FLORIDA TAX REVIEW

VOLUME 1 | 1993 | NUMBER 9

Partnership Securities

Simon Friedman[*]

I. INTRODUCTION
II. BASIC PREMISES
  A. *Capital Account System*
  B. *Entity and Aggregate Approach*
  C. *Standard Fact Pattern*
III. CASH AS CONSIDERATION FOR PARTNERSHIP SECURITIES
  A. *The Receipt of a Capital Interest for Cash*
  B. *The Receipt of a Partnership Option for Cash*
    1. *Entity Analysis*
    2. *Aggregate Analysis*
    3. *Choice of Characterization*
  C. *The Receipt of a Profits Interest for Cash*
    1. *Entity Analysis*
    2. *Aggregate Analysis*
    3. *Choice of Characterization*
IV. SERVICES AS CONSIDERATION FOR PARTNERSHIP SECURITIES
  A. *The Receipt of a Capital Interest for Services*
    1. *Aggregate Analysis*
    2. *Entity Analysis*
    3. *Choice of Characterization*
  B. *The Receipt of a Partnership Option for Services*
    1. *Consensus View—Hybrid Analysis*
    2. *Entity Analysis*
    3. *Choice of Characterization*
  C. *The Receipt of a Profits Interest for Services*
    1. *Revenue Procedure 93-27*
    2. *General Principles—Consensus Aggregate View*
    3. *General Principles—Entity Analysis*
    4. *Choice of Characterization*
V. CONCLUSION

* Of Counsel, Milbank, Tweed, Hadley & McCloy, New York, N.Y. J.D., 1980, Yale Law School.

I. INTRODUCTION

The convergence of the individual and corporate tax rates and the repeal of the *General Utilities* doctrine have increased the cost of doing business in corporate form and the attractiveness of operating a business as a partnership.[1] That attractiveness has been reinforced by the growing availability of limited liability companies.[2] The proliferation of partnerships has increased the interest in partnerships' issuing securities similar to those issued by corporations—capital interests, options and profits interests that are the partnership equivalent of "stock appreciation rights."[3] However, there has been little discussion of the tax consequences of partnerships issuing securities apart from the long-standing debate as to whether the recipient of a partnership profits interest for services should be subject to tax.[4] That debate has been resolved, as a practical matter, by Revenue Procedure 93-27,[5] in which the Internal Revenue Service ruled that, subject to certain exceptions, the receipt of profits interests for services is not taxable. This

---

1. See William B. Wasserman et al., Tax Planning Opportunities Through the Use of Partnerships in Corporate Transactions, Tax Strategies for Corporate Acquisitions, Dispositions, Financings, Joint Ventures, Reorganizations, and Restructurings 1992, Practising L. Inst. 643, 647-48; Louis B. Freeman, Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships onto C Corporations, Running Amok with the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of *General Utilities*, 64 Taxes 962, 962-64 (1986).

2. William B. Brannan, Lingering Partnership Classification Issues (Just When You Thought It Was Safe To Go Back Into the Water), 1 Fla. Tax Rev. 197, 249-50 (1993).

3. James R. Hamill, Using Options to Compensate Service Providers at the Formation of a New Entity, 76 J. Tax'n 138, 138 (1992).

4. 1 William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 5.01-.10 (2d ed. 1990 & Cum. Supp. No. 2 1993); 1 Arthur B. Willis et al., Partnership Taxation §§ 45, 46 (4th ed. Dec. 1991 & Supp. June 1993). The extensive literature preceding Campbell v. Commissioner, T.C. Memo 1990-162 (CCH), rev'd, 943 F.2d 815 (8th Cir. 1991) is summarized in Barksdale Hortenstine & Thomas W. Ford, Jr., Receipt of a Partnership Interest for Services: A Controversy That Will Not Die, 65 Taxes 880 (1987). The extensive post-*Campbell* literature includes Sheldon I. Banoff, Status of Service Partners Remains Unclear Despite Eighth Circuit's Reversal in *Campbell*, 75 J. Tax'n 268 (1991); W. Lesse Castleberry, Commentary: *Campbell*—A Simpler Solution, 47 Tax L. Rev. 277 (1991); Terence F. Cuff, Current Issues in Partnership Taxation, in 49 N.Y.U. Inst. on Fed. Tax'n ch. 13 (1991); Terence F. Cuff, Campbell v. Commissioner: Is There Now "Little or No Chance" of Taxation of a "Profits" Interest in a Partnership?, 69 Taxes 643 (1991); Laura E. Cunningham, Taxing Partnership Interests Exchanged for Services, 47 Tax L. Rev. 247 (1991); Thomas W. Henning, The Receipt of a Partnership Interest for Services, in 44 U.S.C. Inst. of Fed. Tax. 1600 (1992); Leo L. Schmolka, Commentary: Taxing Partnership Interests Exchanged for Services: Let *Diamond/Campbell* Quietly Die, 47 Tax L. Rev. 287 (1991).

5. Rev. Proc. 93-27, 1993-24 I.R.B. 63 (July 6). Revenue Procedure 93-27 is discussed infra part IV.C.1.

resolution makes timely an analysis of the consequences to the partnership and other partners of a partnership's issuance of partnership securities.

This article, through a series of examples, considers the possible consequences under current law of the receipt by a partner of a capital interest, an option and a profits interest for either cash or services. These consequences differ depending on whether a partnership is viewed as an entity or aggregate.[6] The article recommends the adoption of an entity approach that permits the consequences of a partnership's issuance of securities to resemble those of corporate issuances. This recommendation requires reconsidering the accepted view of the tax consequences of a partnership's issuing a capital interest for services.

II. Basic Premises

A. *Capital Account System*

The article relies on the capital account system of Regulations section 1.704-1(b). Under that system, each partner's interest in a partnership at any time is reflected in the partner's capital account. The capital account equals a partner's (or its predecessor in interest's) contribution to the partnership, increased by any income allocated to the partner and decreased by any losses allocated to, and any distributions made to, the partner. Contributions made in property are reflected in the partner's capital account at the property's fair market value net of associated liabilities. Income and loss (including depreciation or amortization deductions) as to contributed property are based on the property's gross fair market value at contribution, which also represents the property's initial book basis.

On liquidation, a partnership must distribute the proceeds of liquidation to its partners in accordance with the partners' capital account balances. Thus, if a partnership were to sell its assets for their book basis, each partner must be distributed the current balance in its capital account. If the partnership's assets are sold for an amount other than their book basis, the proceeds of sale must be distributed to the partners in accordance with their capital accounts as adjusted for the allocation of any gain or loss realized on the sale. To enable this rule to correspond to economic reality, when a new partner is admitted to a partnership that holds appreciated property, Regulations section 1.704-1(b)(2)(iv)(*f*) permits the partnership to revalue its property and adjust the book basis of its property to the property's fair market value at the time of revaluation and to adjust the partners' capital accounts

---

6. The difference between the entity and aggregate approaches is discussed infra part II.B.

as if the property had been sold for its fair market value and the resulting gain or loss allocated to the partners.[7]

If the book basis and tax basis of contributed property differ, section 704(c)(1)(A) requires that income, gain, loss and deduction with respect to the contributed property be allocated to take that difference into account. Differences in the book and tax basis of assets resulting from partnership revaluations under Regulations section 1.704-1(b)(2)(iv)(*f*) must also be taken into account under section 704(c) principles.[8] Generally, and subject to specific rules and exceptions, book-tax differences are to be taken into account on an asset by asset basis by allocating to partners that are not responsible for a book-tax difference the tax income, gain, and deduction that the property would have generated had there been no book-tax difference and allocating any remaining attributes to the partners responsible for the book-tax difference.[9]

B. *Entity and Aggregate Approach*

As used in the article the term "entity approach" refers to the approach that treats a partnership as a separate entity, like a corporation, distinct from either the assets it owns or the partners that own interests in it. Under the entity approach, a person receiving a partnership interest is viewed as receiving an interest in that entity and not an interest in the entity's underlying assets. The term "aggregate approach" refers to the approach that

---

7. This description of the capital account system is blatantly oversimplified and no attempt will be made to discuss its infinite complexities. Technically, the Code and Treasury Regulations do not require the use of capital accounts at all. The proper use of capital accounts provides no more than a safe harbor within which the Internal Revenue Service will respect a partnership's allocation of income and loss. Within this permissive system, the revaluation of capital accounts to reflect fair market values on a contribution of property is itself merely permissive. Despite the modest legal status of capital account analysis, capital accounts are often used as an overarching method of determining partnership tax consequences. For example, McKee uses a capital account analysis to distinguish between distributions and § 707(c) guaranteed payments, McKee et al., supra note 4, ¶ 13.03[1][b], and Prop. Regs. § 1.704-3(a)(2) provides that a partnership that does not maintain capital accounts under Regs. § 1.704-1(b)(2)(iv) must maintain similar accounts to comply with § 704(c). This article follows that analytic tradition.

