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Using Profits to Compensate a Service Provider—Potential Partnership Characterization

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Whoever starts out toward the unknown must consent to venture alone.
André Gide, *Journals* (1927) (Justin O'Brien) (trans.)

Problems of partnership characterization are never simple to resolve, particularly when the parties to the transaction under scrutiny do not desire the tax consequences of a partnership relationship but aggressively seek its economic advantages. Moreover, unraveling the effects of recharacterization is especially difficult when the form of the transaction is a service contract. Service contracts that run the risk of partnership characterization are those that include a provision for contingent compensation to the service provider. The risk of recharacterization is insubstantial where the compensation is measured as a percentage of gross receipts or of gross income. However, where the compensation is measured as a percentage of net profits, there is a very real risk of recharacterization.

The problems associated with recharacterization of these service contracts are difficult because, if the relationship is deemed to be a partnership, the service provider at the outset has received a partnership profits interest in exchange for future services. The tax consequences of such an event are largely uncertain, but may be very substantial. The tax advisor trying to weigh tax concerns against a client’s business desires may feel very much alone in determining just how much weight should be accorded the tax concerns.

Service contracts in which a constructive partnership is deemed to arise compound all the problems associated with constructive equity interests generally together with those associated with the receipt of a profits interest for services specifically. Because constructive interests

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by their nature are unanticipated, the opportunities to take protective measures to mitigate the tax impact of the receipt of a profits interest for services are largely unavailable. Thus, the need to avoid over-reaching and ultimate recharacterization at the outset is critical.

The following discussion will, therefore, begin by considering the existing case law and administrative pronouncements reviewing the characterization of various service contract relationships. Planning strategies to avoid partnership treatment are readily apparent from these decisions and pronouncements. However, inevitably some transactions will occur in which steps were not taken to avoid recharacterization, either because appropriate counsel was not sought, or because business concerns overrode legal ones. The following discussion will conclude by considering current schools of thought on the consequences of receipt of a profits interest for services. With the recent decisions of the United States Tax Court and the United States Court of Appeals for the Eighth Circuit in *Campbell v. Commissioner*, the law in this area is in a state of flux.

I. CHARACTERIZATION OF A SERVICE CONTRACT AS A PARTNERSHIP FOR TAX PURPOSES

For two reasons, the issue of constructive partnership arises most frequently in the area of service contracts. First, the service provider's performance of services can be readily characterized either as services performed for compensation or as services contributed to a partnership in exchange for a partnership interest. Second, the tax consequences of a constructive partnership in the context of service contracts can be particularly significant. The characterization issue may arise in several situations. For example, a cash basis service provider may enter into a service contract with a proprietor for a one-time performance of services; in exchange, the service provider will receive a percentage of the enterprise's profits to be paid over a period of several years. If the form of the service contract is respected, the service provider can spread its income from the enterprise over an extended period. However, the Internal Revenue Service (IRS) may argue that the service provider and proprietor are actually partners, and therefore the service provider should report its total distributive share

2. Constructive partnership issues also arise in connection with loans, see, e.g., *Venneri Co. v. United States*, 340 F.2d 337 (Ct. Cl. 1965); *Hartman v. Commissioner*, 17 T.C.M. (CCH) 1020 (1958), and leases, see, e.g., *Haley v. Commissioner*, 203 F.2d 815 (5th Cir. 1953); *Place v. Commissioner*, 17 T.C. 199 (1951).
of partnership income for the taxable year of the constructive partnership in which the services were performed. Alternatively, in the same situation, the service provider may observe that the enterprise is generating significant long-term capital gain and find it advantageous to argue for the existence of a constructive partnership in order to have its compensation classified, at least in part, as a distributive share of partnership capital gain. However, such a position is very difficult to sustain, since a taxpayer is generally bound by the transaction form he or she selected.

A. Tax Definition of Partnership

The Internal Revenue Code (Code) defines "partnership" as a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or estate or a corporation." The two most important decisions dealing with the tax definition of a partnership are the United States Supreme Court decisions in Tower v. Commissioner and Commissioner v. Culbertson. In Tower, the Court held that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is a community of interest in the profits and losses." The Culbertson Court provided further elaboration of the partnership defini-
tion, stating that the issue to be resolved is whether, considering all of the facts—the agreement, the conduct of the parties in the execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of the income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith, and acting with a business purpose, intended to join together in the present conduct of the enterprise.9

While the Court stressed that all facts should be considered and that the absence of any one should not be conclusive,10 the cases suggest that four basic elements are indicative of partnership intent: an agreement, a community of interest in profits and losses, a joint contribution of capital or services, and a joint participation in management and control.11 Thus, on the basis of the federal tax definition of partnership articulated by the Supreme Court in Tower and Culbertson, the courts have developed the four-part test for determining partnership intent. It is this test that has been applied when considering the tax character of service contracts.12

B. Application of Partnership Definition to Service Contracts

I. Beck Chemical Equipment Corp. v. Commissioner

In Beck Chemical Equipment Corp. v. Commissioner,13 the taxpayer entered into an oral agreement with a manufacturing company to supply the company’s pending patents and services for a flamethrower invented by its principal shareholder.14 In exchange, the taxpayer was to receive half of the total net profits from the manufacture and sale of the device when the enterprise terminated at the end of

10. Id. at 742, 744-45. The Court stressed that all the facts must be considered to determine whether the parties “joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits . . . .” Id. at 744-45. On remand, the Tax Court found that there was no partnership for the tax years in question. 9 T.C.M. (CCH) 647, 659 (1950).
13. 27 T.C. 840 (1957).
14. Id. at 843.
World War II. An operating loss in a particular year would offset the ultimate amount of net profits to be divided. The manufacturing company was to be solely responsible for the management and control of the enterprise, and it held itself out to the general public and to the government as the owner of the enterprise, never filing a partnership tax return.

As a result of several disputes with the manufacturing company, in part because of the company's failure to distribute profits at the appropriate time, the taxpayer commenced litigation which ultimately established, over the manufacturing company's vehement objection, the existence of a joint venture partnership for state law purposes. Eventually, the taxpayer received its share of the net profits. The IRS contended that a partnership had existed for tax purposes between the taxpayer and the manufacturing company from the inception of their agreement, and that the taxpayer should have reported its distributive share of partnership income in the taxable years in which such income was earned, not in the taxable years when the income was actually distributed.

The Tax Court reviewed the Culbertson decision and stated that the Culbertson principles were equally applicable to all situations in which a partnership allegedly existed for tax purposes, even though circumstances might indicate otherwise. In deciding that the facts suggested that the taxpayer and the manufacturing company had a "mutual proprietary interest in the venture's profits," the court relied on the following factors: the taxpayer had the burden of proving the nonexistence of a partnership, there was no agreement indicating that a master-servant relationship existed between the parties, the taxpayer had succeeded in establishing the existence of a partnership for state law purposes, the taxpayer had indicated it was a joint venturer with the manufacturer on its own tax returns for the years in question, and the taxpayer's participation in net profits suggested a proprietary interest in profits. The court observed that the absence of joint participation in management and control was not dispositive, but was only

15. *Id.* at 843. The agreement was entered into in 1942. *Id.*
16. *Id.*
17. *Id.*
19. *Id.* at 845-46.
20. *Id.* at 846.
21. *Id.* at 848.
24. *Id.* at 850-51, 853.
one of the factors to be considered in the overall determination. Similarily, the court admitted that the method of loss sharing, through adjustment of the net profits, could be compatible with either a compensation or partnership arrangement, but that this factor, too, was only one of many to be considered.

The court noted that both parties had contributed elements necessary to the enterprise and concluded that a partnership existed for the taxable years in question. Therefore, the court decided, the taxpayer should report the income in the year it was earned, rather than in the year in which it was distributed.

Absent the taxpayer's own efforts to establish the existence of a partnership, the facts of Beck Chemical seem to suggest the existence of an employer-employee relationship. The manufacturing company clearly intended an employment arrangement, and in no way indicated that it and the taxpayer were coproprietors of the enterprise or partners for tax purposes. The circumstances of the arrangement were not essentially different from other service contracts that have been held not to be partnerships for tax purposes. The outstanding factor in Beck Chemical is the taxpayer's own initial position that a partnership existed for state law purposes, which it apparently assumed for the purposes of enhancing its litigation position concerning a separate, non-tax issue. Once the taxpayer adopted this position, it thereafter indicated on its federal tax returns that it was a partner of the manufacturing company, but did not report any profits from the partnership because of the manufacturing company's refusal to divulge the information needed for such reporting. These factors seem to have substantially influenced the court's decision that a constructive partnership existed for tax purposes. The court was unwilling to allow the taxpayer to argue against the existence of a constructive partnership in order to achieve a tax advantage after it had already argued for the

25. Id. at 852.
26. Id. at 851.
27. Id. at 852-53.
28. Beck Chem. Equip. Corp. v. Commissioner, 27 T.C. 840, 856 (1957). Before deciding this, the court resolved another issue. The taxpayer argued that his dispute with his partner prevented the income of the partnership from being includable in income until the dispute was resolved and the amounts were actually received. This claim was essentially a claim of right doctrine argument: the taxpayer was asserting that he had "no established or uncontroverted right to the funds." Id. at 855. The court rejected this argument as inapplicable to prevent a partner's distributive share of partnership income from being taxable. Id. at 856.
30. 27 T.C. at 845.
31. As a consequence of the decision that the taxpayer should have reported the income in the years it was earned, as a distributive share of partnership income, the taxpayer was liable for
existence of a constructive partnership in order to resolve a state court issue in its favor. Though the requirements for a constructive partnership for state law purposes and for federal tax purposes are not necessarily the same, the intent of the alleged partner for federal tax purposes is determined by all the facts and circumstances, including the intent demonstrated in a previous legal proceeding. Thus, though the facts might not otherwise have supported the existence of a constructive partnership for tax purposes, the taxpayer's own actions demonstrating an intent to join together in the present conduct of an enterprise, when considered with other relevant facts, were sufficient to create one.

*Beck Chemical* also demonstrates that the absence of participation in control and management will not prevent a court from finding a constructive partnership if other factors indicate that one exists. Moreover, *Beck Chemical* emphasizes the significance of participation in net profits as resembling a proprietary interest in profits, particularly when those profits are to be offset by losses generated in years in which there were no net profits.

2. *Luna v. Commissioner*

As *Luna v. Commissioner* demonstrates, it is generally very difficult for a service provider to argue for the recharacterization of a service contract as a partnership for tax purposes unless it is able to produce concrete evidence indicating that this was the venturers' intent. In *Luna*, the taxpayer entered into an agreement with an insurance company whereby, in exchange for his management services, he was to receive a percentage of the renewal commissions from an insurance policy he had designed. Several years later, the parties decided to end the arrangement, and the insurance company paid the taxpayer a fixed sum to discharge the insurance company's obligation to pay penalties for failure to file excess profits tax returns for those years. These penalties would not have been incurred had the taxpayer failed to report the amount as compensation income in the year it was distributed. *Id.* at 857-60.

32. Generally, the state law requirements for a constructive partnership are more difficult to satisfy than the federal tax law requirements. See *Union Partnership Act* § 6(1), 6 U.L.A. 22 (1969).

33. Normally, equity participation arrangements provide for at least yearly determinations of contingent compensation, rent, or interest (in the case of participating loan joint ventures). While losses may reduce the contingent income to zero in an unsuccessful year, the existence of an operational loss in one year usually will not reduce the subsequent year's net profits for this purpose.


35. *Id.* at 1069-71.
the taxpayer’s renewal commissions. The taxpayer reported the amount as capital gain from the sale of a partnership interest; the IRS contended that the amount should be recognized as compensation income.

The Tax Court first reviewed the Supreme Court’s holding in Culbertson and determined that the essential question was whether the parties intended to, and did in fact, join together for the present conduct of an enterprise. The court countered the taxpayer’s argument that a partnership had been formed for state law purposes (though it remained unconvinced that the taxpayer was correct in that respect) by observing that the existence of a partnership for state law purposes was not determinative of the issue of intent for federal tax purposes. The court then listed factors it considered significant in determining the parties’ intent. The court specifically stated that no factor alone was conclusive of the issue.

In deciding that the taxpayer was not a partner of the insurance company and that the taxpayer’s lump sum payment must be reported as compensation income, the court considered several facts particularly important. First, neither the taxpayer nor the insurance company in any way indicated, prior to the suit, an intent to join together as partners. Partnership tax returns were not filed, and neither party held itself out to others as a joint venturer with the other. Second, the taxpayer was not authorized to engage in the insurance business except as an agent selling policies. Third, the written contract itself

36. Id. at 1071-74.
37. Id. at 1074.
38. See Commissioner v. Culbertson, 337 U.S. 733 (1949); supra notes 7-10.
39. Luna v. Commissioner, 42 T.C. 1067, 1077 (1964). Compare Priv. Ltr. Rul. 90-07-013 (Nov. 15, 1989) (relying on Luna, the IRS found organization composed of harbor pilots who contributed services to the organization while maintaining mutual interest in its net profits to be a partnership) and Priv. Ltr. Rul. 89-25-092 (Mar. 30, 1989) (where IRS found arrangement between state municipalities to construct, operate, and maintain system to transport a commodity throughout the buyer-municipality region to be partnership for federal income tax purposes, based on fact that both parties made contributions to the venture, and parties exercised mutual control and assumed mutual responsibilities for the venture) with Form Builders v. Commissioner, 58 T.C.M. (CCH) 1415, 1417 (1990) (relying upon Luna, the court found no partnership existed because the parties’ arrangement lacked requisite joint profit motive) and Koss v. Commissioner, 57 T.C.M. (CCH) 882, 891 (1989) (court found requisite intent to form partnership lacking), aff’d, 908 F.2d 962 (3d Cir. 1990).
40. 42 T.C. at 1077.
41. Id. at 1077-78. The list basically included all the elements of partnership discussed above, plus several more objective factors, such as whether the parties filed federal partnership returns, whether the enterprise was conducted in the joint names of the parties, and whether the parties represented to others that they were joint venturers. Id.
42. Id. at 1077.
43. Id. at 1078.
44. Luna v. Commissioner, 42 T.C. 1067, 1078 (1964).
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was structured as an employment contract, and agents recruited by the taxpayer were employees of the insurance company. 45 Fourth, the taxpayer received a percentage of the commissions on each policy sold, but did not have an interest in the net profits generated by the sale, and would not share in any losses resulting from the sale of the policy. 46

Though the sharing of losses is generally not requisite to a finding of constructive partnership, the absence of loss sharing places a heavier burden on a service provider trying to prove the existence of a constructive partnership. This is particularly true if neither the service contract nor the conduct of the parties indicates that the parties intended to be partners, and if, as the court believed to be the case in Luna, the idea of a constructive partnership arose as an afterthought. 47 Similarly, the fact that the service provider participates in the control and management of the enterprise is not indicative of a constructive partnership if the facts establish that the intent of the parties was to establish control and management by the service provider as an employee-manager, rather than as a coproprietor.

