for his profits in the Tax Court held and the Seventh Circuit affirmed the case, no resale value. That amount was in turn income by an immediate resale upon which to base its valuation of its, the Eighth Circuit, in Campbell, held that the profits received had no fair market value when received and, thus, in his income. While the court did not allow liquidation of the court applied the same rule to the court applied constructive liquidation value, determined the interest. If the partnership liquidated following Campbell would receive nothing since the partnership had cover, the partnership might never have profits, so it would sell on the present worth of projected profits. The valuation is from that involved when the partner receives a capital interest, for services. Extrapolating to the Campbell test, Campbell will be subject to tax on his share of profits they arise. Those profits will have the same character in all of the partnership. If Campbell sells his partnership interest to the special rules for substantially appreciated inducements, would be capital, while his receipt of these are known. Diamond involved precisely that issue.

A tax partner in Campbell is currently taxable under section 83 of the 1954 value of partnership profit interests received for services. This decision did not address the issue of current liability of the service partner who receives an interest in the partnership. See, e.g., Robert C. Ricketts, Section 83 and Service Partners, Terence F. Cuff, New Decision Threatens Tax-Free Formation of Most Partnerships 599 (May 7, 1990), Mark P. Gergen, A Partnership Should Be an Interest in a Partnership Interest in Services, 47 Tax Notes 1487 (June 1995, Note, Revisiting the Controversy over the Taxation of the Receipt of Interest for Services: Campbell v. Commissioner, 23 Conn. L. Rev. 413 (1991)).

The same section numbering as the 1954 Code, the Tax Reform Act of 1976, recodified the Code in 1986, by note 15. The result, but not the rationale, of the decision is also reported infra text accompanying notes 88-121.

A gain or loss from the sale or exchange of a partnership interest is capital gain. See section 751, the capital gain. Section 751 classifies as gain property other than a capital asset the gain resulting from the required consideration received by the selling partner to the partner's share of receivables, defined in section 751(c), and substantially appreciated in section 751(d).

Diamond wished to have short-term capital gain rather than ordinary income so that he could absorb his capital losses. This Article addresses principally the problem of valuing a capital interest received for services, and demonstrates that the value traditionally selected for that interest, its liquidation value, is economically unsound. Use of liquidation value to value a capital interest violates notions of horizontal equity because it causes similarly situated taxpayers to be taxed dissimilarly. A horizontal equity analysis in valuing a profits interest reveals that assigning a zero value to a profits interest issued by the partnership in return for services is never justified, and that fear of double taxation of the service partner is baseless. If the value of the interest is not ascertainable, the transaction should remain open and so-called double taxation should continue until the true value of the interests becomes ascertainable.

II. VALUING AN INTEREST IN PARTNERSHIP CAPITAL

A. Valuation Methods: The Anomaly of Liquidation Value

Most commentators select liquidation value as the amount on which partners should be taxed when they receive interests in capital for their services. Liquidation value is the amount the service partner would receive if the partnership liquidated immediately after the service partner's admission to the partnership. Zero valuation, of course, is rarely possible when the service partner receives an interest in the capital, as opposed to profits, but in and of itself liquidation value is anomalous. It disregards the economic reality of the transaction: the partnership would not admit a service partner if it contemplated immediate liquidation, unless it could convert the service partner's contribution of services into money or property.

The anomaly of liquidation value manifests itself clearly when one considers the following example:

A. B, and C contribute $100 for equal interests in a new partnership. Immediately after formation, but before anything occurs that might alter the value of the partnership, the partners are notified that the partnership is liquidating. The partners are then required to choose between accepting a distribution of capital property, if any, or receiving the dictation of liquidation value that they are receiving their interest.

1291 F.2d at 287.

12Double taxation generally would continue under section 83. See also discussion of open transaction reporting infra text accompanying notes 88-121.

13See, e.g., 1 WILLIS ET AL., supra note 4, § 45.01; CURTIS J. BERGER AND PETER J. WIREDENBECK, CASES AND MATERIALS ON PARTNERSHIP TAXATION 175 (1989). 1 McKee ET AL., supra note 4, § 5.02[1], § 5.06[1], implicitly endorses but questions the propriety of using liquidation value. Regulations section 1.721-1(b)(1) supports this conclusion in that it views the transfer of a capital interest as a reassignment of services or as the relinquishment by one or more of the other partners of a portion of their respective capital interests.

Similarly, in the case of Mark IV Pictures, Inc. v. Commissioner, 60 T.C.M. (CCH) 1171, T.C.M. (P-H) 99,571 (1990), aff'd 969 F.2d 669 (8th Cir. 1992), the Tax Court utilized liquidation value in determining the value of a capital interest received for services. The Eighth Circuit affirmed the valuation without questioning the propriety of liquidation value.

Notwithstanding the fact that the capital interests of the other partners are diluted, however, the assets of the partnership actually increase as a result of admission of the service partner. Thus, the other partners in fact do not relinquish part of their right to return of capital. See infra text accompanying and following note 29.
partnership’s assets, D asks to join the partnership as an equal partner. How much should D pay for her interest?

The question seems ludicrous. A, B, and C would not agree to D’s admission to the partnership as an equal partner unless D also were willing to pay $100 for her interest. Similarly, if the partnership admits D after the assets of the partnership have appreciated from their original cost basis of $300 to $600, and assuming the partnership has no other assets such as going concern value, A, B, and C would expect D to pay $200 for an equal interest in the partnership.\(^8\)

The partnership employs a simple algebraic formula to determine the price D should pay:

\[
\frac{D \times \text{FMV}}{1 - D's \%} \times \text{D's } \%
\]

where:
- \(P\) is the price D should pay,
- \(D's \%\) is D's ownership interest in the partnership represented as a decimal fraction, and
- \(\text{FMV}\) is the value of the partnership’s assets immediately before D’s admission.\(^17\)

In fact, if the partnership admits D as an equal partner for $75, one assumes that something unstated occurs. Among the possibilities are that D may be performing services, contributing property other than money or receiving a gift from the other partners through the partnership. That A, B, and C consent to admitting D for a smaller capital contribution is irrelevant to the taxation issue emanating from the arrangement. When D contributes services in addition to capital, D should be taxed on her receipt of property for services. Otherwise D enjoys a benefit vis-à-vis the world of capital-contributing partners whose services produced the capital they contribute, whether property or cash, to all other partnerships.\(^18\) If on the other hand A, B, and C are making a gift to D, the gift should be subject to gift tax.\(^19\)

\(^8\) D would wish the partnership to revalue its property under Regulations section 1.704-1(b)(2)(iv)(b) and adjust the partners’ capital accounts accordingly so that D will not be taxed on pre-admission appreciation in the value of the partnership’s properties.

\(^17\) The price D should be such that the price is equal to the amount necessary to increase the value of the partnership’s assets so D’s share of the assets immediately after admission would equal the amount D pays. The formula derives as follows:

\[
P = \frac{(\text{FMV} + P) \times D's \%}{1 - D's \%} = \frac{D's \% \times \text{FMV}}{1 - D's \%} = \frac{D's \% \times \text{FMV}}{1 - D's \%}
\]

\(^18\) United States v. Frazell, 335 F.2d 487, 489 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965); holds that a capital contribution may consist of both property and services. The service portion is taxable as ordinary income if the value of the property contributed is less than the value of the interest the partner receives. See also Mark IV Pictures, 60 T.C.M. (CCH) 1171, T.C.M. (P-H) 90,571.


Despite the appeal of the foregoing pricing model, if D as an equal partner solely in return for D’s services the commentators agree that D has $75 rather than $100 in this conclusion by examining the assets of the partnership. D’s admission to the partnership, the partnership has $300 interest in the partnership, its value is $75, because in all of the partnership, D would receive only $75. Thus, $75 of D realizes.

At first glance, the logic of this conclusion is almost obvious, however, is odd. Would it not have been more reasonable to refuse D admission as a service partner? If D’s services would have been more advantageous for the partnerships cash and require her to contribute $100 for an equal interest? The partnership would enhance its cash position by $25, with $300, paid D $75, and D would contribute $100, in the partnership.

It is no doubt difficult to determine the value of D’s services to charge as much or as little as she wishes so long as her services is willing to pay. Efforts to base the value of D’s market price for comparable services may fail for want of market price.\(^21\) But there may be no need to search for one. If it is difficult to determine the value of one side of a contract, are dealing at arm’s length in an exchange of property, the fair-market values of the exchanged properties are the equivalency rule applies as well when property is exchanged.

If one can value the property D receives, one knows how D realizes. That D receives property for services is clear, the nature of the property D acquires is less than clear. S

\(^20\) See supra note 15.

\(^21\) In United States v. Davis, 370 U.S. 65 (1962), the Supreme Court used the equitable rule revaluing by one spouse in a divorce settlement which have been relinquished for the rights of the property received. Because the length of the property, the two sides of the transaction are assumed to be relinquishing appreciated property in exchange for the marital estate as between the property and the value of the property equal to value of the property and the property received. Alternatively, recoveries for marital property rights by analogy to damage recoveries for personal injuries under section 12 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421(a), settlements, but did not alter the principle of equivalency.