8. Regs. § 1.704-1(b)(2)(iv)(*f*)(4).

9. This article will generally apply the classical method of reconciling book-tax differences described in Prop. Regs. § 1.704-3(b). The other methods described in the Proposed Regulations attempt to mitigate the effect of the ceiling rule, the rule that permits a partnership, in taking into account book-tax differences, to use only an asset's actual tax attributes. For example, under the ceiling rule, the depreciation allocable to any partner with respect to an asset cannot exceed the total depreciation attributable to the asset. By a careful choice of examples, the article avoids considering the ceiling rule.

treats a partnership as a collection of assets and the acquisition of a partnership interest as the acquisition of an interest in those assets.

The article's use of the "aggregate approach" is a simplification of the general use of the term to treat a partnership as a number of persons (partners) that own indirect interests in the partnership assets.[10] Under the full-fledged aggregate approach, a new partner's receipt of a partnership interest is viewed in two steps: First, the new partner is deemed to acquire a portion of each continuing partner's undivided interest in partnership assets in exchange for a portion of the consideration provided by the new partner; second, the new partner is deemed to contribute its newly acquired interest in the partnership assets and the continuing partners are deemed to contribute the consideration they received from the new partner to the partnership. The article avoids this double deemed contribution to the partnership by treating the new partner's receipt of a partnership interest as a taxable acquisition of an undivided interest in the partnership assets from the partnership followed by the new partner's contribution of those assets to the partnership. The partnership is viewed as allocating any income it realizes on the deemed sale to the continuing partners. The results of the article's approach are substantially similar to the results of the full-fledged aggregate approach. For example, the gain recognized by the continuing partners is the same. Similarities and differences in the effects of the two versions of the aggregate approach are discussed in footnotes.[11]

C. *Standard Fact Pattern*

In the examples that follow, unless otherwise specified, A and B are partners in partnership P. Each has invested 100 in return for a 50% partnership interest, and the partnership has used the 200 to purchase an asset (the "Asset"). C wishes to join P. At times, C will join immediately, prior to any property appreciation. At other times, C will do so after the Asset has appreciated to 400. Generally, there will have been no income, loss, depreciation or other tax consequences during the period the Asset appreciates. After C's admission, the Asset will be placed in service and will be depreciable over ten years.

---

10. For a discussion of the entity and aggregate approaches to partnerships, see McKee et al., supra note 4, ¶ 1.02; Willis et al., supra note 4, § 4.

11. The article does not discuss the cases under the 1939 Code, which held that, under an aggregate theory of partnerships, a partner could not realize services income from a partnership to the extent the partner was deemed to be paying himself. See, e.g., Commissioner v. Moran, 236 F.2d 598 (8th Cir. 1956).

III. CASH AS CONSIDERATION FOR PARTNERSHIP SECURITIES

A. *The Receipt of a Capital Interest for Cash*

After the Asset has appreciated to 400, C contributes 44.44 to P in exchange for a 10% partnership interest.

The consequences of C receiving a capital interest for cash are certain. Neither the partnership nor any partner has gain, loss or other tax consequences.[12] C's contribution is a revaluation event under Regulations section 1.704-1(b)(2)(iv)(*f*). P's balance sheet after the revaluation and cash contribution would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	200	A	200	100
Cash	44.44	44.44	B	200	100
			C	44.44	44.44
Total	444.44	244.44		444.44	244.44

After C's admission, under section 704(c) principles, P's annual depreciation of 20 is allocable 4 to C, and 8 each to A and B. (In addition, if C's cash bought a new asset with a 10-year life, or made a capital improvement to the Asset of 44.44, C would be entitled to annual depreciation of .444 and B and C each would be entitled to 2 of depreciation.)

This result is the archetypal entity analysis. For purposes of comparison, the consequences of an aggregate approach might be noted. Under that approach, C would be viewed as purchasing 10% of P's property from P for 10% of its value (40). P would recognize gain of 20 (amount

---

12. IRC § 721. This generalization is subject to an important exception for partnerships that own § 751 assets, certain assets the sale of which would produce ordinary income. If a partnership is leveraged, the admission of a new partner may reduce each partner's share of the partnership's debt under the rules of Regs. § 1.752 (Regs. § 1.752-2 in the case of recourse debt; Regs. § 1.752-3(a)(3) in the case of nonrecourse debt). The reduction in a partner's share of partnership debt is deemed to be a cash distribution from the partnership to that partner. IRC § 752(b). To the extent an existing partner is deemed to receive that cash distribution in exchange for a new partner's receipt of an interest in the partnership's § 751 assets, the distribution is deemed a taxable exchange between the distributee partner and the partnership on which both the partnership and the partner may recognize gain or loss. IRC § 751(b). This possibility may be an important disincentive against the granting of partnership options. In practice, the possibility that the admission of a new partner would cause a § 751 exchange is often ignored, sometimes on the basis of a provision in the partnership agreement that purports (with varying qualifications), on the admission of a new partner, to allocate potential ordinary income to the existing partners.

realized of 40 less allocable basis of 20) and allocate that gain equally, 10 each, to A and B. C would then be deemed to contribute the purchased property interests, together with 4.44 of cash, to P. P would hold the Asset with a basis of 220 (180 for the initial 90% and 40 for the portion deemed contributed by C). P's balance sheet, after a Regulations section 1.704-1(b)(2)(iv)(*f*) revaluation, would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	220	A	200	110
Cash	44.44	44.44	B	200	110
			C	44.44	44.44
Total	444.44	266.44		444.44	266.44

After the transaction, under section 704(c), P's annual depreciation of 22 is allocable 4 to C and 9 each to A and B.[13] The principal difference between an entity and aggregate approach is that under the aggregate approach existing partners A and B recognize gain.

B. *The Receipt of a Partnership Option for Cash*

> C pays 4 for an option entitling C to acquire a 10% partnership interest for 25 (a small premium over current market value of 200). The 4 is placed in a non-interest bearing account. C exercises its option when the Asset has appreciated to 400.

1. *Entity Analysis.*—The grant of an option is generally not a taxable event,[14] so that P's grant of an option to C should have no tax consequences. It is tempting to treat P as having received 4 of tax exempt income, allocable 2 each to A and to B. In that case, A's and B's bases in their partnership interest and their capital account balances would each be increased to 102. This result has been suggested by the Tax Court.[15] However, because P's income is deferred rather than fully exempt, it is more

13. The results (including P's balance sheet and the § 704(c) implications) generally would be the same if A and B were viewed as directly selling undivided 10% interests in the Asset to C. C would be viewed as paying 20 to each of A and B, each of whom would recognize 10 of gain. A and B would then each be deemed to contribute the 20 of cash they received from C to P, while C would be deemed to contribute its purchased asset (with a basis of 40) plus 4.44 of cash to P.

14. Rev. Rul. 58-234, 1958-1 C.B. 279.

15. Helmer v. Commissioner, 34 T.C.M. (CCH) 727, 731 n.4. (1975).

appropriate that P's receipt of 4 from C be viewed as having no tax consequences.[16] C is not yet a partner and has no capital account.

The analysis of C's exercise of the option is more difficult. When the Asset is worth 400, C contributes 25 to P in exchange for a 10% interest in the partnership. Immediately after C's exercise of its option, P's balance sheet, including its partners' capital accounts, should be revalued pursuant to Regulations section 1.704-1(b)(2)(iv)(*f*) to reflect the fair market value of the partnership's property. That property has a fair market value (taking into account the total of 29 contributed by C) of 429. The partners' business understanding requires that C be entitled to 10% of P's capital and have a capital account balance of 42.9, and that A and B should each have a capital account balance of 45% of 429 or 193.05.

There are three routes by which A, B and C can reach their required capital account balances. First, C could be viewed as being the recipient of a taxable capital shift of 13.9 (its capital account of 42.9 over its actual contributions of 29). That would appear to be the least tenable interpretation as a taxpayer generally does not realize income on the exercise of a favorable option.[17]

Second, C can be viewed as having contingently become a partner at the time it acquired its option, so that on C's exercise of its option and P's revaluation of its assets under Regulations section 1.704-1(b)(2)(iv)(*f*)(2), A and B are each entitled to 45% of the Asset appreciation and C to 10% of that appreciation. A and B would then each have capital account balances of 190 and C a capital account balance of 49. To achieve the economically required capital account balances, there would have to be a capital shift of 6.1 from C to A and B, and A and B would each recognize income of 3.05. That position is more tenable. The 6.1 capital shift represents the premium paid by C for the privilege of allowing it to defer its decision as to whether to become a partner.