Service providers almost by definition participate in the management and control of the proprietor's enterprise. 48 The courts must determine the exact nature of the service provider's role in the proprietor's enterprise, as evidenced by the venturers' agreement, their actual conduct, and other objective criteria. Factors other than control and management thus assume greater importance in establishing the intent of the parties to join together in the present conduct of an enterprise.

Luna demonstrates the rigorous scrutiny that a service provider will receive when it argues for the existence of a constructive partnership in order to improve its tax position. The IRS's approach to recharacterization, however, is also result-oriented; it will not litigate such a case unless recharacterization will generate tax revenue. Such an unprincipled approach does not support the development of a coherent body of case law. Perhaps the IRS's use of this approach would be deterred if its recharacterization argument was subject to the same level of scrutiny as applies to taxpayers.

45. Id.
46. Id.
47. Id.
48. In loan and lease transactions involving profit sharing, lender/lessee generally does not participate in the management and control of the enterprise of the borrower/lessee. Thus, a lender or lessor possessing significant management and control rights is automatically at risk for partnership recharacterization. See, e.g., Place v. Commissioner, 17 T.C. 199, 206 (1951); Talbot Mills v. Commissioner, 3 T.C. 95 (1944), aff'd, 146 F.2d 809 (1st Cir. 1945), aff'd, 325 U.S. 521 (1946).
II. Tax Consequences of a Service Provider's Receipt of a Partnership Profits Interest

Under the broad sweep of Code section 61, there can be little doubt that the receipt of a partnership interest in exchange for past, present, and/or future services provided by a service provider may give rise to ordinary income. Because the service provider's constructive partnership interest would likely be treated as a profits interest, as opposed to a capital interest, the amount and timing of the income is uncertain. This uncertainty in turn affects the amount and timing of the deduction to which the proprietor is entitled as a result of compensating the service provider with a partnership interest. The following discussion explores the distinction between profits and capital interests, the common law and statutory treatment to date of the taxpayer who receives a profits interest, and the current views regarding the tax consequences of receipt of a partnership profits interest for services. Given the recent decisions of the Tax Court and the Eighth Circuit in Campbell v. Commissioner, there is a very real possibility of immediate taxation of the receipt of a profits interest. Even greater caution is now required than before when structuring a service contract with profit sharing to avoid partnership characterization. While the IRS's latest explanation of the tax consequences of receipt of a profits interest gives a great deal of comfort to taxpayers, the scope of Revenue Procedure 93-27's application is uncertain and probably does not extend to constructive partnerships.

A. What is a Profits Interest?

Neither the Code nor the regulations defines the term "profits interest". One commentator has defined it based on an analysis of Treasury Regulation sections 1.721-1(b)(1) and 1.704-1(e)(1)(v) as "any
interest which would not entitle the holder to receive assets on an immediate liquidation, but does give the holder the right to share in future partnership profits or earnings." The IRS has defined the term profits interest by what it is not, a capital interest.

The following example illustrates the distinction between a profits interest and a capital interest:

X and Y form partnership XY. X gets a capital interest. Y gets a profits interest. X contributes an apartment building with a cost

1.721-1(b)(1) and 1.704-1(e)(1)(v). Treasury Regulation section 1.721-1(b)(1) distinguishes profits from capital interests by providing, in part: "To the extent that any of the partners gives up any part of his right to be repaid his contribution (as distinguished from a share in partnership profits) in favor of another partner as compensation for services . . . section 721 does not apply." Treasury Regulation section 1.704-1(e)(1)(v) provides, in part: "The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership."

A recent report of the Section of Taxation of the American Bar Association recommends that Treasury Regulation section 1.721-1(b)(1) be amended to provide the following definition of a partnership capital interest:

To the extent that any person receives an interest in partnership capital as compensation for services (or in satisfaction of an obligation) section 721 does not apply. A person will be deemed to have received an interest in partnership capital if such person has the right (with respect to the partnership interest so received) to share in the proceeds of a sale of the partnership assets at fair market value followed by a complete liquidation of the partnership immediately after the receipt of such partnership interest.

American Bar Association Section of Taxation, Report on the Tax Consequences of the Receipt of a Partnership Profits Interest for Services (Oct. 22, 1992), reprinted in 46 Tax Law. 453 (1993) [hereinafter ABA Report]. The report goes on to recommend that "a partnership profits interest be defined as any equity interest in the partnership other than a capital partnership interest."

Id. at 236.

55. McKee et al., supra note 54, at ¶ 5.05[1]. In contrast to his definition of a profits interest, McKee defines a capital interest as "any interest which would entitle the holder to receive a share of partnership assets upon a hypothetical winding up and liquidation of the partnership immediately following acquisition of the interest." Id. In Mark IV Pictures, Inc. v. Commissioner, 60 T.C.M. (CCH) 1171 (1990), aff'd, 969 F.2d 669 (8th Cir. 1992), the Tax Court concluded that the taxpayer had received capital interests for services because it had "the right to receive a specified share of the partnerships' liquidation proceeds (assets)." Id. at 1176. Whether in fact it actually received anything after outside creditors were repaid and the limited partners were returned their capital contributions was irrelevant. The mere right to receive a share of liquidation proceeds determined the character of the interests. Id. While it is difficult to see why the court bothered to distinguish a capital interest from a profits interest in this context after its decision in Campbell, see infra notes 241-92, it is nonetheless worth noting that the definition used by the court would render virtually every partnership interest a capital interest. Because almost every partner has the right to liquidation proceeds in some hypothetical liquidation scenario.

56. Revenue Procedure 93-27, 1993-24 I.R.B. 63, defines a "profits interest" as "a partnership interest other than a capital interest." Id. at 64. A "capital interest" is defined as "an interest that would give the holder the right to share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest." Id.
basis and fair market value of $500,000, and Y is to manage the apartment building. Thus, initially, X's capital account is $500,000 and Y's is zero. X and Y are to share profits and losses seventy percent and thirty percent, respectively. Upon immediate liquidation of the partnership, X would receive $500,000 and Y would receive nothing. This is because X has a capital interest while Y only has a profits interest.57

In the event of an immediate liquidation, the service provider would be in essentially the same position as Y in the example above. Therefore, in a situation where a service contract is treated as a partnership for tax purposes, the service provider should be treated as holding a profits interest in the constructive partnership.

The distinction between the grant of a capital interest and the grant of a profits interest for services may be the critical threshold question in determining whether there has been a taxable event. If a taxpayer receives a capital interest in exchange for services, a taxable event has occurred and the tax consequences, apart from issues relating to valuation of the interest, are certain.58 On the other hand, the tax consequences to a taxpayer receiving a profits interest in exchange for services remain somewhat unsettled.59 The determination of the nature of a partnership interest as capital or profits becomes more difficult where a partner shares in both operating profits and appreciation in the partnership's assets, but has no other right to share in the partnership's assets in the event of his or her withdrawal or a liquidation.

B. Pre-Diamond Treatment of Receipt of a Profits Interest for Services

1. Pre-1954 Code Nonrealization

Under pre-1954 law, substantial authority existed for the proposition that the receipt of a partnership profits interest in exchange for services was not a taxable event.60 This authority was based on the notion that payments by a partnership to a partner for services should not be treated as compensation, but should instead be treated as dis-

57. See supra notes 53-55 and accompanying text.
60. See WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ¶ 5.02[1][c][i] (Supp. 1993); ABA Report, supra note 54, at 228-29.
tributive shares of partnership income. This follows from the premise that an individual cannot be his or her own employee. Thus, a partner did not realize income when his or her partnership compensated the partner with cash, much less an intangible right to future profits.

The enactment of the 1954 Internal Revenue Code provides no evidence that Congress intended to modify this rule of nonrealization. Section 61, defining "gross income," was intended essentially as a restatement of existing law. The 1954 Code also codified the rules of partnership taxation as subchapter K. The only rules that in some way address the tax consequences of a partner's receipt of a partnership interest are set forth in sections 721 and 707.

Section 721 codified "the existing case law" that contributions of property in exchange for partnership interests do not result in income or loss recognition. Congress included section 707 to address its concern that the existing blanket rule of no compensation to partners yielded "unrealistic and unnecessarily complicated" results in certain circumstances. Sections 707(a) and 707(c) provide the only exceptions to the no compensation rules. Neither of these sections should apply where a partner is compensated with a share of partnership profits.

61. Commissioner v. Moran, 236 F.2d 595, 598 (8th Cir. 1956); see Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968); Commissioner v. Deak, 234 F.2d 704 (4th Cir. 1956); Foster v. United States, 221 F. Supp. 291 (S.D.N.Y. 1963), aff'd, 329 F.2d 717 (2d Cir. 1964); Miller v. Commissioner, 52 T.C. 752 (1969) (acq.); Lloyd v. Commissioner, 15 B.T.A. 82 (1929) (acq.); Estate of Tilton v. Commissioner, 8 B.T.A. 914 (1927) (acq.).

62. Moran, 236 F.2d at 598.

63. See McKee et al., supra note 59, ¶ 5.02[1][c][ii]; ABA Report, supra note 54, at 228.


68. Id. § 721.

69. Id. § 707.


74. See Pratt v. Commissioner, 550 F.2d 1023, 1026 (5th Cir. 1977); Foster v. United States, 329 F.2d 717, 718 (2d Cir. 1964); Miller v. Commissioner, 52 T.C. 752, 762 (1969).

75. If the consideration received is an entrepreneurial, sharing interest in the partnership's income, it cannot be received in a nonpartner capacity under § 707(a) .... Because the value of a profits interest, by definition, cannot be determined "without
2. Section 721 and the Regulations

The general nonrecognition rule of section 721(a) provides that "[n]o 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." However, the regulations limit section 721's grant of nonrecognition: "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 (or in satisfaction of an obligation), section 721 does not apply." The parenthetical, "as distinguished from a share in partnership profits," seems to distinguish the tax consequences of the exchange of a capital interest for services, which clearly does not constitute a nonrecognition transaction, from the tax consequences of the exchange of a profits interest, which arguably does.

3. The Hale Case

Hale v. Commissioner confirmed the opinion of many commentators that the receipt of a profits interest is not a taxable event. In that case, Hale Company, a partnership, received a profits interest in Walnut Company, another partnership, in exchange for its contribution of future services to Walnut Company. Hale Company sold ninety percent of its profits interest to D-K Investment Corporation before receiving any income from Walnut Company. Hale Company then reported its proceeds from the sale of its profits interest in Wal-

regard to the income of the partnership, it cannot, by definition, be a § 707(c) guaranteed payment.

McKee et al., supra note 59, ¶ 5.02[1][c][iii].
77. Treas. Reg. § 1.721-1(b)(1).
78. Id.
80. 24 T.C.M. (CCH) 1497 (1965).
82. Hale, 24 T.C.M. at 1500.
83. Id. at 1501.
nut Company as proceeds from the sale of a capital asset. The court held that Hale Company realized ordinary income, as if it had received such income directly from Walnut Company.

For the purposes of this analysis, the significance of Hale is not that the court characterized the income Hale Company received as ordinary rather than capital; rather, its significance lies in dictum in a footnote that "[u]nder the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. Sec. 1.721-1(b), Income Tax Regs." It is unclear why the Hale court made such a statement, since the question of whether a taxable event had occurred when Hale Company received its profits interest was not before the court.

C. Taxable Receipt of a Profits Interest

1. The Diamond Landmark

Six years after Hale, in Diamond v. Commissioner, the United States Court of Appeals for the Seventh Circuit held that the mere receipt of a profit share with determinable market value is taxable income.

The facts in Diamond were as follows: Kargman paid $25,000 for a buyer's right in a contract for the sale of an office building, and requested that Diamond, a mortgage broker, obtain a mortgage for the $1.1 million purchase price of the office building. They agreed that Diamond would receive a sixty percent share of the profit or loss of the venture if he arranged the financing. Diamond obtained a $1.1 million mortgage as Kargman requested, and on January 15, 1961, Diamond and Kargman entered into a joint venture agreement. The agreement provided that Kargman would provide all cash needed for

84. Id. at 1502.
85. Id.
86. Id. at 1502 n.3.
87. Revenue rulings issued both before and after the Hale decision suggest that the IRS too believed receipt of a profits interest should not be a taxable event. While the situations considered involved receipts of profits interests for services, the focus of the rulings was on the timing of inclusion of the service partner's profit share. The IRS did not comment on the tax consequences of the receipt of the interest itself. See Rev. Rul. 70-435, 1970-2 C.B. 100, ex. 5, modifying Rev. Rul. 60-31, 1960-1 C.B. 174.
88. 492 F.2d 286 (7th Cir. 1974), aff'g 56 T.C. 530 (1971).
89. Id. at 291.
90. Id. at 286.
91. Id.
92. Id. at 286-87.
the purchase beyond the mortgage proceeds, and that profits and losses would be shared, forty percent to Kargman and sixty percent to Diamond. Upon a sale of the building, however, Kargman would receive sale proceeds first, to reimburse him for the cash he provided to purchase the building, and excess proceeds would be split forty/sixty. On February 18, 1962, the partnership closed on the property. Three weeks later, Diamond assigned his interest in the building for $40,000 to Kargman, who in turn sold it to Liederman for the same amount. Diamond reported the $40,000 sale proceeds as a short-term capital gain, but reported no tax consequences from the receipt of the interest in the joint venture.