\(^22\) Hensel Phelps, 74 T.C. at 954; Regs. §§ 1.61-2(d), 1.83-1(b)(1).\(^6\)

\(^23\) In the case of a profits interest, commentators argue, but none seem to be receiving property at all but rather the partnership’s unfunded compensation in the future. See, e.g., Cowan, supra note 2, at 164-165. The court in Campbell rejected such arguments. 543 F.2d 198.
D asks to join the partnership as an equal partner. How for her interest?

judicious. A, B, and C would not agree to D’s admission an equal partner unless D also were willing to pay $100 slary, if the partnership admits D after the assets of the escrated from their original cost basis of $300 to $600, and hip has no other assets such as going concern value, A, $D to pay $200 for an equal interest in the partnership. Does a simple algebraic formula to determine the price D

\[
P = \frac{D's \% \times FMV}{1 - D's \%}
\]

ould pay, the partnership interest as a decimal al property in the partnership’s assets immediately before D’s admission.17

hip admits D as an equal partner for $75, one assumed occurs. Among the possibilities are that D may be contributing property other than money or receiving a gift ers through the partnership. That A, B, and C consent to al capital contribution is irrelevant to the taxation issue arrangement. When D contributes services in addition to xed on her receipt of property for services. Otherwise D vis the world of capital-contributing partners whose scrip they contribute, whether property or cash, to all other the other hand A, B, and C are making a gift to D, the gift gift tax.19

Partnership to revalue its property under Regulations section 1.704-1(b)(2)(i)tal accounts accordingly so that D will not be taxed on pre-admission of the partnership’s properties.

be such that the price is equal to the amount necessary to increase the assets so D’s share of the assets immediately after admission would equal formula derives as follows:

\[
P = (FMV + P) \times D's \%
\]

\[
P = (D's \% \times FMV)
\]

\[
(1 - D's \%)
\]

\[
P = D's \% \times FMV
\]

\[
(1 - D's \%)
\]

335 F.2d 487, 489 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965), ration may consist of both property and services. The service portion is if the value of the property contributed is less than the value of the services. See also Mark IV Pictures, 60 T.C.M. (CCH) 1171, T.C.M. (P-H) Possibly a generation-skipping transfer tax would be applicable as well

Despite the appeal of the foregoing pricing model, if the partnership admits D as an equal partner solely in return for D’s services to the partnership, most commentators agree that D has $75 rather than $100 in income.20 They reach this conclusion by examining the assets of the partnership. Both before and after D’s admission to the partnership, the partnership has $300. Since D owns a 25% interest in the partnership, its value is $75, because in an immediate liquidation of the partnership, D would receive only $75. Thus, $75 is the amount of income D realizes.

At first glance, the logic of this conclusion is almost compelling. The result, however, is odd. Would it not have been more reasonable for A, B, and C to refuse D admission as a service partner? If D’s services were worth only $75, it would have been more advantageous for the partnership to pay D the $75 in cash and require her to contribute $100 for an equal interest with A, B, and C. The partnership would enhance its cash position by $25. It would have started with $300, paid D $75, and D would contribute $100, leaving a total of $325 in the partnership.

It is no doubt difficult to determine the value of D’s services since D is free to charge as much, or as little as she wishes so long as the consumer of the services is willing to pay. Efforts to base the value of D’s services on the free-market price for comparable services may fail for want of a comparable free-market price.21 But there may be no need to search for a value for D’s services. If it is difficult to determine the value of one side of a transaction and parties are dealing at arm’s length in an exchange of property, the tax law assumes that the fair-market values of the exchanged properties are equal.22 This exchange equivalency rule applies as well when property is exchanged for services.23

If one can value the property D receives, one knows the amount of income D realizes. That D receives property for services is clear.24 Unfortunately, the nature of the property D acquires is less than clear. Some commentators hold

30See supra note 15.

31Cf. Engel Phelps Construction Co. v. Commissioner, 74 T.C. 939, 954 (1980), aff’d., 703 F.2d 485, 488 (10th Cir. 1983) (Tax Court valued an interest in capital on the basis of the fair market value of the services provided).

32In United States v. Davis, 370 U.S. 65 (1962), the Supreme Court held that marital property rights relinquished by one spouse in a divorce settlement which have no readily ascertainable value are equal in value to the property received for those rights. Because the spouses are dealing at arm’s length in the divorce, the two sides of the transaction are assumed to be equal in value. Thus, the spouse relinquishing appreciated property in exchange for the marital rights receives consideration on the exchange of the property equal in value to the property and recognizes gain accordingly. Why the spouse relinquishing marital property rights does not recognize gain or loss is unclear. Perhaps the adjusted basis of one’s marital property rights floats and is always equal to the consideration received. Alternatively, recoveries for marital property rights may be excluded from income by analogy to damage recoveries for personal injuries under section 104. Section 104, added by the Deficit Reduction Act of 1984, Pub. L. No. 98-360, § 421(b), changed the result for divorce settlements, but did not alter the principle of equivalency.

33Engel Phelps, 74 T.C. at 954; Regs. §§ 1.61-2(d), 1.83-1(a)(1).

34In the case of a profits interest, commentators argue, but none seem persuaded, that D may not be receiving property at all rather the partnership’s unfunded and unsecured promise to pay compensation in the future. See, e.g., Cowan, supra note 2, at 169-70; Stamps, supra note 7, at 420-21. The court in Campbell rejected such arguments. 943 F.2d at 818.
the view that the transaction is equivalent to the partnership’s distributing to D a proportional share of each of its underlying properties followed by D’s contributing the properties back to the partnership. In D’s case, this approach seemingly results in D realizing income of $75 since D receives constructively 25% of the partnership’s $300 of assets. But such an approach assumes the partnership has no additional assets, tangible or intangible, as a result of D’s services; D’s services have added nothing of value to the partnership. Such an assumption is untenable. If A, B, and C are not fools willing to give something away for nothing, D’s services must bring something of equal value to the partnership. The partnership must have assets with enhanced value or additional assets, even if the additional asset is only the right to demand specific future services from D.

Alternatively, the entity nature of a partnership suggests that the partnership interest is property separate from the partnership’s underlying assets, so it is such property that requires evaluation. In the abstract, the value of an interest in any newly created business venture is difficult to ascertain. In this case, however, the task is elementary. The evaluator need look only to comparable sales of equivalent interests. If three such sales, to A, B, and C respectively, occurred within the immediate time frame, and each sale was for a price of $100, then the value of D’s interest also must be $100.

A professional appraisal frequently discloses several valuations derived from the use of differing, but related, methodologies. When comparables are available, the comparable sales approach suggested in the preceding paragraph is one of the methods that appraisers customarily employ. Other methods include capitalization of income and market value. Both these latter approaches take account of the intangible income-producing assets of the business. Among those intangible assets are the value of the business name, going-concern value, and goodwill and reputation.

Going-concern value may include all the intangible features of a business in operation, including such matters as the expense of asse acquiring the business operating assets, creating the bus partnership organization expenses, and raising capital for borrowing or syndication of interests in the entity. In or concern value of a business, appraisers may employ the concept of value approach, and, as such, capitalization constitutes a common value approach rather than a separate method. If, after a capitalization factor to the business’ income history, the value exceeds the value of its underlying tangible assets, the intangible assets such as going concern value generate.

Liquidation value disregards the intangible income-проду нesses. In the case of a valuation of a failing business, there may show liquidation value as an alternative because it is necessary to sell the business’ component parts. Liquidation value of possible resale value a business will yield and thus that the business is, or its owners intend it to become, a going con....

B. Identifying the Service Partner’s Contribution and To

While it may be futile to search for going-concern value in a partnership because the partnership has no income-earner to ground the search, if the partnership admits D with capital contribution, one may extrapolate from that fact the created additional, albeit possibly hidden, assets for the may prove fruitful to examine the nature of the services and how they affect the partnership’s assets and business. It exists for the characterization of D’s services, but when the concepts, either they must constitute services performed of producing business income or in the production of items which are deductible, or they are capital expenditures, or expenditures that are capitalized to the partnership’s investment.

If D is performing the services on behalf of the partner that will pay for the services, the benefit to the partner is measurable, and probably worth not less than $100. But who will pay for the partnership’s services performed by D? It is greater than zero. After performance of the services, the partner’s value in the partnership is greater than $300 in assets. It will have either the cash itself or will have an account receivable. Under even a liquidation value of the interest D receives for services is greater than...

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24E.g., 1 WILLIS ET AL., supra note 4, ¶ 45.08; 1 MCKEE ET AL., supra note 4, ¶ 5.08[2][b]; Hortonstine & Ford, supra note 2, at 880-881 Commentators support this result with Regulation section 1.721-1(b)(1) by equating the transfer of ownership of the underlying interest in partnership capital with a transfer of a share in each underlying partnership asset from the other partners to the service partner. See discussion of the collateral consequences to the partnership infra text accompanying and following note 58.

25United States v. Baye, 410 U.S. 441, 448 (1973), holds that a partnership is an entity separate from its partners. Accordingly, when an employer of a partnership made payments to an employee trust for the benefit of partner and nonpartner employees of the partnership, the partnership, rather than the ultimate beneficiaries of the trust assets, was taxable on the amount of the payments to the trust under a constructive receipt doctrine. And section 707, a section of Subchapter K, characterizes a partnership as a separate entity in addressing the situation when the partner dealt with the partnership as a third party.