Third, C's aggregate contribution of 29 can be viewed as its acquisition of a 10% interest in a partnership with total assets of 290 (the Asset valued at 261 and a total cash contribution of 29) and its becoming entitled to 10% of any subsequent appreciation. C's acquisition of a 10% interest in P when P's assets have a value of 290 corresponds to the following P balance sheet:

---

16. McKee et al., supra note 4, ¶ 6.02[3][a].

17. This generalization follows from the rule that the option holder's basis in property acquired on the exercise of an option equals the amount paid for the property plus the amount paid for the option. Rev. Rul. 58-234, 58-1 C.B. 279, 286; Realty Sales Co. v. Commissioner, 10 B.T.A. 1217 (1928), acq., C.B. VII-2, 33 (1928). The rule does not apply to the exercise of options on § 1256 contracts. IRC § 1234(c)(1).

Asset	Book	Tax	Partner	Book	Tax
Asset	261	200	A	130.5	100
Cash	29	29	B	130.5	100
			C	29	29
Total	290	229		290	229

Under section 704(c) principles, P's annual depreciation of 20 is allocable 2.61 to C and 8.695 each to A and B.

Taking into account the Asset's appreciation of 139 to 400 after C's deemed admission, P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	200	A	193.05	100
Cash	29	29	B	193.05	100
			C	42.9	29
Total	429	229		429	229

The allocation of depreciation is unaffected.

This final analysis, which results in no gain to A, B or C, seems preferable. It permits the treatment of options to acquire partnership interests to parallel the treatment of options to acquire corporate stock. In addition, it is consistent with a literal reading of section 721, which states: "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."[18] C has received a partnership interest in exchange solely for two cash contributions.

However, Regulations section 1.721-1(b)(1) can be read to cause section 721 not to apply:

> Normally, under local law, each partner is entitled to be repaid his contribution of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.[19]

18. IRC § 721(a).
19. Regs. § 1.721-1(b)(1).

Appreciation that has economically accrued prior to the admission of a new partner can be treated as the equivalent of a contribution of money or other property by the other partners,[20] and P's transfer of a partnership interest to C can be viewed as the satisfaction of an obligation created by the option agreement. Regulations section 1.721-1(b)(1) should not be read so expansively to cause any of A, B or C to recognize gain. Causing C to recognize gain is, as noted above, inconsistent with the ordinary treatment of exercising favorable options. Causing A and B to recognize gain on C's "bargain" contribution of cash for a partnership interest is not consistent with A and B not being required to recognize gain on C's contribution of full value for a partnership interest.[21]

2. *Aggregate Analysis.*—Under the aggregate analysis, C is treated as paying P 4 for an option to acquire 10% of P's property. There are no tax consequences to A, B, C or P as a result of P's receipt of that payment.

If C exercises its option to acquire 10% of P's property, C should be treated as paying 26.1 (and not 29) for 10% of the Asset, because C's 29 contribution also entitles it to 10% of its 29 cash contribution. P would then recognize gain, measured by the excess of the amount realized (26.1) over the allocable basis of the property (20) or 6.1 and would allocate that gain 3.05 each to A and B. The gain corresponds to the possible capital shift to A and B discussed above. C would then be viewed as contributing the purchased 10% of the Asset with a basis of 26.1 plus 2.9 of cash to C. P would have a stepped-up basis in the Asset of 206.1.

C's deemed contribution of property to P requires a revaluation of the partners' capital accounts. While the matter is not certain, the best analysis of the revaluation is the two-step analysis adopted above. First, C is deemed to exercise its option when P's total assets have a value of 290. At that time, P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	261	206.1	A	130.5	103.05
Cash	29	29	B	130.5	103.05
			C	29	29
Total	290	235.1		290	235.1

20. The arguments for treating unrealized appreciation at the time of the admission of a new partner as the equivalent of the old partners' capital are summarized in Willis et al., supra note 4, § 45.02.

21. If C does not exercise its option, P will recognize ordinary income of 4. Rev. Rul. 58-234, 1958-1 C.B. 279, 283. It will allocate that income equally between A and B, increasing their bases in their partnership interests and their capital account balances to 102 each.

The remaining unrealized gain of 139 would be allocated 10% to C and 45% each to A and B resulting in the following P balance sheet:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	206.1	A	193.05	103.5
Cash	29	29	B	193.05	103.5
			C	42.9	29
Total	429	235.1		429	235.1

Under section 704(c) principles, P's annual depreciation of 20.61 is allocable 2.61 to C and 9 each to A and B.[22]

3. *Choice of Characterization.*—Under the aggregate theory, A and B are required to recognize the gain inherent in 10% of the Asset at a deemed valuation of 261. There seems to be no reason to require that income recognition. If C had, without prearrangement, contributed 29 to P for a 10% interest at a time when the Asset had a value of 261, A and B would not be required to recognize income. The result should be no different if C receives its P interest as a result of exercising its option. While C's possession of an option has allowed C to acquire an interest worth more than 29, this accession to C's wealth does not seem a good reason to tax A and B. In addition, section 721 should apply to protect A and B from income recognition.

---

22. The results of the aggregate analysis differ if C is viewed as paying A and B 2 each for an option to acquire 10% of their interests in the Asset. If C is viewed as acquiring an option against P, A's and B's capital account balances and bases in their P partnership interests are not increased until C either exercises its option or allows it to expire unexercised. If C pays 2 to A and B directly, A and B are treated as contributing 2 each to P, immediately increasing the capital account balances and the bases of their P interests. The total increase in A's and B's bases and capital account balances ultimately remains the same, 2, if C allows the option to lapse and 3.05 if C exercises the option. In the latter case, C would be deemed to purchase 10% of A's and B's interest in the Asset for 13.05 each, 2 paid for the option and 11.05 paid on the exercise of the option. A and B would each realize 3.05 of gain. A and B would then be treated as contributing the 11.05 purchase price to P, and C as contributing the purchased interest (with a value of 40 and a basis of 26.1) as well as 2.9 of cash to P. The momentary difference in A's and B's bases may make a difference if P treats A's and B's early deemed contribution of 2 as a revaluation event or if A or B sell their interests prior to the lapse or exercise of C's option. These differences suggest that if an aggregate approach is to be used, C should be viewed as acquiring an option against P rather than against A and B.

C. *The Receipt of a Profits Interest for Cash*

Immediately after P's formation, C contributes 10 to P in exchange for a 10% profits interest.

1. *Entity Analysis.*—While C's contribution of cash for a partnership interest would appear to result in no gain or loss to A, B, C or P under a literal reading of section 721, Regulations section 1.721-1(b)(1) (quoted above in Part III.B.1.) may cause section 721 not to be applicable. On an immediate P liquidation, A and B would each be entitled to 50% of all partnership capital, so that C has given up the right to be repaid its capital, but C did not give up its right to capital "as compensation for services (or in satisfaction of an obligation)." Whether or not Regulations section 1.721-1(b)(1) applies, treating C's contribution as tax-free does not appropriately reflect the shift of C's capital to A and B.

There are two ways of justifying the shift of C's capital to A and B under an entity theory, neither of which is totally satisfactory. First, C could be treated as never becoming a partner, but as having purchased 10% of P's future income. The purchase would be treated as an effective assignment of future P income for consideration of the kind discussed in P. G. Lake v. Commissioner[23] and Estate of Stranahan v. Commissioner.[24] The effects of the assignment would be that (i) P would recognize the entire consideration it received as an ordinary income substitute for future income and would not be allowed to offset that income with any portion of its basis in its assets; (ii) in the future C (and not P) would recognize income with respect to the 10% of its income P had sold; and (iii) C would have a basis of 10 in its purchased right to receive 10% of P's income and, if it could demonstrate that the intangible right had a reasonably determinable life, would be able to amortize its basis of 10 over that life.[25] Thus, P would have 10 of ordinary

---

23. 356 U.S. 260 (1958).

24. 472 F.2d 867 (6th Cir. 1973).