The Internal Revenue Commissioner (Commissioner) contended that the profits interest in exchange for services was not within section 721 and was taxable when received under section 61. The Commissioner also determined that Diamond's interest in the partnership had a market value of $40,000 on February 18, 1962. Diamond argued that his receipt of a profits interest in the partnership was not a taxable event and was eligible for nonrecognition under section 721. He further argued that the subsequent sale produced a capital gain under section 741.

The Tax Court found that there is no statute or regulation which addresses the taxation of the receipt of a profits interest. Despite the court's conclusion that section 721 and its applicability to a profits interest is "obscure," the Tax Court went on to hold that "what is plain is that the regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefor by giving him an interest in a partnership that came into being at a later date." The Seventh Circuit, in affirming the Tax Court's decision, noted that there is no authority in the Code or regulations that exempts receipt of a profits interest from taxation. The Seventh Circuit rejected Diamond's argument based on Treasury Regulation section

93. Diamond v. Commissioner, 492 F.2d 286, 287 (7th Cir. 1974), aff'g 56 T.C. 530 (1971).
94. Id.
95. Id. Liederman, however, received only a 50% interest from Kargman. Id.
96. Id. Diamond had a capital loss carryover that he wanted to use in the year in question. Id.
97. See id.
98. Diamond v. Commissioner, 492 F.2d 286, 287 (7th Cir. 1974), aff'g 56 T.C. 530 (1971); see I.R.C. § 741 (1992) (providing the general rule that the character of the gain or loss from the sale of a partnership interest is capital).
100. Id. at 546.
101. Diamond, 492 F.2d at 290.
1.721-1(b)(1), instead interpreting the regulation as solely determining the tax consequences to a partner who contributed money or property for a partnership capital interest but then later assigned a portion of that interest to a service provider as compensation. After considering the views of commentators, judicial interpretation, legislative history, administrative interpretation, and policy considerations, the Seventh Circuit held that there is a taxable event when a service partner's profits interest has a determinable market value.

2. Criticism of Diamond

The Diamond decision has been heavily criticized for its lack of practicality, logic, simplicity, and predictability. The Seventh Circuit in Diamond acknowledged that "in many if not the typical situations [a profits interest] will have only speculative value, if any." Thus, the court anticipated that the vast majority of profits interests would not be taxed upon receipt. The court, however, did not find this reason sufficient to defer taxation of all profits interests. While this conclusion is at least arguably correct, the court failed to go one

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102. Id. at 288-89. The court concluded:

The quoted portion of the regulation may well be read, like § 721, as being directly addressed only to the consequences of a contribution of money or other property. It asserts that when a partner making such contributions transfers to another some part of the contributing partner's right to be repaid, in order to compensate the other for services or to satisfy an obligation to the other, § 721 does not apply, there is recognition of gain or loss to the contributing partner, and there is income to the partner who receives, as compensation for services, part of the right to be repaid.

Id. at 288.

103. Id. at 291. The Seventh Circuit found a "startling degree of unanimity" among the commentators that the receipt of a profits share for services is not income, id. at 289; one judicial statement on point, in Hale, 24 T.C.M. at 1502 n.3; and "equivocal" legislative history, Diamond, 492 F.2d at 289-90. The court went on to find no evidence of administrative action consistent with the Tax Court's decision in Diamond. Id. at 290. Nonetheless, the Seventh Circuit deferred to the Tax Court's decision that it was sound tax policy to tax the receipt of a profits share received for services when it is created if it "has a market value capable of determination." Id. The almost immediate sale of the interest received by Diamond made a determination of its market value relatively easy. The Seventh Circuit left for resolution through appropriate regulations the practical problem of avoiding double taxation. Id. Such regulations still do not exist. See also Finkelman v. Commissioner, 56 T.C.M. (CCH) 1269 (1989). In Finkelman, the petitioner received a profits interest in a partnership formed by the petitioner in exchange for securing and investigating real estate for the partnership to purchase. The court held that petitioner's receipt of a partnership interest in exchange for services constituted a taxable event. However, the interest had no value here because the partnership purchased the real estate for substantially more than its value, through non-arm's length bargains, incurred no genuine indebtedness, and did not sell any properties, thus demonstrating the absence of a profit motive. Id.

104. See Willis et al., supra note 53, § 46.12, at 46-39.

105. Diamond, 492 F.2d at 290.
step further and consider the ramifications of its holding where the profits interest has a determinable value.

Critics have stated that the Diamond decision was unnecessarily broad and controversial. For example, the holding could have been tailored specifically to situations involving the receipt of a share of profits for past services, since that was the situation in Diamond. The Tax Court’s decision appears to be so limited. However, the Seventh Circuit’s decision does not include such a qualification. Moreover, the Diamond court could have held that Diamond received a capital interest. Accordingly, the receipt of a capital interest would have been a taxable event.

Alternatively, the Diamond court could have reached the same result applying the step transaction doctrine. Given the sale of Diamond’s interest to his partner only three weeks after he completed the agreed-upon services, it is not difficult to conclude that Diamond never intended to contribute his services to the partnership. While Diamond and Kargman may have structured their deal in the form of a partnership, in substance the partnership structure was used only to accomplish the payment of cash to Diamond. The partnership form was used only to convert ordinary income to capital gain. Had the Seventh Circuit insisted that Diamond be taxed on the basis of the substance of the transaction—the payment of ordinary compensation income—the same result could have been reached without the creation of an analytically flawed and incomplete precedent.

106. Willis et al., supra note 53, § 46.06, at 46-12 to -13.
107. Id. Other suggested alternatives to the Diamond approach include following Hale and taxing the proceeds of the sale of Diamond’s interest as ordinary income, or rejecting the presence of a partnership between Diamond and Kargman altogether. Id.
108. See William S. McKee et al., Federal Taxation of Partnerships and Partners, ¶ 5.02(1)[a], at 5-8 (2d ed. 1990); Willis et al., supra note 53, § 46.06, at 46-13. See also Gen. Couns. Mem. 36,346 (July 23, 1975 and July 25, 1977) (IRS described Diamond’s interest as mostly capital).
110. Under the step transaction doctrine, for the purposes of determining income tax consequences, “separate steps of an overall transaction will be treated as part of a single transaction if the steps can fairly be integrated.” Richard A. Westin, Shepard’s 1990-1991 Tax Dictionary 573 (1991). The doctrine has been applied in circumstances where the taxpayer intended the end result from the outset. See id.; e.g., Helvering v. Alabama Asphalitic Limestone Co., 315 U.S. 179, 184, 185 (1942); Van Zandt v. Commissioner, 341 F.2d 440, 443 (5th Cir. 1965). In Gen. Couns. Mem. 36,346 (July 23, 1975 and July 25, 1977), the IRS noted:

The fact that a future profits interest acquired as compensation for services is sold shortly after it is acquired may be evidence that the seller of the interest intended to receive a fixed amount for the services rather than investing the services in the enterprise and that, therefore, it was not intended that the seller become a partner.
111. Diamond v. Commissioner, 492 F.2d 286, 287 (7th Cir. 1974), aff’g, 56 T.C. 530 (1971).
Another subject of debate surrounding Diamond is the import of the regulations denying nonrecognition under section 721 when a capital, as opposed to a profits interest is received for services.\textsuperscript{112} Substantial arguments have been advanced that neither the Tax Court nor the Seventh Circuit respected Treasury Regulation section 1.721-1(b)(1).\textsuperscript{113} The Hale court\textsuperscript{114} recognized the distinction apparently intended by the Commissioner when the court commented, citing the regulation under section 721, that "the mere receipt of a partnership interest in future profits does not create any tax liability."\textsuperscript{115} The Tax Court in Diamond appears to have ignored its earlier dictum.

If the value of a profits interest received for services is determined, and that value is included in income under Diamond, the service partner ends up being taxed twice unless some method for a partnership's amortization of the value of the interest is developed and the amortization deductions are specially allocated to the service partner.\textsuperscript{116} This conclusion assumes that the value reflects the present value of the anticipated profits to be earned by the service partner, since the profits interest can have by its nature no liquidation value.\textsuperscript{117} A corollary to this problem is the effectively double deduction that the non-service partners would inappropriately enjoy.\textsuperscript{118}

To remedy the double deduction and income problems, the transfer of the interest could be considered an assignment of income triggering immediate taxation of the other partners. It would follow that the service partner would then be deemed to transfer the right to profits to the partnership in exchange for a partnership interest. That right to profits would have, in the hands of the partnership, a carryover basis equal to the income recognized by the service partner. This tax cost basis could then be amortized by the partnership and the amortization deductions allocated to the service partner under section 704(b). The principal problems with this approach are apparent: first, there is no guidance regarding the appropriate amortization period; and second,


\textsuperscript{113} See Willis et al., supra note 53, § 46.06, at 46-12.

\textsuperscript{114} Hale v. Commissioner, 24 T.C.M. (CCH) 1497 (1965).

\textsuperscript{115} Id. at 1502 n.3.

\textsuperscript{116} See Diamond, 492 F.2d at 289 (citing Arthur B. Willis, Willis on Partnership Taxation 84-85 (1st ed. 1971)). Willis and his successors continue to maintain the correctness of his original opinion on this point. See Willis et al., supra note 53, at § 46.04 (Supp. Dec. 1991).

\textsuperscript{117} See St. John v. United States, 84-1 U.S.T.C. (CCH) ¶ 9158 (C.D. Ill. 1983).

\textsuperscript{118} The availability of the deduction would be dictated by general principles of income taxation distinguishing current expenses from capital expenditures.
the partners are forced to grapple with the complex quagmire of drafting an effective section 704(b) special allocation.\textsuperscript{119}

\section*{3. Post-Diamond Decisions}

After \textit{Diamond},\textsuperscript{120} both the IRS and the judiciary were uncertain of the scope of its holding. The IRS attempted, without success, to issue revenue rulings in response to the \textit{Diamond} case.\textsuperscript{121} Similarly, judicial opinions reflected the courts' uncertainty.\textsuperscript{122} Moreover, the Eighth Circuit's decision in \textit{Campbell v. Commissioner}\textsuperscript{123} will only produce further uncertainty.

The IRS on two occasions, in 1975 and 1977, considered issuing a revenue ruling with a fact pattern similar to that of \textit{Diamond}.\textsuperscript{124} The 1975 proposal concluded that the fair market value of a profits interest received for services is includable in gross income if it is received as compensation for the services performed for an individual, as opposed to the partnership.\textsuperscript{125} The ruling was issued without "further discussion of the alternative positions available."\textsuperscript{126} The 1977 proposed Revenue Ruling\textsuperscript{127} concluded that in both \textit{Diamond} and the hypothetical considered in the ruling, the service partner received a capital interest represented by the service partner's right to share in the unrealized appreciation inherent in the partnership's property, as

\begin{footnotesize}
\bibitem{120} 59 T.C.M. (CCH) 236 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991).
\bibitem{122} See Kessler v. Commissioner, 44 T.C.M. (CCH) 624 (1982). The \textit{Kessler} court commented in a footnote that if the service provider and the service recipient were determined to have formed a partnership,
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we would be faced with the question of how to characterize amounts received from a partnership profits interest, which interest was received in exchange for services, and which interest had an unascertainable value on the date of receipt. The resolution of this knotty problem was left somewhat unanswered in \textit{Diamond} and raises conceptual difficulties which directly stem from the operation of the provisions of Subchapter K.
\end{quote}
\textit{Id.} at 628 n.16 (citation omitted).
\bibitem{123} 943 F.2d 815 (8th Cir. 1991).
\bibitem{126} \textit{Id.}
\bibitem{127} \textit{Id.} at 8-15. The facts of the 1977 proposed ruling were as follows: A purchased a contract to acquire real estate for $10,000. B was to obtain 100% financing for the property in exchange for a 25% interest in profits and losses of partnership AB. Upon a sale, the proceeds would be applied first to any outstanding mortgage, then $10,000 would be paid to A, and the remainder would be allocated, 75% to A and 25% to B. The property was purchased in the names of A and B for $300,000 and shortly thereafter was contributed to partnership AB. The property was valued at $360,000 once financing had been arranged. Within a year, B sold his partnership interest for $15,000. \textit{Id.} at 8-10.
\end{footnotesize}
determined by the property's appraised value immediately after it was purchased. The proposed ruling went on to reject Diamond to the extent that it is read to hold that receipt by a partner of a profits interest as compensation for services gives rise to taxable income.

The General Counsel Memorandum accompanying the proposed 1977 ruling limits the term "profits interests" to interests giving the holder no right to existing partnership assets upon a liquidation of the holder's interest. Moreover, the General Counsel Memorandum and proposed ruling stress the need to distinguish when an individual receives a right to future profits as an employee or independent contractor, rather than as a partner. The right to future profits alone is insufficient to categorize the recipient as a joint venturer or partner for tax purposes. All the facts and circumstances must be considered to determine whether the individual intended to invest his services in the enterprise. The proximate sale of the profits interest, as in Diamond, would be an indication that the requisite investment intent is absent. The compensatory receipt of an interest in future profits by someone who is not a partner is not an event triggering income realization. Compensation income arises as profits are received or when there is a disposition of the interest.

The 1977 proposed ruling concludes by treating the Diamond-like partnership interest as a capital interest, the value of which was to be included in income. IRS's failure to issue either of the proposed rulings or any other revenue rulings or regulations until the summer of 1993 probably reflects internal skepticism regarding the correct scope of Diamond's application.