26State law supports this analysis. Section 25(1) of the Uniform Partnership Act (UPA) provides that a partner is a co-owner of partnership property as a tenant in partnership. UNIF. PARTNERSHIP ACT § 25(1) (1914). A partner has no right to possess partnership property except for partnership purposes. UPA § 25(2)(a). Creditors of the partner can reach the partner’s interest but not its underlying partnership assets. UPA § 26. Regardless of the underlying partnership properties, its partner’s interest is personal property. UPA § 26.

27Selection of an appropriate capitalization factor in itself is not obvious. It may become somewhat circular or may overlap other methods. The derives from the yields of comparable businesses.

28Under this analysis, A, B, and C do not relinquish any part of their capital contributions. Regulations section 1.721-1(b)(1) accordingly is.

29I.R.C. § 162 or § 212.

30I.R.C. § 263 or § 263A.
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operation, including such matters as the expense of assembling the work force, acquiring the business operating assets, creating the business form—corporate or partnership organization expenses, and raising capital for the business—initial borrowing or syndication of interests in the entity. In order to deter the going concern value of a business, appraisers may employ the capitalization of income approach, and, as such, capitalization constitutes a component of the market value approach rather than a separate method. If, after applying the appropriate capitalization factor to the business' income history, the value of the business exceeds the value of its underlying tangible assets, the business must have intangible assets such as going concern value generating that excess income. Liquidation value disregards the intangible income-producing assets of the business. In the case of a valuation of a failing business, for example, an appraiser may show liquidation value as an alternative because it may become necessary to sell the business' component parts. Liquidation value tends to be the lowest possible resale value a business will yield and thus has little validity when the business is, or its owners intend it to become, a going concern.

B. Identifying the Service Partner's Contribution and Taxing Its Value

While it may be futile to search for going-concern value in a newly formed partnership because the partnership has no income-earning history upon which to ground the search; if the partnership admits D without a cash or property capital contribution, one may extrapolate from the fact that D's services have created additional, albeit possibly hidden, assets for the partnership. Thus, it may prove fruitful to examine the nature of the services D performs to discover how they affect the partnership's assets and business. Numerous possibilities exist for the characterization of D's services, but when reduced to taxation concepts, either they must constitute services performed in the ordinary course of producing business income or in the production of investment type income, which are deductible, or they are capital expenditures, including in that category expenditures that are capitalized to the partnership's inventory.

If D is performing the services on behalf of the partnership for a third party that will pay for the services, the benefit to the partnership is immediate and measurable, and probably worth not less than $100. But whatever the third party will pay for the partnership's services performed by D, the amount must be greater than zero. After performance of the services, the partnership will have more than $300 in assets. It will have either the cash the third party pays or it will have an account receivable. Under even a liquidation value approach, the value of the interest D receives for services is greater than the $75 first assumed.

36Selection of an appropriate capitalization factor in itself is not obvious. The appraisal process may become somewhat circular or may overlap other methods. The capitalization factor usually derives from the yields of comparable businesses.

29Under this analysis, A, B, and C do not relinquish any part of their rights to be repaid their capital contributions. Regulations section 1.721-1(b)(1) accordingly is inapplicable.

31I.R.C. § 212.

32I.R.C. § 263 or § 263A.
If, for example, the partnership's assets are enhanced by a $75 account receivable, D's entry into the partnership increased the value of the partnership's assets to $375. D's 25% interest in those assets is $93.75. On the most fundamental level, then, $75 cannot be the correct amount on which to tax D.

From a revenue perspective, it may not matter that D includes only $75 rather than $93.75 in income in this case, provided that the partnership allocates its deduction of $75, separately from its income of $75, to A, B, and C only. The partnership allocates 25% of the $75 income it realizes from the third party, i.e., $18.75, to each of A, B, C, and D as it allocates $25 of its $75 deduction to each of A, B, and C only. As a result, D has income from receipt of the partnership interest of $75 plus a share of the partnership's income of $18.75 for a total of the $93.75 identified as the value of D's interest in the preceding paragraph. By the same token, A, B, and C realize a net loss of $6.25 ($18.75 share of income less $25 deduction) leaving each with a net capital of $93.75 and each in an equal capital position to D. Yet, it remains difficult to comprehend why A, B, and C would relinquish part of their capital positions in favor of D when D brings less (the $75 payment from the third party) to the table than each of them.

Assume, as seems more likely, that the third-party payment to the partnership is at least $100. That $100 becomes part of the total partnership capital, and the partnership now has $400 in capital. As a result, D generates as much asset increase to the partnership as does each of A, B, and C. If D's interest is valued at $75, the net income to the partnership is $25 (the $100 received less the cost of D's services). Should all four partners share in the net income equally? Or should the partnership allocate the income from the third party separately from the deduction for D's services, so that all four partners share income, but A, B, and C only receive parts of the deduction?

Looking to the partnership capital accounts for the answer, if D shares, D's account will be $81.25 ($75 plus 25 percent of the net $25 income), while A, B, and C each will have a capital account of $106.25. If the partnership specially allocates the deduction to A, B, and C, each partner will have a capital account of $100 since D will be taxed on her $25 share of partnership profit undiminished by the deduction for D's own services. Under an aggregate analysis of partnerships, this latter choice makes sense. D receives no deduction for payments for the services she performs nor does D include in income a constructive payment for those services from D's own share of the partnership. Moreover, the special allocation preserves the equilibrium between inside basis, the basis of the partnership in its assets, and outside basis, the sum of the partners' bases in their respective partnership interests.

The analysis makes far better economic sense, however, when D is taxed on a $100 value for her partnership interest. No special allocation of the deduction for the payment to D is necessary. The partnership has net income of zero: the $100 receivable or payment from the third party, less the $100 deduction for the payment to D that was in the form of a partnership interest. The transaction has no net effect upon A, B, or C. D has income of $100 plus a capital asset, the partnership interest, worth $100 (25 percent of the partnership's $400 of assets as enhanced by the third-party payment or receipt of services). The fact that D shares in the deduction for a partner makes to her is not problematic, despite the aggregate partnership income. The partnership has separate identity in this case. The Code's scheme of taxation assumes that a partner may have in capacities other than as a partner, e.g., an employee, supplier.

Even when D's services have no such immediate impact on the partnership, they must contribute to the value of the partnership in some way. For example, D may have performed the work necessary for the partnership or the commencement of its business. If so, the completion of state law formalities, going-concern value, and goodwill of the partnership. Absent D, the partnership would be worth part of its other assets in order to buy those items in the market. D must have a value to the partnership greater than zero. The value of D's 25% interest in the partnership must be greater than $93.75. If the partnership has $300 in cash plus those non-zero-value assets and cash and created by, D's services.

C. The Service Partner's Tax Advantage: Why It Is Not Simple

Assignment of a $75 value to D's interest means that the services devoted to formation of the partnership, for example, $93.75 of the value of the partnership, and D's share of the partnership (of $375). Again, it seems contradictory to tax D on only $75 interest D received for services is immediately worth more than the $25 she received. Assigning a $75 value to D's services suggests D is not the reason services are attributable to, and enhance the value of, the partnership. Thus, A, B, and C are entitled to the amortization deduction or organizational expenditures. D captures a tax timer for the other partners. They must spread their deduction for organizational expenditures over sixty months while, by performance, D receives the equivalent of an immediate deduction for her services.

Relative to her partners, and all cash- or property-contributors to other partnerships as well, D's tax advantage becomes in the tax recovery period for the asset created by D's services. The partnership's basis in the asset D creates or enhances over a long depreciable life or first when the partnership ceases to exist. D may be the broker who is instrumental in the partnership's formation. Anyachinery.
partnership’s assets are enhanced by a $75 account receivable, the partnership increased the value of the partnership’s assets to $75 + $75 = $150 in those assets is $93.75. On the most fundamental level, the correct amount on which to tax D.

Conversely, it may not matter that D includes only $75 rather than $75 in this case, provided that the partnership allocates its income from its $100, to A, B, and C only. The 25% of the $75 income it realizes from the third party, i.e., B, C, and D as it allocates $25 of its $75 deduction to D. As a result, D has income from receipt of the partnership’s share of the partnership’s income of $18.75 for a total of the value of D’s interest in the preceding paragraph. By C realizes a net loss of $6.25 ($18.75 share of income leaving each with a net capital of $93.75 and each in at $D. Yet, it remains difficult to comprehend why A, B, or C, share in the value of D’s interest if the other partner’s interest in each of the other partners in the marketplace. Thus, they must have a value to the partnership greater than zero. Accordingly, the value of D’s 25% interest in the partnership must be greater than $75, as the partnership has $300 in cash plus those non-zero-value assets attributable to, and created by, D’s services.

C. The Service Partner’s Tax Advantage: Why It Is Not Taxed

Assignment of a $75 value to D’s interest means that the asset created by the services devoted to formation of the partnership, for example, adds $75 to the value of the partnership, and D’s share of the partnership is worth $93.75 (25% of $375). Again, it seems contradictory to tax D on only $75 since the partnership interest D received for services is immediately worth more than that amount. Assigning a $75 value to D’s services suggests D is not taxed to the extent her services are attributable to, and enhance the value of, the interest D receives. Thus, A, B, and C are entitled to the amortization deduction for partnership organizational expenditures, and D captures a tax timing advantage vis-à-vis the other partners. They must spread their deduction for partnership organizational expenditures over sixty months while, by performing the services, D receives the equivalent of an immediate deduction for her share of those expenditures.