25. The classic article on assignment of income is Charles S. Lyon & James S. Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case, 17 Tax L. Rev. 293 (1962). There is little authority as to how C should recover its basis in its profits interest. The most likely result is that C should amortize the basis over the expected life of the profits interest. See McKee et al., supra note 4, Supp. ¶ 5.08A[3]. Because an income interest often does not have a determinable useful life, this result may require C to recognize income without basis offset until it realizes a capital loss on P's liquidation. It might appear fair to allow C basis recovery under an open transaction analysis on the theory that C's payment has accelerated P's income recognition so that C should receive 10 of tax-free "pre-taxed" income. Castleberry, supra note 4, at 282, provides an ingenious justification of that approach based on Associated Patentees v. Commissioner, 4 T.C. 979 (1945). However, there seems to be no authority for that approach. Even when the open transaction doctrine was in greater favor,

income on that sale which it would allocate 5 each to A and B, increasing each of their capital account balances to 105. C would not have a capital account in P and would have a basis of 10 in its right to receive 10% of P's income.

This solution solves the partnership accounting problems most simply and there is authority that the holder of a profits interests should not be treated as a partner.[26] That authority, however, is highly fact specific and arises primarily out of atypical, tax-motivated transactions.[27]

While it may be appropriate to treat the holder of a profits interest as not being a partner in some circumstances, that cannot be correct as a general rule. A partner is a person that has "in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[28] A holder of a profits interest may have manifested that intent: It might be recognized as a partner under state law, hold itself out as a partner to others and be a general partner liable for its share of partnership liabilities. It would typically file tax returns as a partner. In addition, the holder would have contributed capital used in the partnership's business (though it would have abandoned its claim to that capital) and would be vitally concerned with the partnership's profitability.

Any rule that a holder of a profits interest is never a partner also creates major administrative difficulties. In the typical partnership, all profits are not automatically distributed to the partners. If any profits are retained, the holder of a profits interest will accumulate a capital account. Does that holder immediately become a partner on its obtaining a capital account, or must the capital account reach some minimum, non-de minimis level? Based on the Internal Revenue Service's ruling guidelines, a capital account equal to 1% of all partners' capital accounts would, at least in the case of a general

---

profits interests were required to be amortized over their estimated life. Latendresse v. Commissioner, 26 T.C. 318 (1956), aff'd, 243 F.2d 577 (7th Cir. 1957). More recently, the Service has attempted to limit the open transaction doctrine to "rare and extraordinary cases." Regs. § 15A.453-1(d)(2)(iii).

26. See McKee et al., supra note 4, ¶ 3.02[5] and authorities cited therein; Willis et al., supra note 4, § 3.04.

27. Typical transactions involve either attempts to shift income within a family, Poggetto v. Commissioner, 306 F.2d 76 (9th Cir. 1962), or between a shareholder and his corporation, Merryman v. Commissioner, T.C. Memo 1988-72 (CCH) 1988, or attempts by the Commissioner or a taxpayer to recharacterize transactions initially characterized in a different fashion, Luna v. Commissioner, 42 T.C. 1067 (1964) (assertion that agreement formed a partnership characterized by the Court as an "afterthought") and Connelly v. Commissioner, 46 B.T.A. 222 (1942), acq., 1942-1 C.B. 4 (attempt by Commissioner to recharacterize contractual rights).

28. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

partner, be sufficiently large to guarantee partner status.[29] Major changes in tax result should not follow from relatively small changes in economic substance. This "cliff" effect can be avoided by treating C as a partner solely to the extent of its capital interest and as a holder of an assigned income interest as to the remainder of its interest. However, this approach is impractical. It would change (and substantially complicate) the anticipated tax treatment of numerous general partners that have a 1% capital investment, and "overrides" in the form of substantial profits interests.

The second way of justifying the shift of C's capital to A and B under an entity theory would be to view C as receiving an initial capital account of 10 and then transferring its capital to A and B in a taxable transaction that requires A and B to recognize income of 5 and C to recognize a loss of 10. A's and B's income would give each a capital account balance of 105 and C's loss would give C a capital account balance of zero.

This solution is simple and straightforward. There is also probably general agreement that A and B deserve their income recognition. C, however, is being permitted to expense the cost of purchasing an asset with a life that may substantially exceed one year. Nonetheless, permitting that deduction is consistent with the traditional capital account analysis. Any partnership with significant net losses could achieve substantially the same result by giving C an initial capital account of 10 and having the partnership agreement provide that C is allocated the first 10 of net losses and A and B are allocated the first 5 of net profits each. These allocations would almost certainly be respected and would, indeed, be mandated under the section 704(b) regulations, if C subordinated the return of its capital to A's and B's return of their capital.[30] If P were not projected to have significant net losses, the same result could be achieved in most, if not all, cases by giving C its capital account balance and allocating C the first 10 of items of deduction.

2. *Aggregate Analysis.*—The aggregate analysis yields another less than totally satisfying option for dealing with the receipt of a profits interest for cash. C may be treated as purchasing a nonpartnership profits interest from P and recontributing that profits interest to P for a partnership profits interest. P would have income of 10 on the sale of that profits interest and would allocate that income equally to each of A and B, providing each with

29. Rev. Proc. 89-12, 1989-1 C.B. 789 (stating that the Service will generally recognize a general partner with a 1% partnership interest as a partner).

30. The transaction could be bifurcated into C's receipt of a 5% capital interest for 10 and its receipt of a 5% profits interest as a fee for subordinating its capital to A's and B's capital and allocating the first 10 of net profits to A and B. Such a bifurcation analysis would make the tax treatment of any but the simplest partnerships incomprehensible.

capital account balances of 105. C's contributed profits interest would be treated, for purposes of maintaining capital accounts and Regulations section 1.704-1(b)(2)(iv)(*b*), as having a fair market value equal to its liquidation value of 0 (and a basis of 10).[31] In that event, P's balance sheet immediately after the contribution would be as follows:

Asset	Book	Tax	Partner	Book	Tax
Asset	200	200	A	105	105
Prof. Int.	0	10	B	105	105
Cash	10	10	C	0	10
Total	210	220		210	220

C would have contributed an asset with built-in loss, i.e., one whose basis exceeded its fair market value. Under section 704(c), all amortization attributable to the asset would be allocated solely to C. C would thus be allocated 10% of P's income and would be allowed to offset against that allocation whatever amortization of its profits interest was appropriate.[32]

This characterization produces the same correct tax results as the first entity option discussed above, but without the complications of not permitting C to be a partner. It has two related disadvantages—its treatment of fair market value is artificial and the combined tax bases of the Asset and profits interest, exceeds the combined value of the Asset and profits interest, raising the issue of whether the excess is properly depreciable.[33]

3. *Choice of Characterization.*—Assuming that C is treated as a partner, the major difference between the entity and aggregate approach is whether C is allowed an immediate deduction for the cost of its profits interest or is required to amortize that interest over some appropriate life. Both alternatives pose difficulties. The first requires stretching the capitalization rules to give C an immediate deduction; the second requires stretching the meaning of fair market value to treat an asset acquired for 10 as worth

31. Treating fair market value as determined solely by liquidation value, while economically wrong, is implicit in both the test for substantial economic effect in the § 704(b) Regulations and in the determination of responsibility for recourse debt under § 752. It is one example of the difficulties created by the capital account system not taking into account present value of money concepts.

32. The same results would follow if C were viewed as acquiring a 5% profits interest in the Asset from A and B in exchange for 5 each. A and B would each recognize income of 5 and would be treated as each contributing 5 of cash to P. C would be treated as contributing its purchased profits interest.

33. See, e.g., Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988); Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).

0. While the second view is more conservative and more likely to be adopted by the Internal Revenue Service, the first is at least as tenable.

IV. SERVICES AS CONSIDERATION FOR PARTNERSHIP SECURITIES

A. *The Receipt of a Capital Interest for Services*

> After P's Asset has appreciated to 400, C receives a 10% capital interest in P for services.

There is a general consensus that receipt of a capital interest for services should be subject to an aggregate analysis.[34] Because of that consensus, the aggregate analysis will be considered first.

1. *Aggregate Analysis.*—Under section 83, C must recognize ordinary income and, subject to the capitalization rules, P is entitled to a deduction.[35] In addition, P is deemed to distribute an undivided 10% interest in the Asset to C in exchange for C's services and C is deemed to recontribute that 10% interest in exchange for a partnership interest. While it is often assumed that the value to be assigned the 10% interest for purposes of maintaining book capital accounts is 40,[36] that amount does not appear correct if C's services must be capitalized. In that case, the value of P's Asset should be increased by the value of the services. If C is to have a 10% interest in the Asset as enhanced by its services, P's Asset must be worth 444.44 and C's 10% interest must be worth 44.44.[37]

---

34. McKee et al., supra note 4, ¶ 5.08[2]; Willis et al., supra note 4, §§ 45.08-.09; 1 J. Bonn, Taxation of Partnerships § 4:63 (1987); Proposal by Individual Members of Committee on Partnerships of Section of Taxation of American Bar Association to Amend the Regulations Under the Internal Revenue Code of 1986 to Define a Partnership Interest, and to Clarify the Tax Treatment of Compensatory Transfers of Both Forms of Partnership Interests, 87 Tax Notes Today 91-24 (May 11, 1987).