The desire of the IRS and the courts to avoid addressing the Diamond issue has been revealed on many occasions. Primarily, three approaches have been employed to avoid dealing directly with Diamond: (1) framing the issue as whether the service provider is an employee versus a partner; (2) focusing on the absence of value of the profits

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128. Id. at 12, 15. The IRS concluded that B had received a capital interest to the extent of his share in the unrealized appreciation in the value of the property when he received his interest and should therefore recognize income of $12,500 (($360,000 - $300,000 - $10,000) x 25%). B's adjusted basis would include the $12,500 recognized on receipt of his interest. Upon the sale of his interest, B would recognize gain to the extent the amount realized exceeded the adjusted basis of his interest in partnership AB, $2,500 ($15,000 - $12,500). Id. at 15.


130. Id. at 5.

131. Id. at 7-8, 14-15. The IRS stressed, however, that focusing only on whether the taxpayer rendered services as a partner would inappropriately "place a premium on whether the partnership is formed before or after the services are rendered." Id. at 2-3.

132. Id. at 12-14.

133. Id. at 15.
interest; or (3) characterizing the service provider’s contribution as property within the meaning of section 721.134

_**Wheeler v. Commissioner**_135 provides an example of the first approach, employee versus partner.136 In that case, Wheeler was in the real estate development and construction business.137 Perrault was to provide financing for a number of projects that Wheeler was pursuing.138 They agreed that profits would be divided seventy-five percent to Perrault and twenty-five percent to Wheeler after Perrault recovered his investment, plus a six percent interest factor.139 Wheeler was also to receive a monthly salary.140 Some of the properties that Wheeler and Perrault obtained were later sold at a profit.141

The Commissioner argued that Wheeler was not a partner but an employee of Perrault and should be taxed on his share of the profit as ordinary income.142 Wheeler insisted that he was a joint venturer, and therefore the gains from the sale of the properties were taxable as capital gains.143

The Tax Court concluded that a joint venture taxable as a partnership existed and that Wheeler was entitled to report his share of profit as capital gain.144 Thus, the controversy in _Wheeler_ was resolved with-

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134. Another alternative would be to treat _Diamond_ as if it involved a capital interest. See, e.g., Hensel Phelps Constr. Co. v. Commissioner, 703 F.2d 485 (10th Cir. 1983), aff’g 74 T.C. 939 (1980). In National Oil Co. v. Commissioner, 52 T.C.M. (CCH) 1223 (1986), the court focused on whether the taxpayer had received a capital interest or a profits interest, concluding it had not received either, since it had received no economic benefit. _Id._ at 1228-29. Here, the IRS stipulated that a profits interest was not taxable. See _id._

In Kobor v. United States, 88-2 U.S.T.C. (CCH) ¶ 9477 (C.D. Cal. 1987), the IRS took the position that the profits interest was taxable, but the court avoided the difficult _Diamond_ issues when it concluded that the interest should not be taxed because it was not freely transferable and was subject to a substantial risk of forfeiture. _Id._ In _id._, the court went on to note the speculative value of the profits interest, taking into consideration that it was subordinate to the capital interests and that it was held subject to the taxpayer’s rendition of future services. _Id._


136. _Kessler v. Commissioner_, 44 T.C.M. (CCH) 624 (1982), also framed the issue as employee versus partner.

137. _Wheeler_, 37 T.C.M. at 884.

138. _Id._

139. _Id._

140. _Id._ Wheeler’s duties included supervising construction, hiring subcontractors, approving payrolls, paying for materials, approving change orders and approving interim payments to subcontractors. _Id._ at 885. Wheeler also assisted in the preparation of financial materials needed to secure certain loans and selected architects and subcontractors jointly with Perrault. _Id._

141. _Id._


143. _Id._

144. _Id._ at 891. In reaching its conclusion, the _Wheeler_ court used a federal tax standard rather than state law standards for determining whether a joint venture exists. See _id._ at 887-89. The court then sought to determine whether the parties intended to form a joint venture, taking
out the Commissioner having to contend that Wheeler received a taxable profits interest.\textsuperscript{145} Nowhere in the \textit{Wheeler} opinion did the court even cite the \textit{Diamond} case, despite the similarity of facts.

\textit{St. John v. United States} illustrates the second approach, focusing on the absence of value.\textsuperscript{146} The facts of that case were as follows: A partnership was formed to operate a nursing home. St. John received a fifteen percent partnership interest in exchange for past and future services.\textsuperscript{147} The other partners contributed $170,000. Their partnership agreement stated that upon liquidation of the partnership, St. John would not receive anything until the other partners had recovered their initial contributions.\textsuperscript{148}

The district court first concluded that St. John had received a profits interest, because he had no right to, or interest in, partnership capital on the date his interest was no longer forfeitable. The court held that since the nursing home's financial forecast was uncertain, St.

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\item Characterization of payments was the focus again in Revenue Ruling 77-84, 1977-1 C.B. 173, where coal royalties were received for services. The taxability of the receipt of the royalty interest was not discussed.

\item \textit{84-1 U.S.T.C. (CCH) \textbar 9158 (C.D. Ill. 1983)}. The Tax Court also used this approach in \textit{Kenroy, Inc. v. Commissioner}, 47 T.C.M. (CCH) 1749 (1984), which held that Kenroy, Inc. received no income upon its receipt of a profits interest because the interest, as valued by the net assets of the partnership less the limited partners' contribution, was worthless when acquired. \textit{Id.} at 1758. In a footnote, the Tax Court distinguished \textit{Diamond} because there the contemporaneous sale of the profits interest proved its value upon receipt. \textit{See id.} at 1758 n.8. \textit{See also Finkel-\textit{\ldots}}

\item \textit{145}. \textit{Characterization of payments was the focus again in Revenue Ruling 77-84, 1977-1 C.B. 173, where coal royalties were received for services. The taxability of the receipt of the royalty interest was not discussed.}

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\item \textit{147}. \textit{St. John v. United States}, 84-1 U.S.T.C. (CCH) \textbar 9158 (C.D. Ill. 1983). St. John's interest was subject to forfeiture if he failed to perform the required services during the eight-month period following formation of the partnership. \textit{Id.}

\item \textit{148}. \textit{Id.}
John's profits interest should be valued at its liquidation value. The court further held that because St. John would not receive any proceeds upon liquidation of the partnership, he did not have to recognize any income upon receipt of his profits interest. The court distinguished Diamond because in that case the quick sale of the interest clearly proved value.

The St. John court correctly looked to liquidation value to determine whether St. John received a profits interest or capital interest. A clearer line of authority would have developed in this area, however, had the St. John court applied the Diamond standard of determinable market value, rather than liquidation value, in concluding that the receipt of St. John's profits interest was not a taxable event. Notwithstanding the court's use of the wrong standard, it correctly decided that St. John's profits interest had no value at the date he received it, and therefore it did not give rise to taxable income. Using liquidation value to determine both whether there is a profits interest and what that interest is worth, however, results in the receipt of a profits interest never giving rise to taxable income.

The third approach to skirting the Diamond issue, characterizing the service provider's contribution as property, was used in Stafford v. United States. The issue in Stafford arose from Stafford's receipt of a limited partnership interest in exchange for his assignment to the partnership of a letter of intent from an insurance company to finance the construction of a hotel. In the two district court and two appellate court decisions in Stafford, no determination was made as to whether the interest received by Stafford was a profits or a capital interest, and there was no mention of Diamond. The United States Court of Appeals for the Eleventh Circuit finally concluded that an unenforceable letter of intent could be property and that this letter was property within the meaning of section 721. All that remained was to determine the value of the partnership interest and of the letter

149. Id.
150. Willis et al., supra note 53, § 46.07, at 46-16 to -18.
151. 435 F. Supp. 1036 (M.D. Ga. 1977), rev'd and remanded, 611 F.2d 990 (5th Cir. 1980), on remand, 552 F. Supp 311 (M.D. Ga. 1982), rev'd and remanded, 727 F.2d 1043 (11th Cir. 1984). In Dillon v. United States, 84-2 U.S.T.C. (CCH) ¶ 9921 (S.D. Tex. 1981), the right to a partnership interest in A, which was contributed to partnership B for an interest in B, was property, even though the right B received was in exchange for B's services. Id.
152. Stafford, 435 F. Supp. at 1037-38. Stafford was also the general partner and was paid a salary for his supervisory services. Id. at 1038. All of Stafford's efforts to secure the letter of intent occurred before the partnership was formed and were on his own account. Id.
153. See supra notes 53-59 and accompanying text.
154. 727 F.2d at 1051-54.
in order to establish whether part of the interest was received for services.\footnote{155}{Id. at 1054-55.}

\textbf{D. The Enactment of Section 83}

Section 83 was added to the Internal Revenue Code by the Tax Reform Act of 1969.\footnote{156}{Pub. L. No. 91-172, 83 Stat. 487, 588 (1969).} Thus, it should be noted at the outset that the applicability of section 83 to the transfer of a profits interest for services was not at issue in \textit{Diamond}.\footnote{157}{See \textit{Lind et al.}, \textit{supra} note 119, at 80-81. The reason why applicability of section 83 was not contested in \textit{Diamond} is that section 83 applies to transfers occurring after June 30, 1969, and the transfer in \textit{Diamond} was executed in 1962.} It was, however, potentially applicable to the transactions considered in the post-\textit{Diamond} decisions discussed above.\footnote{158}{See \textit{supra} notes 135-55 and accompanying text.} In \textit{Kobor v. United States},\footnote{159}{88-2 U.S.T.C. (CCH) ¶ 9477 (C.D. Cal. 1987).} where the taxpayer received a profits interest in exchange for future services, the district court employed the standards concerning transfer restrictions and a substantial risk of forfeiture that appear in section 83 to conclude that the interest was not taxable, but the court did not even mention section 83.\footnote{160}{Id.} It was not until the Tax Court decision in \textit{Campbell v. Commissioner}\footnote{161}{59 T.C.M. (CCH) 236 (1990), aff'd, 943 F.2d 815 (8th Cir. 1991).} that the effect of section 83 on a transfer of a profits interest for services was explored.

Section 83(a) of the Internal Revenue Code provides:

\begin{quote}
If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of
\end{quote}
such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.  

In determining whether section 83(a) applies to a transfer of a profits interest, the threshold question is whether the profits interest is property for the purposes of section 83. Treasury Regulation section 1.83-3(e) defines property as "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Accordingly, the issue here is whether a profits interest more closely resembles an unfunded and unsecured promise to pay money in the future than it does personal property. Once it is determined that the service provider and the proprietor are partners for tax purposes, rather than merely parties to an employment contract, it becomes difficult, if not impossible, to argue that the service provider's interest is simply a promise to pay.

If a profits interest is property within the meaning of section 83(a), the tax consequences of its receipt in exchange for services appear to be dictated by section 83. The regulations provide that section 83 applies regardless of whether property is received for past, present or future services. The same regulation suggests, however, that section 83's application is limited to circumstances where the service provider receives his or her interest as "an employee or an independent contractor." If section 83 does apply to the receipt of a profits interest and the interest is substantially vested, under section 83 it is taxable upon receipt. The interest is substantially vested if it is freely transferable or not subject to substantial risk of forfeiture.

164. See Prop. Treas. Reg. § 1.721-1(b)(1) (providing that a compensatory transfer of a partnership interest is a transfer of property for the purposes of section 83). A partnership interest is personal property. UNIF. PARTNERSHIP ACT § 29, 7 U.L.P.A. 29 (1914).
166. Id.
167. Treasury Regulation section 1.83-3(b) provides: "Property is substantially vested for such purposes when it is either transferable or not subject to a substantial risk of forfeiture." Treas. Reg. § 1.83-3(b) (as amended in 1985).
169. Code section 83(c)(2) provides: "The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture."
170. I.R.C. § 83(a)(1) (1992); see id. § 83(c)(1)-(2). Treasury Regulation section 1.83-3(c) provides: [W]hether a risk of forfeiture is substantial . . . depends upon the facts and circum-
versely, if a transfer restriction is placed on a profits interest and there is a substantial risk of forfeiture of the interest, the interest is not vested and a taxable event does not occur until the restriction or risk of forfeiture lapses, unless the service partner makes an election under section 83(b) to accelerate the taxable event to the date of receipt.\footnote{71} Moreover, unless a section 83(b) election is made, regulations provide that the transferor of property that is not vested (here the partnership interest) is deemed to remain the owner until the property vests.\footnote{72} Until the property vests, any amount of income received by its holder is considered taxable compensation income in the taxable year of receipt.\footnote{73} If the profits interest is substantially vested or a section 83(b) election is made, section 83 clearly requires that the interest be valued and that value be included in income regardless of how difficult valuation may be.\footnote{74}

From the perspective of the proprietor, as the other partner in the constructive partnership, if section 83 applies, the partnership, subject to limitations on the deductibility of business expenses requiring that certain expenses be capitalized, generally may deduct under section 162\footnote{75} the amount included in income by the service provider when such amount is so included.\footnote{76} The proprietor should then benefit from the deduction.\footnote{77} If the deduction is postponed, or the expense amortized, an effective special allocation would have to be agreed upon by the venturers if the proprietor is to receive the entire tax benefit.

**E. Theories as to the Taxation of a Profits Interest**

Prior to the decision in *Campbell v. Commissioner*,\footnote{78} there were essentially four alternative theories advocated to determine the tax

\footnote{71} See I.R.C. § 83(b) (1992). By making a section 83(b) election within 30 days after the date of such transfer, a partner will be taxed on the value of his or her interest in the year of the transfer. The timing of income inclusion is also accelerated when an interest that has not vested is disposed of in an arm's length transaction. *Id.* § 83(a).


\footnote{73} *Id.*

\footnote{74} Contrast this with the Diamond standard for determinable market value. See *Diamond v. Commissioner*, 492 F.2d 286, 290 (7th Cir. 1974).

\footnote{75} Code section 162(a)(1) allows a deduction for "reasonable . . . compensation for personal services actually rendered" so long as the expense constitutes an ordinary and necessary trade or business expense. I.R.C. § 162(a)(1) (1992).