Relative to her partners, and all cash- or property-contributing partners in all other partnerships as well, D’s tax advantage becomes increasingly valuable as the recovery period for the asset created by D’s services increases. Possibly the partnership’s basis in the asset D creates or enhances is recoverable only over a long depreciable life or first when the partnership sells the asset. For example, D may be the broker who is instrumental in the partnership’s acquisition

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32I.R.C. § 707(a). But see discussion of this concept and Campbell’s reasoning with respect to section 707(a) infra text accompanying note 42. The court views the service partner as acting in his capacity as a partner so that section 707(a) does not apply. Campbell, 943 F.2d at 822.

33I.R.C. § 709(b).
of a building depreciable over 31.5 years or land that is non depreciable, and D receives a partnership interest in lieu of a brokerage commission. Still, more advantageous to D would be an expenditure for which D’s partners would gain tax recovery first when they dispose of their partnership interests—partnership syndication expenditures.

D may enjoy an additional advantage through the under taxation of her interest in the partnership. Ordinary income may become capital gain. Once the amount of the taxable event from receipt of the partnership interests becomes fixed, the character of D’s distributive share of partnership income is determined at partnership level. If the partnership generates capital gain, D’s distributive share is also capital gain. If D immediately sells her partnership interest, the gain, subject to the special rules for substantially appreciated inventory and unrealized receivables, would be capital rather than ordinary, while her receipt of capital income would have been ordinary. Under current law the maximum rate differential of 3% may seem trivial, but when combined with the opportunity to use the potential capital gain to offset capital losses, the conversion of service income into capital gain becomes significant. D’s relative tax advantages of deferral and conversion over her partners who pay for their interests in the partnership with previously taxed dollars are difficult to justify.

The appellate court in Campbell reasoned that the partnership taxation scheme, and section 707(a)(1) specifically, contemplates taxing a partner on a distribution from the partnership as a payment for services only when the partner is acting in a capacity other than as a partner. Otherwise the distribution is a distributive share of partnership profits, if any. Campell and D are acting in their capacities as partners. But, the Campbell court overlooked the “guaranteed payment” provision of Section 707(c), with the partnership making the payment without regard to its income, i.e., the partnership issues the interest to the partner whether or not it has income. While the value of the interest may relate to the partnership income, the issuance of the interest does not.

A leading commentary contends that a partner who receives an interest in the partnership for services is acting in her capacity as neither a section 707(a) payment nor a section 707(c). The payment without regard to partnership income is more like a payment to a non-partner. Until the partnership admits the service provider or grants the service provider is not acting in her capacity as partner interest or additional interest. Those services, whether promised for the future, are payment for the interest. This condition is essential to the service provider’s becoming a partner interest in the partnership, and, as such, the service provider is any employee or independent contractor. She expects to receive payment is to be in the form of property—a new or increased.

As either a payment to a partner not acting as a partner, payment, the distribution to the partner of the partnership currently as ordinary income. But the distribution is not, as the Campbell court mistakenly act, under Section 704. Moreover, characterization partnership as a deductible expense or a capital expense, the characterization of the payment to the partner as either a payment to one not acting in her capacity as a partner.

Perhaps the reason for taxing D on only $75 rather than the amount reflects the more generalized failure of the tax on income consistently. As a rule, gross income does not reflect a taxpayer realizes by performing services for herself or another family member. That portion of the payment less economically as a partner is thus neither included in D’s or capitalized by the partnership. If that were the rule, the partnership pays D with an interest in the partner whether the partnership makes the payment at its formation period. Such a result would obliterate, in part, the partnership and its partners and severely limit the permission to a partnership to deal with its partners as if it.

Nothing in section 707 supports that conclusion. A third line of argument avers that D is situated no

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39 I.R.C. § 168(c)(1).
40 Regs. § 1.167(a)-2.
41 Section 709(a) denies a deduction for amounts paid to promote the sale of interests in a partnership, but section 709(a)(2)(B) does not require a reduction in basis. Accordingly, syndication expenditures reduce gain or increase loss on the sale by a partner of her partnership interest.
42 I.R.C. § 702(b).
43 I.R.C. § 751.
44 See note 12.
45 Section 1 imposes a maximum rate of 31% on the taxable income of noncorporate taxpayers and section 1(b) limits to 28% the maximum rate on net capital gain of the taxpayer. Section 1222 defines the net capital gain as the excess of net long-term capital gain over net short-term capital loss.
46 Section 1211 permits noncorporate taxpayers to deduct capital losses only to the extent of capital gains plus $3,000 per annum. I.R.C. § 1211. The taxpayer may carry capital losses not deducted in the current year forward indefinitely under section 1212(b).
47 Morris F.43 F.3d at 822. The court did not follow the theory through as the statement is dictum.
48 I McKay et al., supra note 4, at ¶ 5.02(1)(c).
49 I.R.C. § 707. See also United States v. Brown, 410 U.S. 44.
the partnership for services is acting in her capacity as a partner and receiving the interest. The payment without regard to partnership income (that is, issuance of the partnership interest) is more like a payment to a non-partner than to a partner. Until the partnership admits the service partner or grants her an additional interest, the service provider is not acting in her capacity as partner with respect to that interest or additional interest. Those services, whether already performed or promised for the future, are payment for the interest in the partnership. Their rendition is essential to the service provider’s becoming a partner, or increasing her interest in the partnership, and, as such, the service partner performs them as any employee or independent contractor. She expects payment for them. The payment is to be in the form of property—a new or increased partnership interest.

As either a payment to a partner not acting as a partner or as a guaranteed payment, distribution to the partner of the partnership interest is taxable to her currently as ordinary income. The distribution of the interest in the partnership is not, as the Campbell court mistakenly assumed, a "distributive share" under Section 704. Moreover, characterization of the payment by the partnership as a deductible expense or a capital expenditure is independent of the characterization of the payment to the partner as either a guaranteed payment or a payment to one not acting in her capacity as a partner.

Perhaps the reason for taxing D on only $75 rather than on some greater amount reflects the more generalized failure of the tax system to tax imputed income consistently. As a rule, gross income does not include imputed income a taxpayer realizes by performing services for herself or, in most instances, for another family member. That portion of the payment to D that D would bear economically as a partner is thus neither included in D’s income nor deducted or capitalized by the partnership. If that were the rule, it should operate whether the partnership pays D with an interest in the partnership or with cash, and whether the partnership makes the payment at its formation or during its operational period. Such a result would obviate, in part, the separate identities of the partnership and its partners and severely limit the effect of the rules that permit a partnership to deal with its partners as if it were a discrete entity. Nothing in section 707 supports that conclusion.

A third line of argument avers that D is situated no differently from another
partner who transforms her services into property and contributes the asset created by the services at an enhanced value to the partnership. The difference between services and property frequently is ambiguous.\(^{50}\) The obvious retort to such an argument is to indicate that \(D\) did not choose that course and thus is not entitled to its tax advantages. Moreover, in many cases, the partner eventually will be taxed on the increase in the value of the property attributable to the partner's services, although the moment of taxation is deferred until the partnership sells the property.\(^{51}\) Of course, some types of services—legal and accounting services, for example—cannot be transformed readily into property except as accounts receivable. If the taxpayer contributes unaccrued accounts receivable to a partnership, they will have a zero basis in the hands of the partnership. As the partnership collects the receivables, the income retains its ordinary character, and the partnership must allocate it to the contributing partner.\(^{52}\) Likewise, the partnership must allocate to the contributing partner its gain on the sale of other types of property created by the contributing partner, but in some cases the gain may change character.\(^{53}\) The gain the partnership so allocates to the contributing partner increases the partner's adjusted basis in her partnership interest but has no other impact on what otherwise would be the partner's distributive share of the partnership's income. It does not entitle the partner to larger distributions by increasing her capital account, as the partnership took the value of the property into account on its books when the partner contributed it.

D. Capital Interest Conclusion

\(D\)'s (the service partner's) tax advantage over the other partners as identified above is primarily derived and secondarily conversion of ordinary income into capital gain. In most failure of the system to tax \(D\) adequately is a permanent.\(^{54}\) \(D\)'s adjusted basis in her partnership interest will be less than the other partners' respective adjusted bases, and \(D\)'s gain will be greater or the loss smaller when \(D\) sells her partnership interest. Lack of tax fairness that prevents \(D\) from deducting currently her full share of partnership income

Nevertheless, deferral of income, in and of itself, is not in itself tax avoidance which should be tolerated only when justified by the need for an overriding tax principle such as realization.\(^{55}\) By virtue of the conclusion that the parties to the formation of the partnership as equal in value to each of their contributions, \(D\) becomes an equal owner of the partnership and would be equal to the then value of each other partner's income as \(D\) receives the partnership interest in excess of its value.

Accordingly, \(D\) should include the full value of that increase in income.

In many cases, the value of \(D\)'s interest and community property would be determined by means of a simple pricing formula.\(^{57}\) When \(D\)'s interest as a percentage of the partnership but has other features specific to the partnership and loss sharing ratios, the mathematical computation of \(D\)'s share of liquidation value is also used to justify its use in terms of simplicity or obviousness.

