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TAXING SERVICE PARTNERS TO ACHIEVE HORIZONTAL EQUITY*

*Henry Ordower***

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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[1]56 T.C. 530 (1971), *aff'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.

[2]*See, e.g.*, Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 TAX L. REV. 161 (1972); Barksdale Hortenstine & Thomas W. Ford, Jr., *Receipt of a Partnership Interest for Services: A Controversy That Will Not Die*, 65 TAXES 880 (1987); Michael D. Thompson, Note, *Receipt of a Partnership Profits Interest for Services:* St. John v. United States *and a Suggested Solution*, 5 VA. TAX REV. 127 (1985).

[3]*See infra* text accompanying note 15.

[4]A 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. WILLIS 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.

[5]59 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*.[6] 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.[7] 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,[8] 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.[9] 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.[10] If Campbell sells his partnership interest, the gain, subject to the special rules for substantially appreciated inventory and unrealized receivables,[11] would be capital,[12] while his receipt of service income would have been ordinary. *Diamond* involved precisely that issue:

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[6]492 F.2d at 291.

[7]The 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.

The *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. Cuff, *New Decision Threatens Tax-Free Formation of Most 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).

Maintaining substantially the same section numbering as the 1954 Code, the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter 1986 Act], recodified the Code in 1986.

[8]*See infra* text accompanying note 15. The result, but not the rationale, of the decision is also consistent with open transaction reporting. *See infra* text accompanying notes 88-121.

[9]*Campbell*, 943 F.2d at 823.

[10]I.R.C. § 702(b).

[11]I.R.C. § 751.

[12]Under 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 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(c), and substantially appreciated inventory items, as defined in section 751(d).

Diamond wished to have short term capital gain rather than ordinary income so that he could absorb his capital losses.[13]

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[14] until the true value of the profits interest 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.[15] 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 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

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[13]491 F.2d at 287.

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

[15]*See, e.g.*, 1 WILLIS ET AL., *supra* note 4, § 45.01; CURTIS J. BERGER AND PETER J. WIEDENBECK, CASES AND MATERIALS ON PARTNERSHIP TAXATION 175 (1989). 1 MCKEE ET AL., *supra* note 4, ¶ 5.02[2], 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 in a partnership for services 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) ¶ 90,571 (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 on 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.[16] The partnership employs a simple algebraic formula to determine the price *D* should pay:

$$P = \frac{D's\ \%\ x\ FMV}{1 - D's\ \%}$$

where:
P is the price *D* should pay,
D's % is *D*'s ownership interest in the partnership represented as a decimal fraction, and
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]

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[16]*D* would wish the partnership to revalue its property under Regulations section 1.704-1(b)(2)(iv)(f) 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 to *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:

$$P = (FMV + P)\ x\ D's\ \%$$
$$P - (D's\ \%\ x\ P) = D's\ \%\ x\ FMV$$
$$(1 - D's\ \%)\ x\ P = D's\ \%\ x\ FMV$$
$$P = \frac{D's\ \%\ x\ FMV}{(1 - D's\ \%)}$$

[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.

[19]I.R.C. §§ 2501-2504. Possibly a generation-skipping transfer tax would be applicable as well. I.R.C. §§ 2601-2663.

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

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[20]*See supra* note 15.

[21]*Cf.* Hensel 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).

[22]In 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 1041, added by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 421(a), changed the result for divorce settlements, but did not alter the principle of equivalency.

[23]*Hensel Phelps*, 74 T.C. at 954; Regs. §§ 1.61-2(d), 1.83-1(a)(1).

[24]In the case of a profits interest, commentators argue, but none seem persuaded, that *D* may not be receiving property at all but rather the partnership's unfunded and unsecured promise to pay compensation in the future. *See, e.g.*, Cowan, *supra* note 2, at 169-70; Stampe, *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.[25] 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[26] suggests that the partnership interest is property separate from the partnership's underlying assets,[27] 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

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[25]*E.g.*, 1 Willis et al., *supra* note 4, § 45.08; 1 McKee et al., *supra* note 4, ¶ 5.08[2][b]; Hortenstine & Ford, *supra* note 2, at 880-81. Commentators support this result with Regulations 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.