\footnote{76} See I.R.C. § 83(h) (1992); Treas. Reg. § 1.83-6(a) (as amended in 1978).


\footnote{78} 59 T.C.M. (CCH) 236 (1990), *aff'd*, 943 F.2d 815 (8th Cir. 1991).
consequences of the receipt of a partnership interest in exchange for services: a nontaxable event; a case-by-case approach; the application of section 83; or the American Bar Association's proposal (ABA proposal). After Campbell, the American Bar Association released a report (ABA report) modifying its recommended approach, and the IRS released Revenue Procedure 93-27 stating its position concerning the taxation of receipt of a profits interest for services. Each of these theories will be discussed in turn below.

1. Nontaxable Event

The most favorable tax treatment for a service provider’s receipt of a profits interest is not to tax him or her upon receipt at all. The Hale court chose this approach when it interpreted Treasury Regulation section 1.721-1(b)(1) to mean that “the mere receipt of a partnership interest in future profits does not create any tax liability.” The service provider then would simply be taxed on his or her share of profits when earned by the constructive partnership. To the extent that the partnership profits are allocated and taxed to the service provider, the amount of profits taxed to the proprietor is reduced, almost as if the proprietor had been allocated a business expense deduction for having paid the service provider compensation. Problems of double taxation and double deduction are eliminated.

Policy reasons favoring a nontaxable event include “[l]ogic, practicality, simplicity, and predictability of results.” The primary objection to this approach is that a service provider will escape taxation on the value of the profits interest received for services until there is a taxable disposition. This approach, moreover, may result not only in substantial deferral of income, but also in conversion of what would

179. American Bar Association Section of Taxation, Committee on Partnerships, Proposal 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 (Apr. 28, 1987) [hereinafter ABA Proposal], reprinted in 87 Tax Notes Today 91-24 (May 11, 1987); excerpt reprinted in Lind et al., supra note 119, at 82-87.

180. 1993-24 I.R.B. 63; see discussion infra part II.G.

181. This method was rejected by the Diamond court. The court did not reject completely the proposition that Treasury Regulation section 1.721-1(b)(1) could have some relevance in this area, but chose only not to apply it to the facts of the Diamond case, where the partnership interest was received for services previously rendered, not future services, and the interest arguably was a capital rather than a profits interest. See Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).

182. Hale v. Commissioner, 24 T.C.M. (CCH) 1947, 1502 n.3 (1965); see supra text accompanying notes 79-86.

183. Willis et al., supra note 53, § 46.12, at 46-38.
otherwise be ordinary income (the service provider's compensation income) into capital gain.\textsuperscript{184}

2. \textit{Case-by-Case Approach}

Another approach to the taxation of a profits interest received in exchange for services is the case-by-case analysis. This approach was applied in the landmark decision of \textit{Diamond v. Commissioner},\textsuperscript{185} discussed \textit{supra}, which held the receipt of a profit share with determinable market value is income.\textsuperscript{186}

A major problem with this approach is that each case would have to be decided on its own merits, taking into account all the relevant facts and circumstances.\textsuperscript{187} Some of the factors used to determine whether a taxable event has occurred include "whether the interest could be valued, whether it was in exchange for past or future services, and whether it could be transferred by the service partner."\textsuperscript{188} This approach is likely to give rise to unpredictability and inconsistency of results.\textsuperscript{189}

Moreover, if the profits interest is included in income upon receipt because it has a determinable market value, it would appear that the service provider, to the extent of the value that was based on the value of the future income stream, is going to be taxed twice when the partnership earns income. Neither the courts nor the IRS has provided guidelines to alleviate this problem. In addition, to the extent that the proprietor deducts the value from income and then allocates partnership income to the service provider, there is a double benefit to the proprietor.

3. \textit{Application of Section 83}

Application of section 83 to the taxation of a profits interest received in exchange for services creates even greater practical and con-
ceptual problems than does the case-by-case approach.\textsuperscript{190} If the profits interest is either not forfeitable or is transferrable, then under section 83(a) its value will be included in the service provider's income upon receipt.\textsuperscript{191} Where the venture is so speculative that the interest is determined to have no value, there is no problem; there is no income or deduction. To the extent that the interest has value, and therefore the amount of that value is included in the service provider's income and deducted from the proprietor's income, the same problems as discussed above in the case-by-case approach arise. The problems with applying section 83 are potentially exacerbated where the interest is subject to a substantial risk of forfeiture and is not transferable. This is likely to be the case in virtually every service contract characterized as a partnership for tax purposes, because the service provider generally receives an interest in profits in exchange for rendering future services. In such circumstances, the profits interest is generally non-transferable and forfeitable if at any time during the life of the constructive partnership the service provider no longer renders services.\textsuperscript{192} In the absence of a section 83(b) election,\textsuperscript{193} the value of the profits interest would have to be included in the service provider's income whenever the interest becomes vested.\textsuperscript{194} In the context of a constructive partnership, it is unlikely that such an election would be timely made (unless done as a protective measure), since the service provider would not likely consider himself or herself an individual who received property for services when he or she entered into the service contract.\textsuperscript{195}

In the absence of a section 83(b) election, there are two possible ways to analyze the effect of such a nonterminating forfeiture provision. One argument is that the risk of forfeiture never lapses. This

\textsuperscript{190} See Willis et al., supra note 53, § 46.14.

There seems to be no logical reason for applying § 83 to the receipt of a profits interest by a service partner in exchange for services. There is no substantial harm to the government or undue advantage to the partners if there is no tax assessed at that time. Conversely, by applying § 83, there is undue hardship to the service partner and undue benefit to the other partners with little, if any, effect on the revenue.

\textsuperscript{191} I.R.C. § 83(a) (1992).

\textsuperscript{192} See Kobor v. United States, 88-2 U.S.T.C. (CCH) ¶ 9477 (C.D. Cal. 1987) (finding, without citing I.R.C. § 83, that a profits interest granted in exchange for future services was subject to a substantial risk of forfeiture and that requiring a majority of the limited partners' consent to a transfer made the interest not freely transferable).

\textsuperscript{193} I.R.C. § 83(b) (permitting an election to include immediately in income a property interest that is not vested).

\textsuperscript{194} See supra notes 167-74 and accompanying text.

\textsuperscript{195} The section 83(b) election must be made no later than 30 days after the date of receipt of the partnership interest. See I.R.C. § 83(b)(2).
would yield the same results as the nontaxable event approach discussed above. Alternatively, however, one could argue that a lapse occurs each time the service provider becomes entitled to a share of profits, at least with respect to some portion of the profits interest. This analysis is supported by the fact that at the end of each period for which the service provider receives his or her profits share, he or she has received everything to which he or she is entitled for that period as a profits partner. At this point, the question becomes how much must be included in the service provider’s income in addition to his or her share of profits. Perhaps the service provider must include the value of the portion of the profits interest as to which the risk of forfeiture has lapsed. This may be determined by reference to the amount of profit the service provider received and taking into account the nonterminating transfer restriction, resulting in immediate double taxation of the service provider and double benefit to the proprietor.

Regardless of which analysis applies, as long as the profits interest of the service provider is not vested, under Treasury Regulation section 1.83-1(a)(1) the service provider presumably will not be considered the owner of the interest for tax purposes until it vests. This, in turn, triggers a whole series of potential problems, such as the following:

1. [T]he service partner’s distributive share of profits and losses must be reallocated to the other partners, even though the economic benefit or detriment associated with such profits or losses is personally borne by the service partner.

2. All cash distributions from the partnership to the service partner will presumably be taxed to him as ordinary income rather than being subject to the normal distribution rules of section 731.

3. When the service partner’s interest becomes vested and he is recognized as a partner for tax purposes, the remaining partners may be deemed to have received a constructive cash distribution under section 752(b) if the partnership has liabilities, even though the service partner may have been liable for his allocable share of partnership debt from and after the time he originally received his partnership interest.

4. If the service partner happens to be the sole general partner of a limited partnership, the partnership could conceivably fail to qualify

196. Contrast this with the case of a forfeitable capital interest. A capital partner with a forfeitable interest may get current profits, but his or her right to partnership capital may be continuously at risk.

197. I.R.C. § 83(a)(1).
as a true partnership under section 7701 and the regulations thereunder due to the lack of at least one general partner. 198

While such an absurd result could not have been intended when section 83 was enacted, 199 this analysis demonstrates the incompatibility of section 83 and subchapter K. 200

The major advantage of the section 83 approach is its consistent tax treatment of all types of property. 201 The benefit of consistency, however, is often outweighed by the deficiency of logic and practicality when section 83 is applied in this situation. 202

4. ABA Proposal and Report

In 1987, the American Bar Association (ABA) Section of Taxation proposed certain amendments to the regulations under sections 83 and 721 of the Code to clarify the tax consequences of the compensatory transfer of a partnership profits interest. The 1987 ABA proposal includes a definition that would treat as a profits interest any partnership interest where the partner does not have the right with respect to the interest “to share in the proceeds of a sale of the partnership’s assets for their fair market values at the time of receipt of such interest.” 203 Under the ABA proposal, a transfer of a profits interest for services would not be taxed so long as the services were rendered in the service partner’s capacity as a partner. 204 This approach would eliminate, in many cases, the problems of double taxation and valuation associated with inclusion of a profits interest in income. The premise for the proposed amendments is that a partnership profits interest is “arguably analogous to an unfunded, unsecured promise to pay deferred compensation . . . .” 205 Nonetheless, the 1987 ABA proposal goes on to recommend that the value of a profits interest re-

198. LIND ET AL., supra note 119, at 82-83.
199. See WILLIS ET AL., supra note 53, § 46.12.
200. Treasury Regulation section 1.83-3(f)’s reference to an employee or independent contractor receiving property as compensation suggests that section 83 was not intended to apply to a partner’s receipt of property. Moreover, the legislative history of section 83 nowhere mentions receipt of a profits interest, the tax consequences of which were understood to be controlled by subchapter K prior to the enactment of section 83. See Jeffrey M. Paravano, Receipt of a Partnership Profits Interest in Consideration for Services Rendered-Life After Campbell, 44 Tax Law. 529, 545 (1991).
202. Id.; see supra notes 156-75 and accompanying text.
203. ABA Proposal, supra note 179, at 9.
204. Id. at 13. Such nonrecognition treatment would apply even when an interest of this type vests. Id. at 14.
205. Id. at 13.
ceived for services rendered other than in one's capacity as a partner should be included in income unless the interest is not vested.206 A restricted interest would be included in the service partner's income when the interest vests.207 Regardless of whether the interest is vested, however, the partner would be recognized as a partner.208 Thus, the rules converting the distributive share of the partner whose interest is not vested to ordinary income would be inapplicable.209

From the partnership's standpoint, to correspond with the treatment of the service partner, the ABA proposed that no deduction be allowed to, or capital expenditure be deemed made by, the partnership where the transfer of the profits interest is nontaxable.210 Under the rules in Treasury Regulation section 1.83-6(a), any deduction would be allowed and any capital expenditure required to be capitalized.211

Finally, under the 1987 ABA proposal, no gain or loss would be recognized by the partnership when a nontaxable transfer is made.212 A taxable transfer, however, would be treated as an anticipatory assignment of income in the amount of the fair market value of the interest.213 The partnership, having no basis in this profits interest, would therefore recognize income in the amount of this value.214 To offset the service partner's double taxation problem, the ABA proposed that the profits interest be treated as an intangible asset transferred to the service partner and then constructively recontributed to the partnership and eligible for amortization over a sixty-month period.215 Such amortization deductions would be specially allocated to the service partner.216

The 1987 ABA proposal does address some of the problems associated with the other theories of taxation, such as the need for relief from double taxation and the uncertainty as to the applicability of

206. Id. at 14.
207. Id. at 7, 14; supra notes 167-74 and accompanying text.
208. ABA Proposal, supra note 179, at 14.
209. See supra notes 172-73 and accompanying text.
211. Id. Treasury Regulation section 1.83-6(a) (1978) provides the general rule:

In the case of a transfer of property in connection with the performance of services, or a compensatory cancellation of a nonlapse restriction . . . a deduction is allowable under sections 162 or 212, to the person for whom such services were performed. The amount of the deduction is equal to the amount includable as compensation in the gross income of the service provider . . . but only to the extent such amount meets the requirements of sections 162 or 212 and the regulations thereunder.

212. ABA Proposal, supra note 179, at 14.
213. Id.
214. Id.
215. Id. at 14-15.
216. Id. at 15; see I.R.C. §§704(b)-(c).
section 83. It does not, however, address all of the problems discussed above that arise from either nontaxability or immediate inclusion. Moreover, it would add yet another uncertainty: the determination of whether a service provider performed services in his or her capacity as a partner. This standard is used to determine the tax consequences when a partner receives payments for services or the use of property that are not tied to partnership profits. There is ample history involving interpretation of the section 707(a) standard for determining whether the services performed were in one’s capacity as a partner, and often some fine distinctions are required. It seems unnecessary to inject the additional complexity attendant to the application of the section 707(a) standard into an already complex area. It is also difficult to rationalize connecting the determination as to taxability to the capacity in which the partner’s services are rendered. For example, the use of this standard would assure that whenever services are performed before the partnership is formed, the receipt of the profits interest is a taxable event. One cannot perform in his or her capacity as a partner when there is no partnership. This would have nothing to do with the nature of the services performed, the focus of the distinction attempted in section 707(a). The 1987 ABA proposal merely asserted that this standard is consistent with section 707(a)(2)(A) and provides a “more important” criteria for taxability than other proposals.

Five years later, after the Tax Court and Eighth Circuit rendered their opinions in Campbell, discussed infra, the ABA Section of Taxation reconsidered its position regarding the tax consequences of the receipt of a profits interest for services. On October 22, 1992, the ABA Section of Taxation released a report recommending that in almost all cases the receipt of a profits interest in exchange for services

217. See I.R.C. §§ 707(a), (c). Both sections determine the characterization of payments received for services depending upon whether or not the partner was acting in his capacity as a partner.