E. Collateral Consequences of the Service Partner's \(D\)'s
to view the partnership constructed to provide a tax advantage to the service partner a share of each of its underlying assets is the partner's constructive recharacterization of those assets.\(^{58}\) Loss by the partnership when it doubles their adjusted tax bases. The partnership recognizes gain on the sale of a portion of each of its properties to \(D\).\(^{59}\) The share of the properties equal to the fair market value of the constructive recharacterization to the partnership, the partner's capital gain with respect to \(D\)'s share of the properties.\(^{60}\) Such a transaction conveniently permits the partnership to adjust its capital gains to maintain the equity between inside and outside capital accounts.

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\(^{50}\)\text{United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964) (maps created by the taxpayer with respect to the purpose of interest in property). See also United States v. Stafford, 727 F.2d 1041, 1053 (11th Cir. 1984) (court recognized as property a commitment for favorable financing terms).}

\(^{51}\) The precontribution difference between the adjusted basis and fair market value of contributing property is prevented from being taxed to any partner other than the contributing partner. I.R.C. § 704(c).

\(^{52}\) I.R.C. § 704(c). Postcontribution appreciation, if any, would be shared by all the partners. Section 724(a)(2) preserves the ordinary income character of the receivable.

\(^{53}\) I.R.C. § 704(c). In the case of inventory property, section 724(b) preserves the character of five years even if the partnership changes the use of the property to a noninventory use. Otherwise, unless section 1221(3) prevents characterization of the property as something other than a capital asset, the taxpayer could have capital gain rather than ordinary income. Such a result is not peculiar to partnership taxation; the taxpayer could have transformed her services into capital gain in a nonpartnership event.

\(^{54}\) If \(D\) dies before selling the partnership interest, the basis in the interest adjusts to fair market value at date of death or the alternate valuation date under section 1014. Except to the extent the income with respect to a decedent, that adjustment renders the advantage permanent. In any event, the advantage is certainly permanent for \(D\).

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\(^{55}\) Many recent changes in the tax laws have sought to prevent this benefit. See supra \text{tax law accompanying note 25 and accompanying text.}

\(^{56}\) Under Regulations section 1.83-6(b), the exchange of property for shares of the property for the value of the services. The partnership would typically allocate the recognized gain or loss among the partners. Presumably, a direct or indirect owner of more than 50% of the capital or profits interest in property under section 707(b) would disallow the deduction for any loss the partnership recognizes on sale of the property held for use in the partnership's trade or business.

\(^{57}\) I.R.C. § 723.

\(^{58}\) The section 754 election causes the partnership's basis in its assets to be increased by a distribution of partnership property that has a basis in the property from the property's basis in the partnership's hands, a partner recognizes gain or loss from the sale of a partnership interest and may revoke the election only with the consent of the Service—for now.
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smaller when $D$ sells her partnership interest. Lack of ample basis also may prevent $D$ from deducting currently her full share of partnership operating losses. Nevertheless, deferral of income, in and of itself, is a substantial advantage which should be tolerated only when justified by the economics of the transaction or an overriding tax principle such as realization. Economic reality compels the conclusion that the parties to the formation of the partnership viewed $D$'s contribution as equal in value to each of their contributions, i.e., $\$100$. If the partnership admits $D$ later, and $D$ becomes an equal partner, $D$'s contribution would be equal to the then value of each other partner's interest. $D$ realizes the income as $D$ receives the partnership interest in exchange for the services. Accordingly, $D$ should include the full value of that interest in her income.

In many cases, the value of $D$'s interest and commensurate enhancement to the value of the partnership's tangible and intangible properties is measurable by means of a simple pricing formula. When $D$'s interest is not a simple percentage of the partnership but has other features such as differential profit and loss sharing ratios, the mathematical computation becomes more complex. Determination of $D$'s share of liquidation value is also complex and does not justify its use in terms of simplicity or obviousness.

E. Collateral Consequences of the Service Partner's Admission

Incidental to the view that the partnership constructively distributes to the service partner a share of each of its underlying assets followed by the service partner’s constructive reorganization of those assets, is recognition of gain or loss by the partnership when it holds properties, the values of which differ from their adjusted tax bases. The partnership recognizes gain or loss on the constructive sale of a portion of each of its properties to $D$. $D$ takes a basis in her share of the properties equal to the fair market value of the share, and upon constructive reorganization to the partnership, the partnership succeeds to $D$’s basis with respect to $D$'s share of the properties. Such characterization of the transaction conveniently permits the partnership to adjust its basis in its assets to maintain the equilibrium between inside and outside basis, without having to make a permanent basis adjustment election.

Conclusion

The partner's tax advantage over the other partners as identified by the deferral and secondarily conversion of ordinary income in most cases failure of the system to tax $D$ adequately is not adjusted basis in her partnership interest will be less than the active adjusted bases, and $D$'s gain will be greater or the loss smaller when $D$ sells her partnership interest. Lack of ample basis also may prevent $D$ from deducting currently her full share of partnership operating losses. Nevertheless, deferral of income, in and of itself, is a substantial advantage which should be tolerated only when justified by the economics of the transaction or an overriding tax principle such as realization. Economic reality compels the conclusion that the parties to the formation of the partnership viewed $D$'s contribution as equal in value to each of their contributions, i.e., $\$100$. If the partnership admits $D$ later, and $D$ becomes an equal partner, $D$'s contribution would be equal to the then value of each other partner's interest. $D$ realizes the income as $D$ receives the partnership interest in exchange for the services. Accordingly, $D$ should include the full value of that interest in her income.

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Adjustment to basis of existing

521.R.C. § 704(d).
53Many recent changes in the tax laws have sought to prevent deferral of tax liability. See e.g., I.R.C. §§ 1271-75 (original issue discount rules), and § 469 (passive activity loss limitations).
54See supra text accompanying note 16.
55See supra note 25 and accompanying text.
56Under Regulations section 1.83-6(b), the exchange of property for services is treated as the sale of the property for the value of the services. The partnership would take section 704(e) into account in allocating the recognized gain or loss among the partners. Presumably, if $D$ were to become the direct or indirect owner of more than 50% of the capital or profits interests in the partnership, section 707(b) would disallow the deduction for any loss the partnership realizes and would convert any gain from properties held for use in the partnership's trade or business into ordinary income.
57R.C. § 723.
58The section 744 election causes the partnership's basis in its assets to adjust whenever a partner receives a distribution of property that has a basis in the partner's hands which differs from the property's basis in the partnership's hands, a partner recognizes gain from cash distributions, or a partner recognizes gain or loss from the sale of a partnership interest. Once made, the partnership may revoke the election only with the consent of the Service—for non-tax avoidance reasons.
partnership assets, however, is unnecessary to maintain the basis equilibrium. D adds to the value of the partnership’s existing assets or creates new assets for the partnership. The partnership either will add the amount of D’s services in its basis in existing assets as any taxpayer would do with the cost of improvements or will have a basis in the new assets D creates.62

Asserting that the partnership constructively distributes portions of its underlying assets to D is problematic in that it disregards the entity nature of a partnership.63 It fails to distinguish between the partnership and its partners.64 The suggested result might inhere if A, B, and C agreed in their individual capacities to pay D for D’s services to the partnership. In that case, each would have paid D $25, and A, B, C, and D each would have contributed $75 to the partnership.65 But A, B, and C did not agree to pay D for services. Rather the partnership agreed to pay D by distributing to D an interest in itself. D never owned an interest in the partnership’s underlying assets except by virtue of his tenancy in partnership with A, B, and C.66 D received an interest in the partnership as compensation for her services, not an interest in the partnership’s underlying assets.

None of the partnership tax rules expressly prevents the partnership from recognizing gain on the transfer of an interest in itself to the partner. By analogy to a corporation, the partnership recognizes gain equal to the value of the interest it issues for services under the exchange equivalency rule.67 As the partnership arguably has a zero basis in interests in itself. Such a result would be consistent with the Service’s position that a corporation has a zero basis in its own stock.68 As a result of the zero basis, a corporation ought to recognize gain on the transfer of its shares as compensation for services since section 1032 only permits transfers for money or property. Nevertheless, a corporation does not recognize gain as it transfers its own shares as compensation for services because of the fiction that the corporation constructively pays the compensation in cash that the recipient uses to purchase the shares.69 Accordingly, the same result should obtain in the case of a partnership, and, on the partner’s interest is protected by section 721.70

To the counterargument that the special rule for constructive services should not extend to partnerships, note that see the partnership expressly from recognizing gain when receiving cash. Yet, no one seriously argues that a partnership exchange of an interest in itself for cash, even when appreciated in value. In fact, no one asserts that issuance of interest for cash, when the partnership holds an appreciated proportional share of those underlying assets. Thus, a constructive payment for services in cash followed by an assignment of the cash to the partner, one might observe that its own interests is always equal to the consideration.