[26]United States v. Basye, 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 employees 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, clearly characterizes a partnership as a separate entity in addressing the situation when the partner deals with the partnership as a third party.

[27]State 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 the underlying partnership assets. UPA § 28. Regardless of the underlying partnership properties, the partner's interest is personal property. UPA § 26.

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 detect 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[28] 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 that fact that *D*'s services have created additional, albeit possibly hidden, assets for the partnership.[29] 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,[30] or they are capital expenditures, including in that category expenditures that are capitalized to the partnership's inventory.[31]

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.

[28]Selection 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.

[29]Under 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.

[30]I.R.C. § 162 or § 212.

[31]I.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 receivable generated by *D*'s services). The fact that *D* shares in the deduction for a payment the partnership makes to her is not problematic, despite the aggregate nature of taxation of partnership income. The partnership has separate identity from that of its partners. The Code's scheme of taxation assumes that a partner may act for the partnership in capacities other than as a partner, e.g., an employee, supplier, landlord, etc.[32]

Even when *D*'s services have no such immediate impact on partnership income, they must contribute to the value of the partnership in some manner.[33] For example, *D* may have performed the work necessary for the formation of the partnership or the commencement of its business. If so, the partnership agreement, the completion of state law formalities, going-concern value, etc., are assets of the partnership. Absent *D*, the partnership would have had to relinquish part of its other assets in order to buy those items 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,[34] 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 tax 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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[32] I.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.

[33] If *D*'s services contribute nothing to the value of the partnership, there is no reason whatsoever for *D* to receive an interest except as a gift from the other partners. This article assumes the parties are dealing at arm's length and not making gifts to one another.

[34] I.R.C. § 709(b).

of a building depreciable over 31.5 years[35] or land that is non depreciable,[36] 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.[37]

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 interest becomes fixed, the character of *D*'s distributive share of partnership income is determined at partnership level.[38] 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,[39] would be capital rather than ordinary,[40] while her receipt of service income would have been ordinary. Under current law the maximum rate differential of 3% may seem trivial,[41] but when combined with the opportunity to use the potential capital gain to offset capital losses,[42] 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.[43] Campbell 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's income, the issuance of the interest does not.

A leading commentary[44] contends that a partner who receives an interest in

[35] I.R.C. § 168(c)(1).

[36] Regs. § 1.167(a)-2.

[37] Section 709(a) denies a deduction for amounts paid to promote the sale of interests in a partnership, but section 705(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. 1 McKee, et al., *supra* note 4, at ¶ 4.07.

[38] I.R.C. § 702(b).

[39] I.R.C. § 751.

[40] *See* note 12.

[41] Section 1 imposes a maximum rate of 31% on the taxable income of noncorporate taxpayers and section 1(h) limits to 28% the maximum rate on net capital gain of the taxpayer. Section 1222(11) defines the net capital gain as the excess of net long-term capital gain over net short-term capital loss.

[42] Section 1211 permits noncorporate taxpayers to deduct capital losses only to the extent of capital gains plus $3000 per annum. I.R.C. § 1211. The taxpayer may carry capital losses not deductible in the current year forward indefinitely under section 1212(b).

[43] 943 F.2d at 822. The court did not follow the theory through as the statement is dictum.

[44] 1 McKee et al., *supra* note 4, at ¶ 5.02[1][c].

the partnership for services is acting in her capacity as a *partner* and receiving neither a section 707(a) payment nor a Section 707(c) "guaranteed payment." 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, the distribution to the partner of the partnership interest is taxable to her currently as ordinary income.[45] But the distribution of the interest in the partnership is not, as the *Campbell* court mistakenly assumed,[46] a "distributive share" under Section 704.[47] 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.[48] 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 obliterate, in part, the separate identities of the partnership and its partners and severely limit the effect of the rules[49] 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

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[45]The timing of inclusion in the partner's income, and deduction, if deductible, by the partnership depends upon whether the payment is a section 707(a) or 707(c) payment. If the former, the partnership will deduct the payment when the partner includes it in income under the partner's method of accounting. I.R.C. § 267(a)(2). In the case of a guaranteed payment, the partnership's method of accounting controls both the inclusion and the deduction. I.R.C. § 707(c).