Section 707(a)’s legislative history tells us to look at “all the facts and circumstances” to determine whether “a payment [was made] to a partner acting in his non-partner capacity.” Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., Explanation of the Provisions Approved by the Committee on March 21, 1984 225 (Comm. Print 1984). It also provides a list of six factors to consider and several examples. Id. at 227-30.


221. See discussion infra part II.F.
be treated as a nonrealization event. The ABA report also includes a proposed definition of profits interest that uses a "liquidation approach" to distinguish a profits from a capital interest. Finally, the report includes a recommendation that when a profits interest must be included in income an "all factors" valuation method should be used to determine the includable amount.

In support of its recommendation that the receipt of a profits interest for services generally be treated as a nonrealization event, the ABA Section of Taxation relied on the substantial body of pre-1954 law. The report also considered the absence of indicia, other than the inclusion of Code sections 707(a) and (c), that Congress intended, when it promulgated the 1954 Code, to change the existing law con-

223. See supra notes 54-55 and accompanying text.
224. *ABA Report*, supra note 54, at 463. The ABA report acknowledges that existing case law, with the exception of *Campbell*, has used the "liquidation method" to value profits interests. See id.; supra notes 146-50 and accompanying text. Using the ABA's proposed definition of profits interest with this valuation method would always result in a determination of no value. See supra notes 54-55 and accompanying text. The ABA report concludes that this would not be "good tax policy." *ABA Report*, supra, at 469.

Under the "all factors" approach, many unique factors associated with the value of a profits interest are weighed to determine value. A profits interest in a new business generally would have no value, while one in an established business with proven earning capacity may have an ascertainable value. *Id.* at 469. Trading of interests in a secondary market would have substantial weight in the valuation process. In addition, the following list of valuation factors would be taken into account:

(a) The presence or absence of voting or management rights attributable to the interest received.
(b) The rights of the holders of such interests to compel partnership distributions, the dissolution of the partnership and the sale of partnership assets. In the absence of a provision contained in the partnership agreement requiring the distribution of cash, the valuation should also take note of the possibility that the managing partner may withhold distributions of partnership profits even though the service partner will be required to pay tax on his distributive share of such profit.
(c) The ability of the holders of such interests to amend the partnership agreement or veto amendments to such partnership agreement.
(d) The existence or nonexistence of puts, options or buy-sell agreements (and the terms of the agreements) in existence with respect to such interests as of the date of receipt.
(e) Subordination of the profits interest to the rights of other partners to, for example, a priority return on their investment and the right (if applicable) of one or more other partners to terminate the partnership before the service partner is permitted to share in earnings.
(f) The right of one or more other partners to receive guaranteed payments or other forms of compensation that may minimize or eliminate profits in which no holder of the profits interest would otherwise have shared.

*Id.* at 469-70.
225. See *id.* at 456; *supra* text accompanying notes 60-75.
cerning taxation of payments to a partner for services rendered to his or her partnership.\footnote{227} The report points to this essential no-change-of-law analysis as the explanation for the absence of any direct discussion of profits interest received for services in section 721\footnote{228} and the accompanying regulations.\footnote{229} The report also espouses nonrealization as the presumption where the aggregate concept of partnerships prevails and a partner is compensated for services to the partnership.\footnote{230} Thus, particularly where the compensation is in the form of a profits share, nonrecognition is unnecessary. The Section of Taxation reasoned that the addition of section 83\footnote{231} to the Code in 1969\footnote{232} did not change this, since it does not deal with income realization, but instead is concerned with the timing of income and its amount.\footnote{233}

Despite the fact that the report includes substantial policy reasons for not treating the receipt of a profits interest for services as a taxable event, including the consistency of such a position with longstanding administrative practice and the elimination of needless complexity,\footnote{234} the ABA report includes a recommendation that under certain circumstances a profits interest received for services be included in the service provider's income.\footnote{235} The ABA advocates income inclusion consistent with the principles of sections 61 and 83\footnote{236} where the

\footnote{227} ABA Report, supra note 54, at 457.

\footnote{228} I.R.C. § 721. Section 721 provides for nonrecognition of gain or loss when property is contributed to a partnership in exchange for a partnership interest. It has been argued that this provision supports nonrecognition where a profits interest is received for services. See supra parts II.B.2. and II.E.

\footnote{229} ABA Report, supra note 54, at 457. Treasury Regulation section 1.721-1(b)(1) has been the focus of much dispute and discussion concerning the taxability of profits interests received for services, see supra text accompanying notes 76-79 and 181-84, since it was cited in support of nonrecognition in a footnote in Hale v. Commissioner, 24 T.C.M. (CCH) 1497, 1502 n.3 (1965). See supra text accompanying notes 80-87.

\footnote{230} See ABA Report, supra note 54, at 456. The aggregate concept of partnership taxation views a partnership as "two or more persons who pool their capital or labor or both in order to conduct jointly a business or other profit-making endeavor. Thereafter each partner is taxed on his distributive share of income." Id. (citing United States v. Basye, 410 U.S. 441 (1973)).

\footnote{231} I.R.C. § 83; see discussion supra parts II.D., II.E.3.


\footnote{233} ABA Report, supra note 54, at 458-59. Thus, if income is not realized under Code section 61, section 83 is not relevant.

\footnote{234} ABA Report, supra note 54, at 460. The ABA also commented that any possibility for abuse of the proposed general rule of nonrealization could be addressed through regulations that would assist in the identification of situations where the service provider does not intend to be a true partner and where a profits interest really is a disguised capital interest. Id. at 461-62.

\footnote{235} Id. at 466.

\footnote{236} I.R.C. §§ 61, 83. The time when a taxable profits interest becomes vested is governed by Code section 83(a). Once included in income, the partner's outside basis in his partnership interest equals the amount included in income. This approach requires that the partner's employer be deemed to have received the profits interest tax free and then to have transferred it to the partner
partnership interest is received for services provided to someone other than the partnership. While the determination of whether a taxable event occurred would necessarily depend upon the facts and circumstances, the majority of the drafters of the ABA report advocate primarily relying on a primary contractual nexus test and a degree of benefit test. Thus, the ABA report leaves the door open to the needless complexity it disdains and injects another fine distinction that must be made to determine the tax consequences when a partner receives a profits interest for services. Admittedly there is not the same history of administrative practice supporting nonrealization in these limited circumstances, and the ABA report does attempt to address some of the complex issues triggered by includability. The benefit of potential current inclusion, however, does not outweigh the substantial administrative and practical burden of identifying taxable transactions and dealing with their consequences.

F. Diamond Reconsidered: Campbell v. Commissioner

1. The Tax Court Applies Section 83

In Campbell v. Commissioner, the United States Tax Court recently considered, among other things, the validity of the Diamond for his or her services. The employer would be entitled to a business expense deduction under Code section 162(a) in the amount included in income by the partner, subject to the general rules concerning capital expenditures. I.R.C. § 263; Treas. Reg. § 1.83-6(a)(4) (1978). Moreover, the employer would recognize gain equal to the difference between the amount deducted as a business expense or the amount capitalized and the employer's basis in the profits interest (which would be zero since it was deemed to receive the interest tax free). ABA Report, supra note 54, at 460-61.

237. ABA Report, supra note 54, at 454, 466. Essentially, this requires a determination of whether or not the partner who got his or her interest for services, but is also an employee or independent contractor of another partner or a third party, got his interest for services rendered to the partnership. Id. at 454.

238. Id. at 466.

239. The primary contractual nexus test requires a determination of whether, in performing services, the primary contractual nexus exists between the partner and the partnership, as opposed to another partner or a third party. All relevant contracts are to be considered, and with respect to future services, the presumption is that the services are to be rendered for another partner or a third party. This presumption can be rebutted by a direct contract with the partnership for the services. Id.

240. The degree of benefit test looks at the extent to which the partnership benefits from the partner's services. For the services to be viewed as rendered to the partnership, they must provide a significant benefit to the partnership. Id. at 466-67. A minority of the committee who worked on the ABA report would rely exclusively on the degree of benefit test to determine whether the partner's services were rendered primarily to or for the benefit of the partnership. Id. at 467.

241. 59 T.C.M. (CCH) 236 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991).
doctrine and the application of section 83 to a partnership profits interest received in exchange for services. In the court’s memorandum decision, not only did Judge Scott hold that section 83 applied to the profits interest, but she also accepted a novel approach to valuing the interest for the purpose of determining the amount that must be included in the taxpayers’ income.

The findings of fact in Campbell were fairly extensive. This is primarily because Campbell acquired three profits interests in the context of real estate syndications. The terms of the partnership agreements in these settings typically are very elaborate and set forth in great detail by the court. The following discussion will summarize the essential facts that led to the court’s ultimate conclusions.

During 1979 and 1980, Campbell was an employee of Summa T. Group, an organization “primarily engaged in the formation and syndication of limited partnerships.” Early in 1979, Campbell’s responsibilities changed from sales to locating and arranging the acquisition of properties suitable for syndication, assisting in the preparation of offering materials and promoting sales of partnership interests.

In connection with Campbell’s new job responsibilities, he entered into a new compensation arrangement. Campbell was entitled to fifteen percent of the proceeds of the sale of each syndication, in addition to a “special limited partnership interest” in each limited partnership that he helped form and finance. It was the receipt of three of these special limited partnership interests that triggered the tax controversy before the Tax Court.

As a special limited partner, Campbell was entitled to a share of the limited partnerships’ profits and losses. After payment of a priority return to the bulk of the investors, Class A limited partners, as a special limited partner, Campbell was entitled to a special priority return out of available cash. In addition, if more cash was available after payment of the priority returns and a fixed payment to the general partner, cash would be distributed in accordance with Campbell’s share of profits and losses. Campbell also had a right to a share of the proceeds of a sale or refinancing of partnership property.

The projections prepared for each limited partnership offering indicated that there would be quite a few years where the partnerships

243. See id. at 253-56. For the tax years in question, the Campbells filed joint returns.
244. Id. at 237.
245. Id.
246. Id.
would pass through only losses, deductions and credits. In addition, it would take quite a few years for the partnerships to have cash available for distribution. Finally, each offering memorandum cautioned investors that "the partnership's positions with respect to certain deductions and credits were not based on settled interpretations of the tax laws and that the Internal Revenue Service might disallow any of the various deductions and credits claimed."  

As projected, during 1979 and 1980, the partnerships passed through substantial losses, deductions, and credits. Campbell's returns reflected his shares of these amounts. In addition, based upon the advice of reputable tax counsel, Campbell did not report any income representing the value of the partnership interests in the year of receipt. Ultimately, the Commissioner not only asserted that these values should have been reflected as income, but also disallowed substantial amounts of the partnership losses, deductions, and credits.

Prior to trial, the parties stipulated to the allowable losses, deductions, and credits. This left two substantial issues for the Tax Court: (1) "whether petitioners were required to include in income the value of the partnership interests," and (2) "if so, the value of such interests."

The Tax Court began its analysis of these issues by considering whether the nonrecognition rule of section 721(a) applied in this case to defer inclusion in income of the value of Campbell's partnership interests. The taxpayers had asked the court to reconsider the applicability of Treasury Regulation section 1.721-1(b)(1) to the receipt of a partnership profits interest. The court, however, declined to do so, citing its rejection of the same argument in Diamond v. Commissioner and reaffirming the Diamond holding. The court did not believe that section 721(a)'s nonrecognition rule was intended to cover any situation where a partnership interest is received for services rather than property.
Having concluded that there existed no nonrecognition provision that prevented the inclusion in income of the value of Campbell's interest, the court went on to hold that section 83 controlled the timing of the inclusion.\textsuperscript{259} First, the court noted, the limited partnership interests were property within the meaning of section 83. Despite the Commissioner's arguments, the court rejected the idea that even a pure profits interest is akin to the "unfunded and unsecured promise to pay money or property in the future" excluded from the definition of property by Treasury Regulation section 1.83-3(e).\textsuperscript{260} Relying on the Uniform Limited Partnership Acts' characterization of a limited partnership interest as personal property\textsuperscript{261} and the absence of a distinction between profits and capital interests,\textsuperscript{262} the Tax Court held that Campbell received property within the meaning of section 83.\textsuperscript{263}

The court then considered the taxpayers' argument that the partnership interests in two situations were not transferred in connection with the receipt of services. With respect to two of the limited partnerships, an original shell limited partnership was formed prior to the syndication and sale of the limited partnership interests to the ultimate investors. In those partnerships, Campbell acquired a limited partnership interest in exchange for a nominal cash contribution.\textsuperscript{264} Once each syndication was complete, however, Campbell was demoted to special limited partner status.