III. VALUING A PROFITS INTEREST

A. The Campbell Decisions

Prior to the Tax Court’s decision in Campbell,72 the Commissioner had concluded that Diamond v. Commissioner was repelled by the fact that the taxpayer immediately sold the interest he received for services.73 Nonetheless, Campbell held that the Service would begin to tax service partners’ partnership profits interests and that courts would uphold those interests, which tax professionals routinely advised were not currently taxable.74 The Eighth Circuit’s recent reversal of the issue75 ameliorates those anxieties to some extent, but lingers.76

While the Eighth Circuit concluded that the “profits

62See discussion supra text accompanying and following note 29. Incidentally, Regulations section 1.721-1(b)(1) becomes inapplicable because the partnership assets increase so A, B, and C relinquish no portion of their interests in favor of D. If the assets of the partnership have appreciated, D must avoid exposure to taxation on the pre-admission appreciation by requiring that the partnership specially allocate the gain to A, B, and C, or, generally, to book up its assets and adjust capital accounts under the section 704(b) regulations. Regs. § 1.704-1(b)(2)(i)(f), (g).

63See supra note 26 and accompanying text.

64Compare Gunn, supra note 7, with Gergen, supra note 7.

65Consider whether A, B, and C would have paid D for services unless some benefit insured them. If that benefit enhanced the value of the assets they contributed to the partnership, rather than benefiting them in some extrapartnership manner, D still may be contributing too little. Alternatively, D received and should be taxed on her share of the value of the enhanced assets, thereby yielding a nearly identical result to D and the partnership as that proposed in the foregoing paragraphs of this Article. See discussion supra text accompanying and following note 20.

66See supra note 27.


68See supra note 26.

69This analysis solves the problem raised by 1 MCKEE ET AL., supra note 27, partnership having current income from the assignment of its future interests. See discussion infra text accompanying note 114.

70Compare this to the floating basis concept with respect to marital property enacted section 1041, Davis v. United States, 370 U.S. 66.

71See supra note 2.

72Several post-Diamond memorandum decisions of the Tax Court are uncomfortably comfortable that the receipt of the profits interests would result in a taxable event. V. Commissioner, 52 T.C.M. (CH) 1223, 1228, T.C.M. (P-H) 960 (1990).

73In the Campbell appeal, the government abandoned its position that the partner who received and was taxable on receipt of his interests from the partners were not the partnership and that the value of the interests was established under section 61. The Eighth Circuit rejected this theory. Id. at 815.
however, is unnecessary to maintain the basis equilibrium of the partnership’s existing assets or creates new assets for the partnership either will add the amount of D’s services in the new assets as any taxpayer would do with the cost of improvements in the new assets. D creates.

A partnership constructively distributes portions of its underlying assets or distributes assets problematic in that it disregards the entity nature of the partnership and its partners. It might infer that A, B, and C agreed in their individual capacity to transfer assets to D for D’s services to the partnership. In that case, each would have contributed $75 to D, and A, B, and C did not agree to pay $75 for D’s services. Rather, they pay D by distributing to D an interest in itself. D received an interest in the partnership’s underlying assets except by virtue of his ownership with A, B, and C. D received an interest in the partnership’s services, not an interest in the partnership’s underlying stock. The partnership tax rules expressly prevent the partnership from extratransfer fees associated with the transfer of an interest itself to the partner. By analogy, a partnership recognizes gain equal to the value of the interest in the underlying assets under the exchange equivalency rule, as the partnership’s interest in the underlying assets in interest in itself. Such a result would be consistent with the position that a corporation has a zero basis in its own stock.

In this zero basis, a corporation ought to recognize gain on the transaction as compensation for services since section 1032 only protects property. Nevertheless, a corporation does not recognize any compensation for services because the corporation constructively pays the compensation in cash that the corporation purchases the shares. A corporation that constructs the shares.

III. VALUING A PROFITS INTEREST ONLY

A. The Campbell Decisions

Prior to the Tax Court’s decision in Campbell, tax professionals generally had concluded that Diamond v. Commissioner was an aberrant decision compelled by the fact that the taxpayer immediately sold the partnership profits interest he received for services. Nonetheless, Campbell caused considerable fear that the Service would begin to tax service partners on their receipt of partnership profits interests and that courts would uphold current taxability of these interests, which tax professionals routinely advised their clients were not currently taxable.

The Eighth Circuit’s recent reversal of the Tax Court on this issue ameliorates those anxieties to some extent, but the specter of Diamond lingers.

While the Eighth Circuit concluded that the “profits interests in [the partner-
ships] were without fair market value at the time he received them and should not have been included in his income for the years in issue, secondly the court acknowledged that Campbell was "analogous" to Diamond, and at least implicitly approved of its reasoning. Perhaps the appellate court in Campbell simply was unwilling to impose tax liability on Campbell for receipt in the year of issue of an interest that later became worthless. The difference between D, the partner who receives a capital interest for services in the earlier example in this article, and another service partner, E, who receives an interest in partnership profits, however, is not one of realization and inclusion in income. Rather, it is one of difficulty of valuation.

B. Valuing and Characterizing the Service Profits Interest

One commentary demonstrates the difficulty in distinguishing interests in profits from interest in capital, and suggests separating anticipated return on capital ("implicit profit") from that generated by entrepreneurial risk and resourcefulness ("contingent profit"). This commentary argues that, while normal return on capital ("implicit profit") resembles employee payment in the form of a shift of capital from the partners who contributed capital, and thus is not taxed on receipt, the entrepreneurial feature of the service partner's service ("contingent profit") should not be subject to tax except as part of the partner's distributive share.

Insofar as normalcy is a function of risk assessment, it is impossible to arrive at a universal definition of what is a "normal" or "implicit" anticipated return. There is no bright line between normal return and contingent profit, nor should we seek to draw one. When capital is a material income-producing feature of the partnership, the "contingent" entrepreneurial profit attaches to the capital and contributors of the capital anticipate both the "implicit" and "contingent" profit as sources of their reward for use of their capital. Thus, the service partner's share of contingent profit arguably represents a shift in capital also.

The initial acquisition of the profits interest for services is indistinguishable from the initial acquisition of the capital interest for services. The service partner acts as an employee or independent contractor whom the partnership compensates with an interest in itself. Only after the service partner, whether it be the service partner's initial interest or any additional services, does she participate as a partner rather than an employee.

To suggest that taxing E on the value of E's interest in the services is conceptually unsound. The principle of horizontal equity requires that, like all other partners, make her investment in the services as untaxed dollars. If a partner, E, acquires an interest in the profits for cash, F's cash would have been taxed already when F sells services, collecting income from investments, or recovering that was itself already taxed when F made the earlier interest in the distributive share of partnership profits, as the partner F recovers her investment, adjusted basis, only as taxable losses to F or when F sells the partnership interest.

Favorable tax treatment by virtue of performing services in acquiring an interest directly for those services rather than for a third party and acquiring the interest with the cash for the services?

Unquestionably, it is more difficult to determine the value of D's. Most often, the comparable sales of profits interests will not resell the interest immediately, as did Diamond, nor does the service have an ascertainable fair market value. What services requires the service partner to include the value of the services as part of the profits choice is possible: either the value is zero, as the cost of the transaction remains open until valuation is possible.

Despite the difficulty of valuation, it seems fair to say that the value of the interest to be greater than zero, lest E sell services in exchange for the interest. With the exception of

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82See supra text accompanying and following note 26.
83See supra text accompanying notes 43-45.
84Hortenstine & Ford, supra note 2, at 902-03, point out that the service tax But see, e.g., WILLIS ET AL., supra note 4, § 46.04, and 77.
85One might wonder what happens to F's share of the contribution shifted to those who have an interest in capital. If the partner, however, the present value of the shift becomes insignificant, so long as proportional to the capital she contributes.
86Diamond, 492 F.2d at 287.
87See Hensel Phelps Construction Co. v. Commissioner, 74 T.C. 188, the interest in partnership capital was determined to be equal to the present value of an ascertainable value sometimes equates to a zero value. I.R.C. § 7701(b) 318 U.S. 184 (1943) (holding that a retained, contingent reversionary interest to reversionary is deemed to have a zero value).
88Cf. Campbell, 59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162.
89Generally, business arrangements do not give rise to tree gifts.
90See Tax Lawyer, Vol. 46, No. 1
TAXING SERVICE PARTNERS TO ACHIEVE HORIZONTAL EQUITY

with an interest in itself.82 Only after the service partner owns the interest, whether it be the service partner's initial interest or an additional interest for additional services, does she participate as a partner rather than as a non-partner employee.83

To suggest that taxing $E$ on the value of $E$'s interest results in double taxation of $E$ is conceptually unsound.84 The principle of horizontal equity demands that $E$, like all other partners, make her investment in the partnership with already taxed dollars. If a partner, $F$, acquires an interest in the profits of the partnership for cash, $F$'s cash would have been taxed already when $E$ earned it by performing services, collecting income from investments, or recovering investment capital that was itself already taxed when $F$ made the earlier investment. $F$ is taxed on her distributive share of partnership profits, as the partnership allocates them to $F$. $F$ recovers her investment, adjusted basis, only as the partnership allocates losses to $F$ or when $F$ sells the partnership interest.85 Should $E$ enjoy more favorable tax treatment by virtue of performing services for the partnership and acquiring an interest directly for those services rather than performing the services for a third party and acquiring the interest for the cash received in payment for the services?

Unquestionably, it is more difficult to determine the value of $E$'s interest than $D$'s. Most often, comparable sales of profits interests will not be available, and $E$ will not resell the interest immediately, as did Diamond.86 If neither the interest nor the services has a ascertainable fair market value at the time section 83 requires the service partner to include the value of the interest in income, two choices are possible: either the value is zero, as the court found in Campbell,88 or the transaction remains open until valuation is possible.