35. Regs. § 1.83-6(a)(1).

36. See McKee et al., supra note 4, ¶ 5.08[2][b], ex. 8.

37. C would be required to contribute 44.44 of cash to receive a 10% interest in a partnership with assets of 400 (10% = 44.44/444.44). That amount would be unchanged if P then used C's cash to purchase services that had to be capitalized from a third party. The amount should remain unchanged if C, instead of providing cash to pay for the services, provides the services. It also should not matter whether the asset created by C's services is a tangible asset, an intangible asset (such as syndication costs), or whether C will perform its services in the future (in which case the created asset is prepaid services). Note that the issue here is not whether C's services are "really" worth 40 or 44.44 in some abstract sense, but the amount to be assigned C's services for book capital account purposes so that P's books are logically consistent. That amount is related to "real" value because of the rule that a partner's opening capital account balance should reflect the value of the partner's contribution to the

If C performs services with a value of 44.44 and is paid with a 10% interest in the Asset, which it contributes to P, (a) the Asset's value is increased by 44.44 to 444.44 and the tax basis of the Asset is increased by 44.44 (P's section 83 deduction, which it was required to capitalize) to 244.44; (b) C has ordinary income of 44.44; and (c) P has gain of 20 (amount realized of 44.44 less allocable basis of 24.44[38]) on satisfying its liability with appreciated property, which it allocates 10 each to A and B. This increases their book and tax capital account balances and the bases of their P interests to 110. C, which holds its 10% interest with a book and tax basis of 44.44, is then treated as contributing the 10% interest in the Asset to P. After the contribution, P's total basis in the Asset is 264.44 (initial basis of 200, asset created by services of 44.44 and step-up of 20 corresponding to the gain recognized by B and C). P's balance sheet, after the Regulations section 1.704-1(b)(2)(iv)(*f*) revaluation (permitted because of C's deemed contribution to P) is:

Asset	Book	Tax	Partner	Book	Tax
Asset	444.44	264.44	A	200	110
			B	200	110
			C	44.44	44.44
Total	444.44	264.44		444.44	264.44

Under section 704(c) principles, P's annual depreciation of 26.44 is allocable 4.44 to C and 11 each to A and B.[39]

If payment for C's services can be deducted currently, the simplest approach is to view the services as momentarily increasing the value and tax basis of the Asset, with that increase being immediately offset by a deduction.

---

partnership and because P's continuing partners have implicitly valued C's services in agreeing to the percentage interest in P to which C is entitled.

38. If the value of the distributed 10% interest is 44.44, the interest must be the post-services interest, so that its basis is the post-services basis of 24.44.

39. The result is the same if the aggregate approach is applied to A and B, though the path is somewhat more tortuous. C is treated as transferring a 45% interest in its services (worth 20) to A and B in exchange for a 10% interest in their 45% share of the Asset (also worth 20, taking into account the asset's enhancement by C's services). A and B would each recognize 10 of gain. A and B would then each be deemed to hold an interest in C's services with a basis of 20 and to contribute C's services to P (with A and B thus increasing the bases of their partnership interest by 10 and P increasing the basis of its assets by a total of 20). C would be deemed to contribute its newly acquired 10% interest in the Asset together with a 10% interest in its services for a 10% interest in P. C's contribution of 10% of its services should be viewed under the entity approach, with C being allocated 4.44 of income and receiving a 4.44 basis in its services and P holding the services with the same 4.44 basis. After these contributions, P would have a total basis of 264.44 in the Asset.

In that case, the analysis immediately above would be applicable, except that P would be entitled to a 44.44 deduction, which it would allocate 45% each to A and B and 10% to C. This would result in the following P balance sheet:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	220	A	180	90
			B	180	90
			C	40	40
Total	400	220		400	220[40]

This analysis probably produces the same balance sheet as the more traditional analysis in which the value of C's services is treated as being 40, C recognizes 40 of income, and P realizes a deduction that it allocates solely to A and B.[41]

---

40. The transaction is analogous to a transaction, using a circular flow of cash, consisting of the following steps:

(i) The Asset initially has a value of 400 and a basis of 200; A and B have capital account balances and bases in their P partnership interests of 100.

(ii) C performs services worth 44.44 for a promise to be paid 44.44 of cash. The Asset's value increases to 444.44 and its tax and book basis increases to 244.44. There is no change to A's and B's capital account balances and bases in their P interests.

(iii) C purchases a 10% interest in the Asset for 44.44 cash. P owns 90% of the Asset with a value of 400 and a basis of 220 and 44.44 of cash. P recognizes 20 of tax and book gain on the sale, which it allocates 10 each to A and B. A's and B's capital account balances and their bases in their P interests are increased to 110.

(iv) P pays C for its services with the 44.44 of cash.

(v) C contributes its 10% of the Asset (with a value and basis of 44.44) to P for a 10% interest. P owns 100% of the Asset with a value of 444.44 and a basis of 264.44. C has a capital account balance and a basis in its P interest of 44.44. P revalues its pre-contribution property, its 90% interest in the Asset. That 90% interest has a value of 400 (90% of 444.44) and a book basis of 220 (90% of 244.44) so that P has 180 of unrealized gain on a deemed sale, which, if realized, would be allocated 90 each to A and B. Under Regs. § 1.704-1(b)(2)(iv)(*f*)(2), A's and B's book capital account balances are increased to 200. Their tax capital account balances remain 110.

(vi) P is allowed a deduction of 44.44, which it allocates 4.44 to C and 20 each to A and B. C's capital account balance and its basis in its P interest are reduced to 40. A's and B's book capital account balances are reduced to 180 and the bases of their P interests and their tax capital account balances are reduced to 90.

41. While the P balance sheets may be identical, the tax effect to C may not be. Under the analysis in the text, C has 44.44 of compensation income and a deduction of 4.44; under the traditional analysis, C has 40 of compensation income. The results would differ if, for example, C's deduction were treated as a passive loss.

2. *Entity Analysis.*—Section 83 would also apply under an entity analysis, but C's receipt of a 10% capital interest would be accounted for solely by C's recognition of income and P's corresponding recognition of a deduction, and A and B would not be required to recognize income.

For the entity analysis to be tenable, C's services must be viewed, if they are not currently deductible, as increasing the value of the Asset to 444.44 and the Asset's tax basis to 244.44. P, having paid C for services (which C has taken into income), should be entitled to a cost basis in the services. If C had contributed cash and P bought capitalizable services from a third party, P would be entitled to the additional basis. Similarly, if C had received the property created by its services in exchange for services performed for a third party and contributed the property to P, C and P would have tax basis in the property. By contrast, if C had performed services on its own behalf, created property and contributed the property, C, and consequently, P, would have a zero basis in the property, but C would not have any income.[42]

C's performance of services in exchange for a capital interest should be treated as a contribution of the services, permitting a revaluation under Regulations section 1.704-1(b)(2)(iv)(*f*) and triggering the applicability of section 704(c). If P's payment for C's services is capitalized, P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	444.44	244.44	A	200	100
			B	200	100
			C	44.44	44.44
Total	444.44	244.44		444.44	244.44

Under section 704(c) principles, P's annual depreciation of 24.44 is allocable 4.44 to C and 10 each to A and B.

If P is entitled to deduct its payment to C for services, the deduction should be allocated 10% to C and 45% to each of A and B. P's balance sheet would be:

42. Thus, if C had a contract right that had risen to the level of property, IRC § 721 would apply to protect C from income or gain. See Stafford v. United States, 435 F. Supp. 1036 (M.D. Ga. 1977), rev'd and remanded, 611 F.2d 990 (5th Cir. 1980), modified, 552 F. Supp. 311 (M.D. Ga. 1982), rev'd and remanded, 727 F.2d 1043 (11th Cir. 1984). However, P and C would have a zero basis in the contract right.

Asset	Book	Tax	Partner	Book	Tax
Asset	400	200	A	180	80
			B	180	80
			C	40	40
Total	400	200		400	200

Under section 704(c) principles, P's annual depreciation of 20 is allocable 4 to C and 8 each to A and B.