[46]943 F.2d at 822.

[47]Rather, distributions of partnership income, gain, loss, deduction, or credit allocated with respect to that interest are "distributive shares". I.R.C. § 704(b).

[48]1 McKEE ET AL., *supra* note 4, at ¶ 5.02[1][c] (citing a series of pre-1954 Code cases and making precisely this argument in support of the proposition that a service partner is not taxable on receipt of a profits interest). *See also* Hortenstine & Ford, *supra* note 2, at 882.

[49]*See* I.R.C. § 707. *See also* United States v. Basye, 410 U.S. 441, 448 (1973).

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 or increase 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 deferral and secondarily conversion of ordinary income into capital gain. In most cases failure of the system to tax *D* adequately is not 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

[50]United States v. Frazell, 335 F.2d 487, 490 (5th Cir. 1964) (maps created by the taxpayer were treated as property for purposes of section 721). *See also* United States v. Stafford, 727 F.2d 1043, 1053 (11th Cir. 1984) (court recognized as property a commitment for favorable financing terms the taxpayer arranged and contributed to the partnership).

[51]The precontribution difference between the adjusted basis and fair market value of contributed 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. *Id.* 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 for 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 any 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 of income with respect to a decedent, that adjustment renders the advantage permanent. In any event, the advantage is certainly permanent for *D*.

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.[55]

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.[56] 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.[57] 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 recontribution of those assets,[58] 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*.[59] *D* takes a basis in her share of the properties equal to the fair market value of the share, and upon constructive recontribution to the partnership, the partnership succeeds to *D*'s basis with respect to *D*'s share of the properties.[60] 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.[61] Adjustment to basis of existing

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[55] I.R.C. § 704(d).

[56] Many 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).

[57] *See supra* text accompanying note 16.

[58] *See supra* note 25 and accompanying text.

[59] Under 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(c) 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.

[60] I.R.C. § 723.

[61] The section 754 election causes the partnership's basis in its assets to adjust whenever a partner receives a distribution of partnership 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 nontax 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 to 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 her 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 protects 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

[62]*See* 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* may 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)(iv)(f), -(g).

[63]*See supra* note 26 and accompanying text.

[64]*Compare* Gunn, *supra* note 7, *with* Gergen, *supra* note 7.

[65]Consider whether *A*, *B*, and *C* would have paid *D* for services unless some benefit inured to them. If that benefit enhanced the value of the assets they contributed to the partnership, rather than benefitting 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 30.

[66]*See supra* note 27.

[67]United States v. Davis, 373 U.S. 65, 73-74 (1962).

[68]Rev. Rul. 74-503, 1974-2 C.B. 117. *Cf.* 1 WILLIS ET AL., *supra* note 4, § 45.09.

[69]Regs. § 1.1032-1(a).

obtain in the case of a partnership, and, on the partnership's side, the transaction is protected by section 721.[70]

To the counterargument that the special rule for corporations issuing stock for services should not extend to partnerships, note that section 721 does not protect the partnership expressly from recognizing gain when it issues an interest for cash. Yet, no one seriously argues that a partnership recognizes gain from the exchange of an interest in itself for cash, even when its underlying assets have appreciated in value. In fact, no one asserts that issuance by a partnership of an interest for cash, when the partnership holds appreciated assets, is a sale of a proportional share of those underlying assets. Thus, as an alternative to constructive payment for services in cash followed by a constructive contribution of the cash to the partnership, one might observe that the partnership basis in its own interests is always equal to the consideration it receives for them.[71]

III. VALUING A PROFITS INTEREST ONLY

A. *The Campbell Decisions*

Prior to the Tax Court's decision in *Campbell*,[72] 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.[73] 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 those interests, which tax professionals routinely advised their clients were not currently taxable.[74] The Eighth Circuit's recent reversal of the Tax Court on this issue[75] ameliorates those anxieties to some extent, but the specter of *Diamond* lingers.[76]

While the Eighth Circuit concluded that the "profits interests in [the partner-

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[70]This analysis solves the problem raised by 1 McKEE ET AL., *supra* note 4, ¶ 5.08[2][b], of the partnership having current income from the assignment of its future income to the service partner. *See* discussion *infra* text accompanying note 114.