Despite the difficulty of valuation, it seems fair to assume that $E$ perceives the value of the interest to be greater than zero,89 lest $E$ would not perform the services in exchange for the interest. With the exception of gifts of services,90

1. See supra text accompanying and following note 26.
2. See supra text accompanying notes 43-45.
3. Hensel Phelps Construction Co. v. Commissioner, 74 T.C. 939, 954 (1980) (the value of the interest in partnership capital was determined to be equal to that of the services the court was able to value).
4. In the estate and gift tax cases and statutes, but not the income tax cases, absence of an ascertainable value sometimes equates to a zero value. I.R.C. § 7702. See Robinson v. Helvering, 318 U.S. 184 (1943) (holding that a retained, contingent reversionary interest which is not susceptible to evaluation is deemed to have a zero value).
5. Cf. Campbell, 59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162.

taxpayers expect remuneration for their services, although they may be willing
to defer receipt of the remuneration in the hope of receiving more in the future.
Zero valuation for property received in exchange for services is difficult to
support. Except for options having no readily ascertainable fair market value
that are specifically excluded from its coverage, section 83 assumes that the
provider and the recipient of services will be able to determine the value of
property transferred in exchange for the services. The provision does not address
the issue of inability to ascertain value, perhaps relying on the adversity in
interests of the parties to arrive at the value. The silence of the statute regarding
the absence of ascertainable value, however, does not imply that a zero value
is appropriate when value cannot be ascertained.

The manner in which section 83 handles stock options having no ascertainable
value suggests leaving the transaction open is the preferred approach, even though
section 84 permits the transaction to remain open longer than necessary in the
case of stock options. When the service provider exercises or sells the option,
and not when the value becomes ascertainable, section 83 applies to the
transaction. The excess of the amount received for the option, in money or
property, over the amount paid for it is ordinary service income. Despite the
possible excessive deferral in the case of options without ascertainable value,
the concept embedded in section 83 is deferral. The transaction remains open
until the rights of the payee become fixed, i.e., no longer subject to a substantial
risk of forfeiture. When the transaction closes, the payee’s income is ordinary
service income.

When section 83 is not involved because there is no transfer of money or
property to a third party, cash basis taxpayers generally defer inclusion in income
until the recipient of the service benefit makes payment. And if and when,
however, the remuneration is ordinary service income, whether paid in cash or
property. If received in installments, each installment is ordinary service income.
Indeed, the service transaction remains open permanently, even if the service
provider determines she has no expectation of receiving payment. Whenever a
payment is forthcoming, it generates ordinary service income. The taxpayer may
force closure only by relinquishing her right to payment. A sale of the right to
payment, for example, produces ordinary income to the seller, equal to the
amount the seller realizes on the sale, and closes the transaction. A gift of the
right to payment may close the transaction, but the more likely result is that

the donor continues to include in her income the
86Helvering v. Eubank, 311 U.S. 122, 125 (1940), holds that
commissions for insurance renewal premiums when collected
are compensation for past services performed.
88283 U.S. 404, 412-13 (1931).
89Section 453(j)(2) and regulations section 15A.453-1(c), as
transaction reporting of the *Burnett* type. The installment sale no
change the character of, the gain realized on the underlying sale.
100Compare Proposal by Individual Members of Committee on
of American Bar Association to Amend the Regulations under the
laws to Define a Partnership Capital Interest and a Partnership Profit
Treatment of Compensatory Transfers of Both Forms of Partnerships
(May 11, 1987) (LEXIS, FEDTAX, TNT file, elec. cit. 87 TN,
which recommends taxing each allocation to the service partner as
profit). Section 249 recommends taxing the service partner on her distributive share. Portion
n.249, expresses the reservation about the approach that there may
101The partnership would deduct or capitalize the payment at the
Both the inclusion and the deduction would occur when the partner
is deemed a guaranteed payment. I.R.C. § 707(c). See supra
note 42.
102I.R.C. § 1256.
103I.R.C. § 103.

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the donor continues to include in her income the amount the donee receives when and if the donee receives payments.\(^{96}\)

Proposed regulations requiring open transaction reporting for contingent payments under debt instruments similarly seek to characterize the contingent payment in the same manner as it would have been characterized if it had not been contingent.\(^{97}\) The case of Burnett v. Logan\(^ {98}\) permits open transaction reporting if the value of the consideration received by the seller of property cannot be ascertained. Under Logan, each payment the seller receives, after recovering her tax basis, is gain having the same character as gain on a completed sale of the underlying property would have had.\(^ {99}\) Short-term or long-term holding periods become fixed at the moment of sale, not as the seller receives payments.

Parallel treatment of the service partner is consistent with section 83, the partnership rules, and notions of horizontal equity.\(^ {100}\) Unless the partnership interest in profits received by the service partner is susceptible of valuation when received, the compensation transaction remains open. As the service partner, a cash basis taxpayer, receives cash or property distributions from the profits of the partnership, as opposed to allocations of E's distributive share of the profits not accompanied by any distribution, or at such time as the value of the profits interest becomes ascertained, she has ordinary service income without regard to the character of the income to the partnership.\(^ {101}\) If the partnership's income is capital gain, as it would be in the case of a commodities pool trading futures contracts\(^ {102}\) or from sale of its investment assets, or even nontaxable income from tax exempt bonds,\(^ {103}\) the partner cannot avoid the ordinary income character of payment for services. Once the value of the interest becomes ascertainable and the service partner includes that value in income, the transaction closes for tax purposes and subsequent distributions no longer have the service income character.

\(^{96}\) Helvering v. Eubank, 311 U.S. 122, 125 (1940), holds that the taxpayer remains taxable for commission payments for insurance renewal premiums when collected by the donee of the right to collect the commission payments.


\(^{98}\) 293 U.S. 404, 412-13 (1931).

\(^{99}\) Section 453(1)(b) and regulations section 15A.453-1(c), as currently in effect, prevent open transaction reporting of the Burnet type. The installment sale rules themselves defer, but do not change the character of, the gain realized on the underlying sale.


\(^{101}\) Compare Proposal by Individual Members of Committee on Partnership of Section of Taxation of American Bar Association to Amend the Regulations under the Internal Revenue Code of 1986 to Define a Partnership Capital Interest and a Partnership Profits Interest, and to Clarify the Tax Treatment of Compensatory Transfers of Both Forms of Partnership Interests, Tax Notes Today (May 11, 1987) (LEXIS, FTDAX, TNT file, elec. cit. 87 TNT 91-24) (hereinafter Proposal), which recommends taxing each allocation to the service partner as ordinary service income in lieu of taxing the service partner on her distributive share. Hortensine & Ford, supra note 2, at 918 n.249, expresses the reservation about the approach that there may never be closure.

\(^{102}\) The partnership would deduct or capitalize the payment at that time under section 267(a)(2).

\(^{103}\) In the event the partnership interest is a capital asset, according to the partnership interest to the

\(^{104}\) The partnership would deduct or capitalize the payment at that time under section 267(a)(2).
Moreover, the partner is taxable on her distributive share of the partnership's profits,\textsuperscript{104} the character of that distributive share being determined at partnership level.\textsuperscript{105} While it may seem that the same income is taxed twice to the same recipient, from the perspective of source, the income is intrinsically different each time it is taxed.\textsuperscript{106} Cash or property distributions from the partnership do not constitute income from services directly. Rather, they enable the partner and the partnership to measure part of the value of the partnership interest \( E \) received previously for her services. Since that portion becomes fixed and determinable at the time of the distribution, nothing prevents its inclusion in income currently. It represents, however, a portion, but not all, of the value of the partnership interest. Future distributions (in fact, every distribution until the remaining value of the interest becomes ascertainable) will delineate further the value of the interest \( E \) received. That \( E \) receives this income from the partnership makes it no different from the income that partner \( F \) receives from her third-party employer and, after paying federal income tax, uses to buy an interest in the partnership. Like partner \( F \), partner \( E \) also receives a distributive share of partnership profits, and \( E \) and \( F \) each include their respective shares in their individual incomes.\textsuperscript{107}

As \( F \) takes a basis in her partnership interest equal to the amount of cash \( F \) pays for it, the amount of ordinary service income to \( E \) increases \( E \)'s adjusted basis in her partnership interest.\textsuperscript{108} Similarly, \( E \) and \( F \) increase their respective bases in their partnership interests by the amount of their allocable shares of partnership profit.\textsuperscript{109} Distributions from the partnership are not taxable to \( E \) or \( F \) under the partnership rules unless they exceed the distributee's adjusted basis in her interest.\textsuperscript{109} Distributions to \( E \) have the dual characteristic of partnership distributions governed by section 731 and measures of the value of the initial payment for services, the partnership interest, upon which \( E \) was not taxed previously. Those characteristics remain distinct from one another. \( E \) will recover her basis in the partnership interest, as will \( F \), upon the sale of the interest or as the partnership incurs losses if any of the losses are allocable to \( E \).