3. *Choice of Characterization.*—The entity approach has merit: It is simple, its results are consistent with the effect of a partner acquiring an interest for a cash contribution that the partnership uses to purchase services or of a stockholder acquiring stock for services, and the statutory requirement of section 83 that the service provider recognize ordinary income and the service recipient be allowed a deduction is met.

The principal justification[43] for adopting the aggregate approach is that it causes P (or A and B) to recognize gain as a result of its transfer of property to C as mandated by Regulations section 1.83-6(b):

> Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. In addition, at the time a deduction is allowed under section 83(h) and paragraph (a) of this section, gain or loss is recognized to the extent of the difference between (i) the sum of the amount paid plus the amount allowed as a deduction under section 83(h) and (ii) the sum of the taxpayer's basis in the property plus any amount recognized pursuant to the previous sentence.

The Regulations' reference to section 1032 explicitly exempts a corporation's issuances of its own stock for services from gain recognition. The lack of any reference to partnership provisions can be read as intentionally requiring partnerships to recognize gain.[44]

---

43. The arguments for the aggregate approach discussed here are summarized in McKee et al., supra note 4, ¶ 5.08[2][b].

44. One cannot assume that the explicit reference to § 1032 requires that a transferor recognize gain in any transaction that does not literally satisfy § 1032. If a subsidiary issues parent stock for services, under Regs. § 1.83-6(d), the parent is viewed as contributing its stock to the subsidiary and the subsidiary as transferring the stock to its employee. The subsidiary arguably has a zero basis in its parent stock and the transfer by the subsidiary of parent stock

As a practical matter, the consensus that Regulations section 1.83-6(b) requires a partnership transferring a capital interest for services to recognize gain (as it does under an aggregate approach) means that adopting an entity approach raises a substantial risk of Internal Revenue Service challenge. However, it is not clear that the regulation actually requires gain recognition. The regulation applies to an actual transfer of appreciated property for services. In the case of deemed transfers, the regulation is silent as to what property should be deemed transferred. Under the most literal reading, in the case of the transfer of a capital interest for services, the property transferred by the partnership is a partnership interest. By analogy to the treatment of corporate stock, it can be argued that a partnership has a zero basis in its own interest. The partnership should then be required to recognize gain equal to the total value of the services. That reading seems unusually harsh and leaves unclear how the partnership's gain should be reflected in the bases of the partnership's assets.[45] If the literal reading is abandoned, it seems as reasonable to view a partnership as transferring cash for services as to view it as transferring an interest in some or all of its assets. A partnership viewed as transferring cash would not need to recognize gain. P, A and B would not recognize gain if P borrowed money to pay service provider C and then repaid its borrowing by obtaining a cash contribution from unrelated new partner D. P, A and B are in the identical economic situation if C and D are the same person and a circular flow of cash is avoided.

Other arguments advanced for A and B recognizing gain are also not determinative. The statement in Regulations section 1.721-1(b)(1) that section 721 does not apply to the extent "any of the partners gives up any part of his right to be repaid his contributions . . . in favor of another partner as compensation for services" can be read to require no more than that the service provider be taxable on its receipt of a partnership interest. Indeed, the next sentence in the regulation explicitly states that the value of the interest transferred as compensation is income under section 61.[46]

Regulations section 1.721-1(b)(2) provides that to the extent the value of a partnership interest is compensation for services, the payment is to be

---

does not come under section 1032. Under a literal reading of Regs. § 1.83-6(b), the subsidiary should recognize gain. However, without discussion, the Service ruled that "[b]ecause section 83 applies to the transfer of the P [parent] stock to B [service provider], S [the subsidiary] does not recognize gain or loss on the transfer of the P stock." Rev. Rul. 80-76, 1980-1 C.B. 15.

45. See McKee et al., supra note 4, ¶ 5.01-.10 (causing P to recognize gain measured by the value of the partnership interest transferred to the service provider would cause a discrepancy between the partners' outside bases and the bases of the assets in the partnership). See also 1 William S. McKee et al., Federal Taxation of Partnerships and Partners ¶ 5.03[1][c] (1st ed. 1977).

46. Regs. § 1.721-1(b)(1).

treated as a guaranteed payment for services under section 707(c). While it is generally true that the transfer by a partnership of appreciated property in satisfaction of a guaranteed payment would cause the partnership to recognize gain, that truism begs the question of what property is to be deemed transferred as compensation for services.

Finally, it has been argued that a partnership's failure to recognize gain on a transfer of a capital interest for services would leave the partnership with inadequate basis in its assets and would expose the service recipient to double taxation on the value of its services. Under the entity theory, the service recipient is in the same position as a person that has contributed cash to a partnership holding appreciated assets in exchange for a partnership interest and is equally eligible for the relief granted by section 704(c) principles. While the adequacy of that relief has historically been limited by the "ceiling rule," that limitation has been alleviated by Proposed Regulations section 1.704-3. In any event, there is no need for being more solicitous of the ongoing taxation of a person that recognizes income on becoming a partner in exchange for service than of a person that becomes a partner upon making a cash contribution, one that presumably is made with after-tax dollars.

B. *The Receipt of a Partnership Option for Services*

> C, in exchange for services, receives an option entitling C to acquire a 10% partnership interest for 25. C exercises that option in two years, when the Asset has appreciated to 400.

Assuming, as is generally true, that a P option does not have a readily ascertainable value within the meaning of Regulations section 1.83-7(b), P's grant of an option to C has no tax effect to any of P, C, A or B. The effect of exercising the option depends on whether an aggregate or entity analysis rule is adopted. The consensus would be to adopt an entity view of C's acquisition of an interest for a 25 cash contribution and an aggregate view of the compensatory portion of the acquisition.[47]

1. *Consensus View—Hybrid Analysis.*—On C's exercise of its option, C recognizes ordinary income equal to the excess of the value of the interest received over its purchase price for the interest and, subject to the capitalization rules, P has a corresponding deduction.[48] Assuming that the value of C's services has been included in the Asset's appreciation to 400, the Asset's

47. McKee et al., supra note 4, ¶ 5.08[2][b].
48. Regs. § 1.83-7(a).

pre-services value was 382.5. After the services are taken into account, P has assets of 425 and C's interest has a value of 42.5.[49] Thus C's income and P's deduction each equal 17.50.

C is deemed to receive 25/42.5 of its interest for cash in a tax-free transaction and to receive 17.5/42.5 of its interest for services in a transaction in which P is to recognize gain. The portion of C's interest in P attributable to services (17.5/42.5 x 10% = 4.12%) represents a 4.12% interest in the Asset and a 4.12% interest in P's cash of 25. C is deemed to have had distributed to it a 4.12% interest in the Asset with a fair market value of 16.47 and a basis to P, taking into account the 17.50 increase in basis resulting from C's services,[50] of 8.96. P recognizes 7.5 of gain, half of which is allocable to each of A and B. C is deemed to contribute its 4.12% of the Asset (with a basis and value of 16.47) to P. That contribution increases P's basis in the asset to 225. P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	225	A	191.25	103.75
Cash	25	25	B	191.25	103.75
			C	42.5	42.5
Total	425	250		425	250

Under section 704(c) principles, P's annual depreciation of 22.5 is allocable 4 to C and 9.25 each to A and B.

If P can deduct the value of C's services and the Asset is to have a value of 400 after the deduction, the Asset can be viewed as being initially worth 400 (not 382.5), having its book value increased by C's service and then decreased by the deduction. In that case, P's total assets (prior to taking account the deductibility of C's services) have a value of 444.44, C's 10% interest has a value of 44.44, C's services have a value of 19.44 and the Asset has a value of 419.44 and a basis of 219.44. C has acquired 25/44.44 of its interest for its cash contribution and 19.44/44.44 (43.74%) of its interest for services. Thus C has acquired 4.37% of the Asset, with a value of 18.35

49. This assumption, which is economically realistic because C's services have taken place in the past, makes this example not strictly comparable to the examples above in which the initial value of the Asset is 400. If the initial value of the asset is 400 and C's capitalized services increase its value, P would have total assets of 444.44, an Asset of 419.44, and cash of 25, and C's services would be worth 19.44.