The Tax Court, rejecting the taxpayers' argument, characterized Campbell's receipt of the special limited partnership interests as transfers separate and distinct from his acquisition of the original limited partnership interests for cash. The court viewed the original limited partnerships as being created merely to facilitate the syndications. Campbell's original limited partnership interests were "quantitatively and qualitatively"\textsuperscript{265} different from his special limited partnership interests. The court stated that Campbell acquired the latter interests solely as a product of the prior services he rendered to his employer under his compensation package.\textsuperscript{266} Moreover, the court found no apparent justification to distinguish the tax consequences in the two set-

\textsuperscript{259} Id. at 250.
\textsuperscript{260} Treas. Reg. § 1.83-3(e) (as amended in 1985).
\textsuperscript{261} UNIF. LIMITED PARTNERSHIP ACT § 701, 6 U.L.A. 439 (Supp. 1993).
\textsuperscript{262} Id. at §§ 101(10), 701.
\textsuperscript{263} Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 250 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991).
\textsuperscript{264} Id. at 238, 241.
\textsuperscript{265} Id. at 251.
\textsuperscript{266} Id. at 252.
tings where a shell was used to facilitate the syndication from the one situation where there was no shell.267

Finally, with respect to section 83’s application, the Tax Court considered whether Campbell’s interests were subject to a substantial risk of forfeiture.268 Since the interests were not freely transferable, a substantial risk of forfeiture would postpone income inclusion until the transfer restriction or forfeiture risk lapsed.269 In arguing that there was a substantial risk of forfeiture, the taxpayers relied upon section 83(c)(1). Section 83(c)(1) provides: “The rights of a person in property are subject to a substantial risk of forfeiture if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.”270 They also relied upon Treasury Regulation section 1.83-3(c)(2), which provides in part that “[w]here an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture.”271

The taxpayers’ entire argument focused on the speculative nature of Campbell’s interest. Campbell would not receive any cash distributions unless the partnerships were successful enough to pay more than the Class A limited’s preferential return. Moreover, Campbell would not get any proceeds from a sale or refinancing unless a partnership’s primary asset substantially appreciated. Admittedly, economic success of each partnership depended to some degree on substantial services to be performed by someone.272 All of that, however, goes to the values of the interests. Nowhere did the court find a requirement, once the partnerships reached minimum subscription levels, that Campbell’s interest be returned if the partnerships did not prosper.273

Having thus determined that section 83 required inclusion in income of the value of Campbell’s partnership interests, the court went on to determine their fair market value. The Commissioner’s position at

267. Id. at 251-52.
268. See I.R.C. §§ 83(a)(1), (c)(1)-(2) (1992); supra notes 167-74 and accompanying text.
270. I.R.C. § 83(c)(1); see Campbell, 59 T.C.M. at 252.
271. Treas. Reg. § 1.83-3(c)(2) (as amended in 1985); see Campbell, 59 T.C.M. at 252-53. The court interpreted Treasury Regulation section 1.83-3(c)(2) as requiring that there be an agreement “to actually recover possession of the property rights transferred . . . when increased earnings do not materialize.” Campbell, 59 T.C.M. at 253.
272. See Campbell, 59 T.C.M. at 253.
273. Id. Campbell’s interests never returned any economic benefit, all three partnerships having wound up in Bankruptcy Court within two years of their formation. Paravano, supra note 200, at 540.
trial regarding value was based on the present value of the projected tax benefits and cash distributions set forth in the offering memorandum for each of the partnerships. The taxpayers first argued that the value of the interests was so speculative that the interests were not capable of valuation. Alternatively, the taxpayers had an expert testify that the value of the interests was far less than the Commissioner asserted. This expert's valuation also discounted to present value the projected cash distributions (although using a different discount rate than the Commissioner), but assigned no value to the projected tax benefits, based on the representation in the offering memoranda that there was a substantial risk these would be eliminated if there was an audit. In addition, the taxpayers' expert took into account transfer restrictions and lack of participation in management. Overall, the court rejected the position taken by the taxpayers' expert as "not based on sound reasoning." The primary reason for this conclusion was that very similar interests, Class A limited partnership interests, were sold for a substantial amount at or around the time Campbell got his interests. Thus, the court did not accept the allegation that the values were de minimus or that the projected tax benefits had no value. Finally, the court refused to consider a lapsing transfer restriction in calculating value.

On the other hand, the court also rejected the value determined by the Commissioner. The court concluded that the Commissioner's value was too high because he used a discount rate that was too low. The court found that the rate was too low because the Commissioner projected sales of the partnerships' principal assets before they probably would occur.

274. The Commissioner did not have an expert testify as to fair market value. Campbell, 59 T.C.M. at 253.
275. Id. at 254.
276. Id. at 255. The taxpayers' expert had determined that each partnership interest was worth $1,000. The court described the expert's conclusion that each interest had exactly the same nominal value as "unreasonable, without basis, and quite obviously plucked out of thin air." Id. 277. Id.
278. Id. at 254; see I.R.C. § 83(a); supra note 160 and accompanying text.
279. Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 255-56 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991). The Commissioner calculated value assuming, among other things, that there would be a liquidation of the partnerships in 1989. Id. at 255. It concluded that such a liquidation would result in the Class A limited partners getting nothing. Id. The court believed that it was unlikely the partnerships would liquidate in 1989, since it was likely that soon thereafter there would be sufficient proceeds upon liquidation to repay at least part of the Class A limiteds' capital. Id. Moreover, even a 1989 liquidation would result in some return to these limited partners. Id. The general partners and the special limited partners, on the other hand, had "little realistic chance" of recovering capital or receiving a distribution in the foreseeable future. Id.
Ultimately, for two of Campbell's three partnership interests the court applied the discount rate used by Campbell's expert to the projected value of the tax benefits associated with these interests. The court discounted further the value of the third interest to reflect that Campbell acquired it before the primary financing for the partnership's proposed project was in place. Finally, the court declined to determine whether Campbell was negligent in failing to include any amount in income in the year of receipt of the partnership interests.

The Tax Court's decision in Campbell resolved, at least as far as the Tax Court was concerned, whether section 83 applies to the receipt of a profits interest for services rendered. Unfortunately, the decision left unanswered many more questions than it answered regarding the consequences of section 83's application in this context. The following are examples of unresolved issues: How are problems of double taxation and double tax benefit to be resolved? If the profits interest is not vested, what is the tax effect of the service provider not being the owner of the interest until it vests? When does a lapse occur? Moreover, Campbell involved a situation where the court found that the service provider received his interest for services previously rendered for his employer. Whether section 83 applies where the services are to be rendered in the future in his or her capacity as a partner was left open to speculation. If section 83 does not apply, additional questions arise where some of the services are to be provided in the future as a partner, but some have already been provided as an employee or independent contractor.

Once the Campbell court upheld Diamond and concluded that section 83 applied to the receipt of a profits interest for services, it was not a startling conclusion that the interests were vested and, therefore,

280. The taxpayers' expert calculated the discount rate "by multiplying the 1979 Baa Corporate Bond Rate of 12.22 percent and the 1980 Baa Corporate Bond Rate of 15.19 percent by a factor of 2.5." Id. at 254.

281. Id. at 256.

282. Id. at 258. After holding that the taxpayers were negligent in claiming excessive deductions and credits, the court concluded that it did not have to discuss whether the taxpayers were also negligent in failing to include any amount in income. Id. It should be noted, however, that Campbell consulted two tax attorneys, one of whom taught partnership tax law at New York University. Id. at 237. The attorneys advised Campbell that there was little or no chance he would be taxed on the receipt of the partnership interests and that the facts of Diamond were distinguishable. Id. at 237-38.

283. The Committee on Partnerships of the American Bar Association's Section of Taxation is planning to issue a notice and report concerning the Campbell decision. Bob Casey, Committee Highlights: Panel on the Campbell Case Dealing With Receipt of a Partnership Interest for Services-Committee on Partnership, 10 Sac. TAX'N NEWSL. 21, 23 (1990).

284. See supra part II.E.3.
their value had to be included in income upon receipt.\footnote{285} It was the valuation method used by the Tax Court that was extraordinary. This was the first case involving a profits interest where the present value of projected tax benefits determined value.\footnote{286} Since there were contemporaneous sales of similar partnership interests and little or no prospect of profits or cash distributions for any partner for quite some time, it was not unreasonable that the court found some value in Campbell’s interests and used the projected tax benefits to determine that value. The court erred, however, in refusing to take into account the substantial risk that the projected tax benefits would be disallowed and the fact that Campbell’s return was subordinated to other investors’ return.

In deciding whether the negligence penalty should apply, the court explained that Campbell was not an outsider who merely reviewed the offering memorandum with its warning concerning the risk of loss of the tax benefits.\footnote{287} He was intimately familiar with the way the organizers of the limited partnerships developed overstated values for partnership assets and characterized certain nondeductible payments as deductible fees.\footnote{288} This, in turn, caused the projected tax benefits to be severely overstated.\footnote{289}

The amount included in income under section 83 is equal to the fair market value of the asset received for services.\footnote{290} Fair market value is to be determined on the assumption that a willing buyer and willing

\footnote{285}{\textit{See supra} notes 268-73 and accompanying text.}

\footnote{286}{Earlier decisions dealing with receipt of a profits interest for services, see St. John v. United States, 84-1 U.S.T.C. (CCH) ¶ 9158 (C.D. Ill. 1983); National Oil Co. v. Commissioner, 52 T.C.M. (CCH) 1223 (1986); Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749 (1984), and the IRS's express position in Gen. Couns. Mem. 36,346 (July 23, 1975 and July 25, 1977), support the use of liquidation value for determining the value of a service partner's interest. A pure profits interest would never entitle the owner to anything upon a liquidation. Thus, the interest would be valueless. Another possible valuation method uses the inherent risk approach. Under this approach, a pure profits interest would be accorded no value because of its inherently risky nature. See Paravano, supra note 200, at 554.}

\footnote{287}{Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 257 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991).}

\footnote{288}{Id. at 257-58.}

\footnote{289}{The court refers to the partnerships in which Campbell held interests as Phillips House, the Grand and Airport. In 1979, Campbell's Phillips House K-1 allocated to him a $102 ordinary loss and a $24,000 charitable contribution. For 1980, his Phillips House loss was $36,374. Id. at 241. As to Phillips House, the parties stipulated to a $6000 charitable contribution and no allowable losses. Id. at 247. The 1980 K-1 for the Grand allocated to Campbell an $8115 ordinary loss and a $55 separately accounted-for item. Id. at 244. The parties stipulated to a $4247.94 loss from the Grand. Id. at 247. Campbell's share of the 1980 loss from Airport was $6024. Id. at 246. The parties stipulated to a $1304.55 Airport loss. Id. at 247.}

\footnote{290}{I.R.C. § 83(a)(1) (1992).}
seller have "reasonable knowledge of relevant facts."\(^\text{291}\) When describing the structuring of the three syndications, the court referred to abuses and sham transactions employed to inflate the tax benefits described in the offering memoranda.\(^\text{292}\) The Class A limited partners were not aware of facts relating to these abuses and shams when they purchased their interests. If they had been, they would have been unwilling to pay the offering price for their partnership interests. The undisclosed facts undoubtedly were "relevant" to an assessment of the Class A limited partnership interests' value. The Class A limited partners did not have reasonable knowledge of these relevant facts. Therefore, any reference to the amount paid by the Class A limited partners as demonstrating that Campbell's interest had fair market value is misplaced. The Class A limiteds did not pay fair market value.

The facts relating to the structuring of the partnerships to maximize projected tax benefits, resulting in substantial risk of loss of many of these benefits, were relevant. This structuring technique was not uncommon or unfamiliar in the 1970's tax shelter limited partnership market, with its ample supply of shams and abuses. While the court had the opportunity to take the relevant facts into account to determine the fair market value of Campbell's special limited partnership interests, it did not do so. After failing to consider the subordinated nature of Campbell's interests, the Tax Court in *Campbell* took an approach that clearly overstated the fair market value of Campbell's interests.

2. The Eighth Circuit Finds No Value

With the Eighth Circuit's reversal in *Campbell*,\(^\text{293}\) we return essentially to the uncertainty that existed prior to the Tax Court's decision. The United States Court of Appeals for the Eighth Circuit refused to accept the Commissioner's concession that the Tax Court erred to the extent it held that the receipt of a profits interest for services to a partnership constitutes ordinary income.\(^\text{294}\) It also declined to consider the Commissioner's alternative argument that the interests were received in exchange for services provided to Campbell's employer,\(^\text{295}\)


\(^{293}\) Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991).

\(^{294}\) *Id.* at 818, 821.

\(^{295}\) *Id.* at 818.
despite the fact that the Tax Court clearly stated that this was how Campbell got his interests.296 Instead, the Eighth Circuit focused on the Tax Court’s reaffirmation of Diamond97 and its accompanying reference to the instant case involving the receipt of a partnership interest in exchange for services rendered to the partnerships.298

After rejecting the Commissioner’s factual concession concerning the nature of the services rendered, the Eighth Circuit went on to reject the substantive concession concerning the applicability of section 721.299 The court held that the receipts of the profits interests were not eligible for nonrecognition under section 721.300 The Eighth Circuit considered the taxpayers’ argument that Treasury Regulation section 1.721-1(b)(1)301 evidences an intent to distinguish capital interests from profits interests and acknowledged that there is some justification for the distinction when dealing with the section 721 nonrecognition rules,302 but the court was unwilling to go so far as to allow nonrecognition here.