[71]Compare this to the floating basis concept with respect to marital property rights before Congress enacted section 1041. *Davis*, 370 U.S. at 66.

[72]59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162 (1990).

[73]*See supra* note 2.

[74]Several post-*Diamond* memoranda decisions of the Tax Court led practitioners to become reasonably comfortable that the receipt of the profits interests would not be taxed. In National Oil Co. v. Commissioner, 52 T.C.M. (CCH) 1223, 1228, T.C.M. (P-H) ¶ 86,596 at 2786 (1986), the Service conceded that if the taxpayer received only a profits interest, it would not be taxable. And in Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749, 1756-59, T.C.M. (P-H) ¶ 84,232 at 903 (1984), the court held that the profits interest had no fair market value and, therefore was not taxable on receipt. Similarly, in St. John v. United States, 84-1 USTC ¶ 9158 at 83,197-8, 53 AFTR 2d 718, 721 (C.D. Ill. 1983), the court valued the profits interest at zero based upon liquidation value.

[75]*Campbell*, 943 F.2d 815.

[76]In the *Campbell* appeal, the government abandoned its position that Campbell was a service partner who received and was taxable on receipt of his interests from the partnerships. Instead, the government contended that Campbell received the interests as compensation from his employer, which was not the partnership, and that the value of the interests was thus taxable as ordinary income under section 61. The Eighth Circuit rejected this theory. *Id.* at 818.

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,''[77] the court acknowledged that *Campbell* was ''analogous'' to *Diamond*[78], and at least implicitly approved of its reasoning.[79] 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 examples 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'').[80] 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 taxed on receipt, the entrepreneurial feature of the service partner's services (''contingent profit'') should not be subject to tax except as part of the partner's distributive share.[81]

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

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[77]*Id.* at 823.

[78]*Id.* at 820.

[79]The Eighth Circuit's enigmatic decision is analyzed in Terence Cuff, Campbell v. Commissioner: *Is There Now ''Little or No Chance'' of Taxation of a ''Profits'' Interest in a Partnership?*, 69 TAXES 643 (1991). Other commentators analyzing the uncertain effect of that decision are Sheldon Banoff, *Status of Service Partners Remains Unclear Despite Eighth Circuit's Reversal in* Campbell, 75 J. TAX'N 268 (1991); Robert J. Crnkovich et al., *Receiving a Partnership Profits Interest for Services Is Not (Always) Taxable*, 47 TAX'N FOR ACCT. 268 (1991); Carter G. Bishop, *Taxation of a Partnership Profits Interest: The Intersection of Income Tax Theory and Partnership Principles*, 18 WM. MITCHELL L. REV. 639 (1992); and Mark W. Brennan, Comment, *The Receipt of a Profits Interest in a Partnership as a Taxable Event after* Campbell *and* Mark IV, 57 MO. L. REV. 27 (1992).

[80]Hortenstine & Ford, *supra* note 2, at 890-9.

[81]Hortenstine & Ford, *supra* note 2, at 917-20.

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 nonpartner employee.[83]

To suggest that taxing *E* on the value of *E*'s interest results in double taxation to *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 *F* 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[87] has an 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]

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[82]*See supra* text accompanying and following note 26.

[83]*See supra* text accompanying notes 43-45.

[84]Hortenstine & Ford, *supra* note 2, at 902-03, point out that there is no real risk of double taxation. *But see, e.g.*, WILLIS ET AL., *supra* note 4, § 46.04, and Cowan, *supra* note 2, at 174-77.

[85]One well might wonder what happens to *F*'s share of the contributed capital. It appears to have shifted to those partners who have an interest in capital. If the partnership continues for a lengthy term, the present value of the shift becomes insignificant so long as *F* acquires a profits interest proportional to the capital she contributes.