50. Although there is no reason to believe that C's services resulted in precisely a 17.50 increase in the value of the Asset, P implicitly bought C's services at a contingent price that varies with the value of a 10% interest in P at the time of C's exercise of its option. To the extent the services created a capital asset, its basis to P should be its cost to P.

and a basis to P of 9.6. P has gain of 8.75, which it allocates equally to A and B. P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	419.44	228.19	A	200	104.375
Cash	25	25	B	200	104.375
			C	44.44	44.44
Total	444.44	253.19		444.44	253.19

After deducting the 19.44 value of C's services, the balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	208.75	A	191.25	95.625
Cash	25	25	B	191.25	95.625
			C	42.5	42.5
Total	425	233.75		425	233.75

Under section 704(c) principles, P's annual depreciation of 20.875 is allocable 4 to C and 8.4375 each to A and B.

P's balance sheet differs somewhat from the balance sheet that would result under the traditional analysis in which C's services have a value of 17.5, C recognizes 17.5 of income and P has a deduction of 17.5 that is allocable solely to A and B. Under that analysis, the percentage of its interest that C acquired for services would differ, i.e., it would be 17.5/217.5 or 4.12%, and that difference would cause the gain recognized by A and B to also differ.

2. *Entity Analysis.*—If P must capitalize its payment to C for services and if the post-services value of the Asset is 400, the pre-services value of the Asset must be 382.5. On C's exercise of its option, C recognizes ordinary income of 17.5 and P increases the basis of the Asset to 217.5. P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	217.5	A	191.25	100
Cash	25	25	B	191.25	100
			C	42.5	42.5
Total	425	242.5		425	242.5

Under section 704(c) principles, P's annual depreciation of 21.75 is allocable 4 to C and 8.875 to each of A and B.

If P deducts its payment to C for services and if the post-deduction value of the Asset is 400, the pre-deduction value of the Asset must have

been 419.44. P's balance sheet, not taking into account the 19.44 deduction, would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	419.44	219.44	A	200	100
Cash	25	25	B	200	100
			C	44.44	44.44
Total	444.44	244.44		444.44	244.44

The 19.44 deduction should be allocated 10% to C and 45% each to A and B. P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	400	200	A	191.25	91.25
Cash	25	25	B	191.25	91.25
			C	42.5	42.5
Total	425	225		425	225

Under section 704(c) principles, P's annual depreciation of 20 is allocable 4 to C and 8 to each of A and B.[51]

3. *Choice of Characterization.*—The principal difference between the hybrid and the entity characterization is whether P (or B and C) is to be deemed to recognize income on P's payment for C's services. These issues are discussed in Part III.B.3. and Part IV.A.3. above. It is sufficient to note here that the analysis of the entity characterization is substantially more straightforward.

C. *The Receipt of a Profits Interest for Services*

> C receives a 10% profits interest, with a fair market value of 10, for services.

1. *Revenue Procedure 93-27.*—The treatment of the receipt of a profits interest for services has been substantially simplified by the Internal Revenue Service's issuance of Revenue Procedure 93-27, which provides that

> if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner

51. Because the aggregate analysis is unlikely to be applied to C's purchase of a portion of its interest for a contribution of 25, that possibility is not discussed.

> capacity or in anticipation of becoming a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.[52]

If the Revenue Procedure applies, a service partner's receipt of a profits interest is not a taxable event to the partner or the partnership. The Revenue Procedure is subject to two implicit and three explicit exceptions, which if interpreted broadly would reintroduce the uncertainties the Revenue Procedure was intended to cure.

First, the partner receiving a profits interest must provide service in "a partner capacity or in anticipation of becoming a partner."[53] This requirement will often be straightforward, but may cause difficulties. For example, a developer, investment banker or other employer may give key employees profit interests in partnerships in which the employer is a partner and for which the key employees perform services. It would be artificial to require that the employees enter into separate service agreements with the partnerships and administratively difficult to monitor the precise amount of work the employee performs on behalf of any specific partnership. Alternatively, an individual service provider may act as a general partner through an S corporation and hold her profits interests directly or, for estate planning reasons, have some of the profits interests held by members of her family. The Internal Revenue Service could (but probably should not) insist that the S corporation is the only service provider and that either (i) all affiliated holders of profits interests should be taxable on receipt of their interests or (ii) the S corporation received all the profits interests and distributed them to its stockholder and her family in a dividend that triggered gain under section 311.

Second, the profits interest must qualify as such. A profits interest is defined as a partnership interest other than a capital interest.[54] A capital interest is an interest that would give the holder a share of proceeds if the partnership's assets were sold at their fair market value and the proceeds distributed in a complete liquidation of the partnership.[55] That definition can be interpreted to cause a cliff effect. If the partners agree that the service partner is to receive a share of asset appreciation in excess of a fixed amount intended to represent the asset's current value, but their estimate of current value is deemed by the Internal Revenue Service or a court to be one dollar too low, the service partner would be entitled to a share of the one dollar on an immediate liquidation of the partnership. The entire value of the interest

---

52. 1993-24 I.R.B. 63 (July 6) at § 4.01.
53. Id. § 4.01-.02.
54. Id. § 2.02.
55. Id. § 2.01.

would then, arguably, be includable in its income. It would be better to interpret the rule by bifurcating the service provider's interest into that capital interest that would be owned by a person entitled to the same liquidating distribution as the service holder and to treat the remaining interest as a profits interest.

The Revenue Procedure does not state whether the valuation of the partnership assets should take into account the increase in their value attributable to the services being rendered by the recipient of the profits interest. Thus, it is not clear whether a profits interest granted upon the formation of a partnership entitling a service partner to a portion of the partnership's capital after the other partners have been returned their capital qualifies under the Revenue Procedure if the partner's services are not immediately deductible. The practical approach would be to ignore the effect of the services on value and to allow the service partner to share in the appreciation that its own services creates.

Third, the Revenue Procedure does not apply if "the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease."[56] That exclusion is probably based on the theory that a predictable stream of income alleviates valuation problems. It is not clear whether the exclusion is intended to apply if, as is common, a portion of the income stream is predictable. For example, a partnership may own debt securities of varying quality that have an average yield of 9% and in which the general partner is entitled to 20% of the profits after all partners have received a return on capital of 7%. The 7% return may be a market return which is less than the 9% return on individual loans because the partnership's having assembled a diversified portfolio of loans has reduced credit risk. The general partner expects that most of his 20% return will reflect his (unpredictable) skill in trading the securities, but he has also "locked in" a share of the 2% strip. The exclusion should not apply in this situation.

Fourth, the Revenue Procedure does not apply if "within two years of receipt, the partner disposes of the profits interest."[57] This exclusion is probably based on the facts of Diamond v. Commissioner,[58] and prevents the use of the partnership form to transform ordinary income into capital gains. Because the reclassification of the receipt of a profits interest as a taxable event may cause a partnership and nonrecipient partners to recognize gain, this exclusion raises the administrative problem of the action of the service recipient having consequences to unrelated parties. Rather than

---

56. Id. § 4.02.
57. Id. § 4.02(2).
58. 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).

recharacterizing the transaction in which the service partner received its interest, it would be simpler to provide that any gain realized by the recipient on its sale of a partnership interest within two years is ordinary income.

Finally, the Revenue Procedure does not apply if the interest received is "a limited partnership interest in a 'publicly traded partnership'"[59] within the meaning of section 7704(b). This exclusion may be based on the theory that interests in publicly traded partnerships are readily valued and easily traded. If so, the exclusion should be limited to publicly traded interests in publicly traded partnerships. The publicly traded interests would generally be capital interests. In Campbell v. Commissioner,[60] the Eighth Circuit held that the receipt of a profits interest in a partnership was not taxable in large part because that interest was not readily susceptible to valuation even though there were arm's length transactions that established the value of a capital interest in that partnership.

2. *General Principles—Consensus Aggregate View.*—If the Revenue Procedure does not apply, the tax consequences of a partner's receipt of a profits interest for services must be determined under general principles. Though the Revenue Procedure may create a negative implication that any receipt of a profits interests excluded from the application of the Revenue Procedure is taxable, it can be argued with equal plausibility that the Internal Revenue Service simply did not reach those situations. Thus, all the customary arguments for the receipt of a profits interest not being taxable remain available.[61]

The consensus is that the aggregate analysis should apply.[62] Under that analysis, assuming C is treated as a partner for the reasons discussed above under Part III.B.1.,[63] section 83 applies to C's receipt of a profits interest for services. C would have 10 of income and P would have a corresponding deduction, subject to capitalization. In addition, P would be treated as distributing a profits interest in the Asset to C in payment for C's services and C would be viewed as contributing that profits interest to P for a partnership profits interest. P would have 10 of income on it sale of its profits interest, which it would allocate 5 each to A and B.[64]

---

59. Rev. Proc. 93-27, 1993-24 I.R.B. 63 (July 6) at § 4.02(3).

60. 943 F.2d 815 (8th Cir. 1991).