If \( E \) wishes to avoid this dual nature of partnership distributions, \( E \) may refrain from accepting an interest that cannot be valued at the time of receipt. Alternatively, \( E \) may prefer not to become a partner at all, but rather elect to receive compensation measured by the increase in value of the partnership's property over a fixed term.\textsuperscript{110} Although there is some risk that the government might seek to characterize such an equity participation as a partnership interest,\textsuperscript{111} structuring opportunities exist that will forestall recharacterization of the equity participation.\textsuperscript{112}

\begin{itemize}
  \item \textsuperscript{104}I.R.C. §§ 702, 704.
  \item \textsuperscript{105}I.R.C. § 702(b). The service income to \( E \) may affect \( E \)'s and each other partner's distributive share. See infra text accompanying note 113.
  \item \textsuperscript{106}Cf. Hortonstine & Ford, supra note 2, at 902-03.
  \item \textsuperscript{107}Regs. § 1.722-1.
  \item \textsuperscript{108}I.R.C. § 705(a).
  \item \textsuperscript{109}I.R.C. § 731(a)(1).
  \item \textsuperscript{110}Cf. Cowan, supra note 2, at 203-07.
  \item \textsuperscript{111}See generally I.McRae et al., supra note 4, ¶ 3.0311.
  \item \textsuperscript{112}Regulations section 1.752-1T(d)(3)(vii) and Proposed Regulations section 1.752-1(d) governing allocations of partnership liabilities permit the holding of equity-like interests not to be treated as debt. The lenders being viewed, for purposes of the economic risk of loss to debtors, as bearing the economic risk of loss.
  \item \textsuperscript{113}Compare section 83 when the risk of forfeiture terminates resulting in a deduction under section 83(h) but also may have and adjust depreciation, amortization, etc. accordingly.
  \item \textsuperscript{114}I.McRae et al., supra note 4, ¶ 5.08[2][a].
  \item \textsuperscript{115}See supra text accompanying and following note 25.
  \item \textsuperscript{116}Hort v. Commissioner, 313 U.S. 28, 30 (1941), where payments released from its obligation under a lease are held to be rent substitutes.
  \item \textsuperscript{117}See supra text accompanying and following note 58.
  \item \textsuperscript{118}I.R.C. § 702(a).
\end{itemize}
SECTION OF TAXATION

C. Partnership Level Consequences

As would be the case with any open compensatory transaction, the partnership takes into account the deduction or capitalization of the income to the service partner, as the service partner includes it in income. In those instances in which the payment to E, the service partner, would have been an ordinary and necessary business expense of the partnership, the partnership deducts the amount of the payment, thereby reducing its income as well as E’s, and each other partner’s, distributive share of the income proportionally. Similarly, capitalization of the payment affects depreciation and amortization schedules of the partnership. It even may entitle the partnership to an immediate loss deduction or diminution of an earlier inclusion in income from a sale of property with respect to which the partnership would have capitalized the payment and increased its adjusted basis.

The concern that taxing the partner on receipt of an interest for services creates an assignment of income problem for the partnership is misplaced. Under that line of analysis, which views the transfer of a capital interest to a service partner as a sale by the partnership of a proportional share of each of its underlying assets, the partnership transferring to the service partner a profits only interest arguably is selling a proportional share of its future income (i.e., assignment of that income). The proceeds from the sale, a substitute for the future income, are included immediately, although the character of the income is preserved.

The flaw in the foregoing line of analysis lies, however, in the fact that, since the partnership does not transfer an interest in its underlying assets, neither does it assign to the service partner a share of its future income. The share of future income remains solely the service partner’s distributive share of income received in her capacity as partner. The amount of profits to be received by the service partner serves to quantify the value of the interest in the partnership received by the partner for services. The profits themselves are taxed when earned by the partnership, and each partner, including the service partner, takes her distributive share of the profits into account as they are earned.

D. The Problem of Service Partnerships

Service partnerships differ from the partnerships addressed in this article in that capital theoretically is not a material income-producing factor. Because all allocations of partnership liabilities permit the holding of equity-like interests by lenders without the lenders being viewed, for purposes of the economic risk of loss aspect of the regulation, as partners bearing the economic risk of loss.

13Compare section 83 when the risk of forfeiture terminates resulting in inclusion in income. The employer may have a deduction under section 83(h) but also may have to capitalize the payment and adjust depreciation, amortization, etc. schedules accordingly.

14See supra text accompanying and following note 25.

15See supra note 4, § 5.08[2][a].

16See supra text accompanying and following note 58.

17I.R.C. § 702(a).

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the partners are service partners and no partner contributes capital, no individual service partner has an opportunity to derive a tax advantage relative to others who invest with already taxed dollars. The partnership is a pool of labor in which each partner agrees to share the output of the pool. Admission of a new partner increases the size of the pool but does not represent a payment to the partner because each year in the partnership’s life is separate from every other year. The new partner shares only in the future income of the partnership to which she contributes services, as does each other partner in the partnership. In other words, the partnership interest is itself without value once the partnership has distributed all the year’s profits.

Such a perspective would permit professional service partnerships to continue admitting new partners without capital contributions and without the receipt of the partnership interest representing a payment for services when issued. But such a view is myopic. In some cases, new partners share in outstanding accounts receivable, which give the interest in the partnership immediate value that should be subject to tax. In many cases, the professional partnership has physical assets that may or may not contribute materially to the production of the partnership’s income. If they do not, there is little compensation involved in providing the new partner an interest in the partnership with respect to those assets.

Many professional partnerships, however, have considerable intangible assets: client relationships, goodwill, and reputation. Those assets that generally have a zero basis are material to the production of the partnership’s income. Each new partner benefits from those existing assets and, under the analysis in this Article, should be taxed accordingly although, under this Article’s analysis, the admission of the partner does not cause the partnership to realize income. As appealing as it may be to overlook this problem in order to protect the manner in which service partnerships operate, in the presence of substantial goodwill there is income to each new service partner.

In fact, frequently the new partner has deferred income by accepting for several years a smaller amount of compensation than that to which she otherwise might have been entitled, in the hope of attaining partnership. One might even perceive the partnership as having transferred to each new professional employee a nonvested partnership interest— an interest subject to a substantial risk of forfeiture. When the interest vests and the employee becomes a partner, the employee includes the value of the interest in income.

On the other hand, for many employees becoming partners, inclusion in income will not be a problem insofar as they bring assets with them to the partnership. They may have their own client lists, reputation, and goodwill, which they add to the partnership’s pool. Often the value of those assets will be equal to the new partner’s proportional share of the existing partnership’s assets as enhanced by their contribution. The service partner in such instances could be taxed as well as providing services to the partnership prospectively has no compensation income from receipt of the interest itself.

IV. CONCLUSION

Partners receiving capital or profits interests in a partnership services realize ordinary income upon receipt of those interests. The partnership has sold similar interests to other partners for cash or at a price of such other interests is the correct measure of the interest. When comparable sales have not occurred, but the partnership receives a determinable percentage of the partnership, a simple and straightforward method of valuing the interest is to compare the interest than does liquidation value. Insofar as the interest is an interest in the partnership so that neither comparable sales nor a direct and method is helpful, the value of the interest must be determined by other methods. If not possible to value the interest, the service transaction should occur until the interest is able to be valued. Each intermediate payor or payer with respect to the interest assumes the dual character’s value of the partnership interest received for services, research, income, and partnership distribution. Any other treatment, such as the zero value as occurred in Campbell,121 may permit the tax authorities to capture a tax advantage over other partners who pay cash for similar interests.

The Campbell result, but not its rationale, is consistent with possibility that Campbell never received distributions from the partnership’s profits. If the interests he received could not be valued for income purposes, the service transaction accordingly remained open, he was not taxed. Only if there were distributions to him of partnership profits would Campbell become taxable under the analysis this Article requires.

119) R.C. § 83(c)(1).
120) Under current economic conditions in the legal business, a partnership interest may never vest or may have negative value when it does vest. Many firms have forced partners to relinquish interests in the partnerships as if they had no property right whatsoever.

Campbell, 943 F.2d at 818.
by their contribution. The service partner in such instances contributes property as well as providing services to the partnership prospectively and accordingly has no compensation income from receipt of the interest itself.

IV. CONCLUSION

Partners receiving capital or profits interests in a partnership in exchange for services realize ordinary income upon receipt of those interests. When the partnership has sold similar interests to other partners for cash or property, the sale price of each other interests is the correct measure of the income to the service partner. When comparable sales have not occurred, but the service partner receives a determinable percentage of the partnership, a simple pricing formula provides a far more accurate assessment of the value of the service partner's interest than does liquidation value. Insofar as the interest differs from other interests in the partnership so that neither comparable sales nor a pricing formula is helpful, the value of the interest must be determined by other means. If it is not possible to value the interest, the service transaction should remain open until the interest is able to be valued. Each intermediate payment to the service partner with respect to the interest assumes the dual characteristics of indicator of the value of the partnership interest received for services, and thus service income, and partnership distribution. Any other treatment, such as the assigning of a zero value as occurred in Campbell,121 may permit the service partner to capture a tax advantage over other partners who pay cash or property for their interests.

The Campbell result, but not its rationale, is consistent with this analysis. Campbell never received distributions from the partnerships with respect to his interests. If the interests he received could not be valued when received, and the service transaction accordingly remained open, he was not yet subject to tax. Only if there were distributions to him of partnership profits in the future would Campbell become taxable under the analysis this Article recommends.

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121Campbell, 943 F.2d at 818.

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