[86]*Diamond*, 492 F.2d at 287.

[87]*See* 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).

[88]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. § 2702. *See* Robinette 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).

[89]*Cf. Campbell*, 59 T.C.M. (CCH) 236, T.C.M. (P-H) ¶ 90,162.

[90]Generally, business arrangements do not give rise to true gifts. Commissioner v. Duberstein, 363 U.S. 278, 291-92 (1960).

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,[91] 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.[92] 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 83 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 readily 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.[93] 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.[94] When and if received, 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,[95] but the more likely result is that

[91]I.R.C. § 83(e)(3). The lack of a readily ascertainable fair market value removes the grant of the option from section 83.

[92]To a limited degree, the parties have adverse interests since the payor's deduction and the payee's inclusion occur at the same moment and are equal. Section 83(h) defers the payor's deduction until the payee is required to include the value of the property in income.

[93]Regs. § 1.83-7(a).

[94]*See* Stampe, *supra*, note 7, at 426-28.

[95]*Cf.* I.R.C. 453B (resembles the anticipatory assignment of income rules). Section 453B(a)(2) treats a donor of an installment obligation, which resulted from sale by the donor of property, as if the donor sold the installment obligation for its fair market value at the time of the gift.

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 ascertainable, 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.

[97]Prop. Regs. § 1.1275-4, 56 Fed. Reg. 8308 (1991).

[98]283 U.S. 404, 412-13 (1931).

[99]Section 453(j)(2) and regulations section 15A.453-1(c), as currently in effect, prevent open transaction reporting of the *Burnett* type. The installment sale rules themselves defer, but do not change the character of, the gain realized on the underlying sale.

[100]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, FEDTAX, 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. Hortenstine & Ford, *supra* note 2, at 918 n.249, expresses the reservation about the approach that there may never be closure.

[101]The partnership would deduct or capitalize the payment at that time under section 267(a)(2). Both the inclusion and the deduction would occur when the partnership properly accrues the payment if the partnership is an accrual basis taxpayer and the payment of the partnership interest to the partner is deemed a guaranteed payment. I.R.C. § 707(c). *See supra* text accompanying and following note 42.

[102]I.R.C. § 1256.

[103]I.R.C. § 103.

Moreover, the partner is taxable on her distributive share of the partnership's profits,[104] the character of that distributive share being determined at partnership level.[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.[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.

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.[107] Similarly, *E* and *F* increase their respective bases in their partnership interests by the amount of their allocable shares of partnership profit.[108] 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.[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 properties over a fixed term.[110] Although there is some risk that the government might seek to characterize such an equity participation as a partnership interest,[111] structuring opportunities exist that will forestall recharacterization of the equity participation.[112]

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[104] I.R.C. §§ 702, 704.

[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.

[106] *Cf.* Hortenstine & Ford, *supra* note 2, at 902-03.

[107] Regs. § 1.722-1.

[108] I.R.C. § 705(a).

[109] I.R.C. § 731(a)(1).

[110] *Cf.* Cowan, *supra* note 2, at 203-07.

[111] *See generally* 1 McKEE ET AL., *supra* note 4, ¶ 3.03[1].

[112] Regulations section 1.752-1T(d)(3)(vii) and Proposed Regulations section 1.752-1(d) governing

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.[113] 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.[114] 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,[115] 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.[116]

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,[117] 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.[118] 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.

[113] Compare 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.

[114] 1 McKee et al., *supra* note 4, ¶ 5.08[2][a].

[115] *See supra* text accompanying and following note 25.

[116] Hort v. Commissioner, 313 U.S. 28, 30 (1941), where payments by tenant to landlord to be released from its obligation under a lease are held to be rent substitutes and ordinary income.

[117] *See supra* text accompanying and following note 58.

[118] I.R.C. § 702(a).

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 non-vested partnership interest—an interest subject to a substantial risk of forfeiture.[119] When the interest vests and the employee becomes a partner, the employee includes the value of the interest in income.[120]

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

[119] I.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 their interests in the partnerships as if they had no property right whatsoever.

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 such 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.

[121] *Campbell*, 943 F.2d at 818.