61. The arguments for exemption are summarized in Hortenstine & Ford, supra note 4, at 899-900, McKee et al., supra note 4, Supp. ¶ 5.02[1][c] and Willis et al., supra note 4, § 46.03-.04.

62. See Horntenstine & Ford, supra note 4, at 899-900; McKee et al., supra note 4, Supp. ¶ 5.02[1][c]; Willis et al., supra note 4, ¶ 46.03-.04.

63. If C's interest is not vested, assume that C has made a § 83(b) election.

64. McKee et al., supra note 4, Supp. ¶ 5.08A[2], ex. 8.2.

If C's services are not currently deductible, P's assets would have an increased total fair market value (and book basis) of 210. While economically, the Asset stripped of the profits interest has a value of 200 and the profits interest has a value of 10, on a liquidation basis, the Asset has a value of 210 and the profits interest a value of 0.[65] P's balance sheet would be:

Asset	Book	Tax	Partner	Book	Tax
Asset	210	210	A	105	105
Prof. Int.	0	10	B	105	105
			C	0	10
Total	210	220		210	220

Under section 704(c) principles, C would be entitled to amortize the profits interest over its life and A and B would be entitled to all the depreciation on the Asset. In summary, under the aggregate analysis, if P could not currently deduct its payment to C, each of A, B, and C would recognize gain or income, with C's income being offset by its amortization of its profits interest and A's and B's gain being offset by additional depreciation deductions attributable to the Asset.

If P can currently deduct its payment to C, that deduction would reduce the book and tax basis of the Asset and should, therefore, be allocated solely to A and B, offsetting their income recognition. P's balance sheet would be as follows:

Asset	Book	Tax	Partner	Book	Tax
Asset	200	200	A	100	100
Prof. Int.	0	10	B	100	100
			C	0	10
Total	200	210		200	210

3. *General Principles—Entity Analysis.*—Under the entity analysis, section 83 applies to C's receipt of a profits interest in P, with C recognizing income of 10 and P being entitled to a corresponding deduction, subject to capitalization. If C's services are capitalized, these services increase the Asset's value and basis by 10. On a sale of the Asset for its 210 value, A and

65. This analysis assumes that C does not share in the increase of value caused by C's services. In practice, the increase in value attributable to C's services may not be considered in the partners' definition of the point at which C begins to participate in profits, so that C effectively does share in the appreciation attributable to its services. In that case, on a sale of the Asset for 210, A and B should each be entitled to 104.5 and C to 1; the Asset should have a book basis of 109 and the profits interest a book basis of 1.

B would each be entitled to 105 and C would be entitled to 0. Thus, A and B should have book capital account balances of 105.

The increase in A's and B's capital account balances can be treated in a manner analogous to the treatment of C's acquisition of a profits interest for cash in Part III.C.1. C can be viewed as contributing services with a value and a basis of 10, receiving a positive capital account balance of 10 and then transferring that positive capital account balance to A and B in a taxable transaction in which A and B recognize income and C is entitled to a loss. On that analysis, P's balance sheet, before taking into account P's deduction for its payment for C's services, is:

Asset	Book	Tax	Partner	Book	Tax
Asset	210	210	A	105	105
			B	105	105
			C	0	0
Total	210	210		210	210

C's deduction would offset its section 83 income of 10. Under section 704(c) principles, all depreciation attributable to the Asset would be allocated solely to A and B. This result is somewhat anomalous in that the net effect of treating C's receipt of a profits interest as taxable is to tax not C but A and B. Taxing A and B, however, reflects the increase in their book capital accounts caused by C's services.[66]

If P can deduct its payment to C currently, the deduction should be allocated to A and B, the only persons with positive capital account balances. The resulting P balance sheet would be:

66. An alternate method of accounting for A's and B's increased book bases is to treat C as having contributed services with a book value, based on liquidation value, of 0 and a tax basis of 10. That contribution entitles P to revalue its assets. On the revaluation, A and B are allocated the Asset's unrealized appreciation. That allocation is not a taxable event, so that A's and B's tax bases are not affected. P's balance sheet would then be:

Asset	Book	Tax	Partner	Book	Tax
Asset	210	200	A	105	100
Services	0	10	B	105	100
			C	0	10
Total	210	210		210	210

Under § 704(c) principles, deductions attributable to the amortization of the tax basis of the services would be allocated to C. If the services enhanced the Asset, it would be reasonable to amortize the basis of the services over the Asset's depreciation schedule. This is artificial, but defers any tax to A and B.

Asset	Book	Tax	Partner	Book	Tax
Asset	200	200	A	100	100
			B	100	100
			C	0	0
Total	200	200		200	200

The result is identical to treating P's transfer of a profits interest to C as not being a taxable event—none of A, B, C or P has income recognition.[67]

4. *Choice of Characterization.*—The issues in choosing between an entity or aggregate analysis are essentially similar to those discussed in Part III.C. above. If C's services must be capitalized, although neither an entity or an aggregate analysis is totally satisfactory, the two analyses are equally tenable. If C's services may be deducted, an entity analysis has the advantage of being equivalent to treating C's receipt of a partnership interest as not being a taxable event, the result that applies under Revenue Procedure 93-27.

V. CONCLUSION

The consequences of issuing partnership securities are less clear and less well understood than the consequences of issuing corporate securities. The discussion above amply demonstrates that these issuances are open to multiple interpretations with substantially different results. The lack of clarity as to the effects of issuing partnership securities is especially troubling because issuance of these securities may create adverse tax consequences to both the recipient and the other partners. The possibility of triggering untoward tax results may impede reasonably straightforward business transactions. Authoritative advice would be helpful, whatever the substantive content of that advice. There is no advantage to the Internal Revenue Service in maintaining uncertainty. In the case of abusive transactions, uncertainty can discourage the abuse through an *in terrorem* effect, but there is nothing intrinsically abusive in partnerships' issuing securities for either cash or services and no need to discourage these issuances. Uncertainty also minimizes tax revenue; taxpayers are unlikely to follow a less than certain path (whatever its theoretical merits) that will maximize taxes.

As a substantive matter, it would appear that the better view would be to adopt the entity theory. Generally, while partnerships represent an

---

67. If the analysis in footnote 66 is followed, the deduction for P's services should be allocated to C. The resulting balance sheet would be the same as that above and none of A, B, C, and P would recognize income. On allocating P's deduction so as to offset all income to P's partners, see Martin B. Cowan, Receipt of an Interest in Partnership Profits in Consideration for Services: The *Diamond* Case, 27 Tax L. Rev. 161, 174-78 (1972).

amalgam of the aggregate and entity theories, the entity theory predominates unless there is a affirmative reason to adopt the aggregate theory.[68] As discussed in detail above, the entity theory provides reasonable results in all cases. Further, under the entity theory, the consequences of issuing partnership securities resemble the consequences of issuing corporate securities in more cases than under the aggregate theory.[69] Such resemblance is advantageous, partially because it simplifies the tax law, and more importantly, because laymen's expectations as to the effect of issuing securities are set by the corporate model. To the extent that tax consequences follow lay expectations, business transactions proceed more smoothly and tax compliance is facilitated.

Clearly, lay expectations cannot determine the substantive content of tax law. Equally clearly, defeating lay expectations imposes substantial transaction costs—the costs of educating laymen as to the requirements of substantive law and the greater costs of restructuring business understandings so as to minimize potential tax problems. The costs are multiplied where, as here, the correct, "sophisticated" treatment is so uncertain.

If straying from the corporate model is costly, the corporate model should be followed unless there is an affirmative technical reason not to do so. There is such a reason in the case of the acquisition of a profits interest for cash. Under the capital account system, a partner cannot avoid taxation if cash is credited to its capital account. The consensus that the receipt of a capital interest for services should be subject to an aggregate analysis does not appear to be based on equivalently strong reasons. It is not technically inevitable and is particularly counterintuitive. Businessmen understand that the recipient of property may be required to recognize income and that the payor of property may be entitled to a deduction; they even understand that the deduction may be capitalized. They less readily understand why, as the aggregate analysis requires, "innocent" partners should recognize income. The consensus view should be reconsidered. Abandoning it should not mean foregoing substantial revenue. It is likely that most taxpayers ignore the consensus position altogether, while the well advised structure their transactions so as to avoid it.

---

68. Willis et al., supra note 4, § 4.04.

69. The consequences of issuing partnership securities under an entity theory differ from those of issuing corporate securities in the case of the issuance of a profits interest for cash or, to the extent not covered by Rev. Proc. 93-27, services.