Instead, reminiscent of the ABA proposal and report discussed supra,303 the court concluded that the principles controlling the taxation of payments to a partner for services or the use of property set forth in section 707 of the Code were more dispositive of the issue here.304 Under section 707(a), the characterization of payments for services to a partner depend on whether the partner is acting in his or her capacity as a partner.305 The court described the purpose of this section as assuring that a payment to a partner acting in a nonpartner capacity will not be treated as a distributive share of income.306 Thus, the rules requiring capitalization of certain compensatory payments cannot be avoided. The Eighth Circuit concluded that “[a]rguably, section 707(a) would be unnecessary if compensatory transfers of profits in-

297. See id. at 249. The Eighth Circuit quoted the following language from the Tax Court’s opinion: “‘that section 721(a) and the regulations thereunder are simply inapplicable where, as in the Diamond case and the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership.’ Campbell, 59 T.C.M. at 249.” 943 F.2d at 818 (emphasis added).
299. Id. at 819.
300. Id. at 821.
301. See supra note 54-55.
302. 943 F.2d at 822.
303. See supra notes 203-40 and accompanying text.
306. 943 F.2d at 822.
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interests were taxable upon receipt, because if so, every such transfer would be taxed without this section.307 Overall, the section 707(a) analysis suggests that a partner acting in a partner capacity would not realize income upon receipt of a profits interest, but if acting in a nonpartner capacity, there would be a taxable event. At this point, however, the Eighth Circuit failed to apply its section 707 analysis to Campbell’s receipts and instead considered the valuation issue.308 Before reviewing the Tax Court’s decision, it distinguished the Diamond case from Campbell because Diamond’s “profits interest was properly taxable as easily calculable compensation for services performed.”309 The court reversed the Tax Court and found that Campbell’s profits interest had only “speculative, if any, value.”310 Reliance on the value attached to the Class A limited partnership interests was misplaced, such interests being substantially different from those received by Campbell.311 The predictions as to the ultimate success of the partnership ventures and the projected tax benefits also were inappropriate bases for the calculation of fair market value, as these too were speculative.312

Thus, the Eighth Circuit, like some of its predecessors,313 opted out of reaching any definitive conclusions about the taxation of profits interests received for services, relying instead upon the conclusion that the interests received by Campbell had no determinable fair market value. While the court cited Diamond314 with approval and seemed to reject section 721’s application to the receipt of a profits interest for services,315 it conceded that there is some basis for distinguishing the tax treatment of the receipt of a capital interest from the receipt of a profits interest.316 The Eighth Circuit did not address the issue of section 83’s role here, but turned instead to a section 707(a) analysis, which it ultimately did not apply to Campbell’s case.317 Arguably, the court’s conclusion that Campbell received his interests from the part-

307. Id.
308. Id. at 822-23.
310. Id. at 823.
311. Id.
312. Id.
313. See St. John v. United States, 84-1 U.S.T.C. (CCH) ¶ 9158 (C.D. Ill. 1983); Finkleman v. Commissioner, 56 T.C.M. (CCH) 1269 (1989), aff’d, 937 F.2d 612 (9th Cir. 1991), cert. denied, 112 S.Ct. 1291 (1992); Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749 (1984); see supra notes 146-50 and accompanying text.
314. See Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974); discussion supra parts II.C.1., II.C.2.
316. Id. at 822.
317. Id.
nerships, not his employer, rendered section 83 inapplicable to Campbell's receipt. Finally, while the Eighth Circuit did not reject the valuation method that uses discounted benefits to calculate value, it gave so much weight to the risk that the partnerships would not be successful that it found no determinable value. If this approach is followed by other courts in the future, it is almost certain to eliminate value in any profits interest in a start-up venture. Even the presence of sales of interests with essentially similar risks would not outweigh the speculative nature of the projected benefits to allow valuation of most profits interests. Thus, after the Campbell decision, we seem to be no further along in developing a clear body of law concerning the tax treatment of the receipt of a profits interest for services than we were before.

G. The IRS Takes A Stand: Revenue Procedure 93-27's Safe (?) Harbor

On July 6, 1993, the Treasury Department released Revenue Procedure 93-27 and at long last took a position in a published ruling on the tax consequences of the receipt of a partnership profits interest for services. Essentially, the ruling purports to offer taxpayers a safe harbor where the IRS will not treat the receipt of a profits interest for services as a taxable event. This safe harbor, however, is not only subject to certain express exceptions, but also the scope of its application is unclear even when these exceptions clearly do not apply.

The ruling begins by offering definitions of a "capital interest" and a "profits interest." A capital interest is defined as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination

318. *Id.* at 818, 821.
319. See Treas. Reg. § 1.83-3(f) (as amended in 1985). Alternatively, the Eighth Circuit's decision could be read as silently affirming the Tax Court's decision as to section 83's application since it does not appear that Campbell alleged error in this respect. *See Campbell, 943 F.2d* at 823.
320. Campbell v. Commissioner, 943 F.2d 815, 822-23 (8th Cir. 1991); *see supra* notes 286 and accompanying text.
323. *Id.* at 64.
324. *Id.*
325. *Id.*
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generally is made at the time of receipt of the partnership interest.\footnote{326} A profits interest is defined as "a partnership interest other than a capital interest."\footnote{327} These definitions are consistent with those used by courts\footnote{328} and commentators\footnote{329} and generally work well to distinguish one type of partnership interest from the other.

After providing some regulatory\footnote{330} and common law\footnote{331} background on the tax consequences of receipt of a profits interest for services,\footnote{332} Revenue Procedure 93-27 goes on to provide that the IRS will not treat the receipt of such an interest as a taxable event for the service partner or the partnership "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner . . . .\"\footnote{333} Within this last statement lies the not-so-safe harbor of Revenue Procedure 93-27.

First, the protection of the safe harbor is available only if the services in question were provided "to or for the benefit of a partnership."\footnote{334} While this requirement may sound and frequently will be simple to satisfy, we have already learned from the Campbell decisions that where a taxpayer has multiple relationships with the participants to a transaction involving a partnership, as Campbell did,\footnote{335} it

\footnote{326. Id. The IRS offers no explanation as to the circumstances in which the determination of whether an interest is capital would not be made at the time of receipt. Perhaps a later time is appropriate where a temporary partnership structure is adopted, only to be reorganized as soon as all of the partners are identified and contributions are made. See, e.g., Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 251-52 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991); see supra notes 265-67 and accompanying text.}


\footnote{328. See, e.g., St. John v. United States, 84-1 U.S.T.C. (CCH) ¶ 9158 (C.D. Ill. 1983); see supra notes 146-50 and accompanying text.}

\footnote{329. See, e.g., McKee et al., supra note 54, ¶ 5.05[1]; see supra notes 54-55 and accompanying text.}

\footnote{330. Treas. Reg. § 1.721-1(b)(1) (1960).}

\footnote{331. St. John, 84-1 U.S.T.C. (CCH) at ¶ 9158; Campbell v. Commissioner, 59 T.C.M. (CCH) 236 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991); Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).}

\footnote{332. The IRS begins by acknowledging that the significance of Treasury Regulation section 1.721-1(b)(1) has been the subject of dispute when a profits interest is received in exchange for services. Rev. Proc. 93-27, 1993-24 I.R.B. 63, 64. The IRS goes on to describe the Eighth Circuit's decision in Campbell as suggesting in dictum that such a transaction is not taxable, but that the District Court in St. John and the Tax Court in Campbell held that it is taxable under section 83. Id. The IRS concludes, however, that typically even where courts treat the receipt of the profits interest as a taxable event and where there was a quick sale, with the exception of the result in Diamond, the interests have been found to have no value. Id.}

\footnote{333. Id.}

\footnote{334. Id.}

\footnote{335. See supra notes 244-47 and accompanying text.}
may be far from certain for whom the services are being rendered. Moreover, the ruling is unclear as to whether this requirement for its safe harbor can be satisfied where services are rendered before a partnership exists.

Second, the safe harbor also requires that the services be rendered “in a partner capacity or in anticipation of being a partner.” The potential difficulty of determining whether a partner’s services are rendered in his or her partner capacity has been discussed above. As for the alternative requirement that the services be rendered “in anticipation of being a partner,” there still is ample room for doubt. The application of this requirement is necessarily limited to situations where the partnership interest is transferred in exchange for past services. It is during the period of providing services that the “anticipation” of the service provider must be determined. There is no discussion in the ruling as to how this “anticipation” is to be established. Is the analysis objective or subjective? Should the approach be like that used to determine partnership intent, examining various objective factors to reach a conclusion regardless of the representations of the parties to the transaction? Finally, can one render services in anticipation of becoming a partner when the partnership interest received is a constructive one, as is the case with recharacterized service contracts? With all of these unanswered questions, it is difficult, if not impossible, to conclude with certainty that the IRS will not assert taxability where services are provided before the service provider becomes a profits partner.

After stating its general rule, Revenue Procedure 93-27 lists an interesting series of exceptions. The general rule of the revenue procedure does not apply:

1. If the profits interest relates to a substantially certain and predictable stream of income from partnership assets . . . ;
2. If within two years of receipt, the partner disposes of the profits interest; or
3. If the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b) of the Internal Revenue Code.

336. See Campbell v. Commissioner, 943 F.2d 815, 818 (8th Cir. 1991); Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 237-38, 249, 251-52 (1990); see supra notes 295-96 and accompanying text.
338. See supra notes 217-20 and accompanying text.
340. See id.
341. Id.
Individually, each of these exceptions presents its own potential challenges. With respect to the first exception, the "substantially certain and predictable" standard leaves room for interpretation and thus for uncertainty. While the revenue procedure mentions two situations covered by this exception,\textsuperscript{342} these are merely examples and are not the only situations to which this exception may apply. The second exception seems certain enough, but may eliminate an opportunity for planning for taxability since its application is retroactive and may be unforeseen. Finally, the third exception imports issues concerning the interpretation of the term "publicly traded partnership"\textsuperscript{343} to this already uncertain area of federal income taxation.

When looked at as a group, the exceptions to the general rule that the IRS will not assert that there was a taxable event when a profits interest is received for services reveal the IRS's true perspective on these transactions. Each of the exceptions attempts to identify profits interests received for services that are relatively easy to value.\textsuperscript{344} Essentially, the IRS has agreed not to assert taxability where it probably will be unable to sustain a reasonable value for the profits interest. Thus, the revenue procedure does not suggest a concession on the issue of taxability. Instead, Revenue Procedure 93-27 evidences the IRS's view that it is best to concede cases where it may be able to succeed on the merits, but will likely lose on the valuation issue. Beyond these circumstances, Revenue Procedure 93-27 leaves the IRS with sufficient room for interpretation to allow the IRS in many cases

\begin{itemize}
\item \textsuperscript{342} The two situations mentioned in Revenue Procedure 93-27 where an income stream is certain and predictable are where the income is "from high-quality debt securities or a high-quality net lease." Rev. Proc. 93-27, 1993-24 I.R.B. 63, 64.
\item \textsuperscript{343} Code section 7704(b) (1992) defines "publicly traded partnership" as any partnership if "(1) interests in such partnership are traded on an established securities market, or; (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof)."
\end{itemize}
to continue to press for inclusion in income of the value of a profits interest received for services. At the same time, the IRS continues its silence regarding the various tax consequences of such inclusion to partners and partnerships.

III. Tax Planning

Even with Revenue Procedure 93-27\textsuperscript{345} and Campbell,\textsuperscript{346} the proper tax treatment of the exchange of services for a constructive profits interest is uncertain. Thus, tax planning for a service contract is very difficult, because the risks associated with potential partnership characterization are impossible to quantify.\textsuperscript{347} From the service provider’s standpoint, in the best case, the form of the transaction will be respected and the service provider will report as ordinary income his or her share of profits when it is received.\textsuperscript{348} The proprietor, in contrast, may be content with the respected form if, under the rules governing capitalization,\textsuperscript{349} the proprietor can currently deduct the contingent compensation.\textsuperscript{350}

Even if the service contract is recharacterized, there are substantial arguments supporting no immediate income inclusion, as well as several precautions that can be taken to minimize or eliminate adverse tax consequences. The nature of a service contract is such that it will almost always involve receipt of the service provider’s interest for substantial future services. To the extent that Diamond\textsuperscript{351} and Campbell\textsuperscript{352} reach definitive conclusions about any of the issues associated with the receipt of a profits interest for services, they did so in the case of

\begin{itemize}
\item \textsuperscript{345} 1993-24 I.R.B. 63.
\item \textsuperscript{346} 943 F.2d 815 (8th Cir. 1991).
\item \textsuperscript{347} Leading partnership tax practitioners continue to advise clients that “there is ‘little or no chance’ that you will be subject to federal income tax.” Roundtable Discussion on Partnership Taxation with William S. McKee, Blake D. Rubin, and R. Donald Turlington, 12 ABA Sec. Tax’N NewsL. 47, 47 (Spring 1993) [hereinafter Roundtable].
\item \textsuperscript{348} This assumes that the service provider is an individual and, therefore, uses the cash method of accounting. This also assumes that the contingent compensation is a share of profits, rather than gross receipts. The risk of recharacterization is virtually eliminated when gross receipts provide the measuring rod. See, e.g., Robinson v. Commissioner, 44 T.C. 20 (1965).
\item \textsuperscript{349} See I.R.C. § 263 (1992); Treas. Reg. §§ 1.263(a)-1(a)-(b) (as amended in 1965).
\item \textsuperscript{350} The adverse tax consequences of recharacterization likely will fall exclusively on the service provider. In fact, if taxed as a partnership, the income splitting associated with such a relationship may yield a better result for the proprietor than when the form is respected and the compensation payments must be capitalized. Recharacterization, though, probably is not an alternative the proprietor should rely on, since taxpayers generally cannot use the argument of substance over form. See supra notes 34-48 and accompanying text.
\item \textsuperscript{351} Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974); see supra notes 88-119 and accompanying text.
\item \textsuperscript{352} Campbell v. Commissioner, 59 T.C.M. (CCH) 236 (1990), rev’d, 943 F.2d 815 (8th Cir. 1991); see supra notes 241-321.
\end{itemize}
past services provided in exchange for a profits interest. Although commentators have questioned the wisdom of the timing of service rendering as a basis for determining taxability, such a distinction may be judicially attractive. This is particularly so in light of the Eighth Circuit’s clear expression in *Campbell* of some doubt about the appropriateness of applying the same rule of law to both the receipt of a profits interest and to the receipt of a capital interest.\(^\text{353}\) It did, however, affirm *Diamond* and hold that section 721 does not provide a basis for nonrecognition where a partnership interest is received for services.\(^\text{354}\) Moreover, the receipt of a constructive profits interest for future services does not appear to satisfy the “in anticipation of being a partner” requirement of Revenue Procedure 93-27’s safe harbor.\(^\text{355}\) Therefore, the two circuit court decisions and a revenue procedure provide tenuous precedents for determining whether it is worth the risk of recharacterization to adopt an aggressive service contract structure, and whether protective provisions restricting the service provider’s interest are advisable to guard against possible current inclusion of the value of the service provider’s interest under section 83.\(^\text{356}\)

Moreover, the IRS has announced that it has changed its litigation posture in cases like *Campbell*.\(^\text{357}\) The focus in the future will be akin to the position it attempted to assert on appeal in *Campbell*, distinguishing cases dependent upon whether the taxpayer was acting in his or her capacity as an employee rather than as a partner.\(^\text{358}\) This is reminiscent of the section 707 standard, which the Eighth Circuit in *Campbell* referred to as “[p]robably more relevant”\(^\text{359}\) to their analysis of the issue at hand, and which the ABA Proposal advocated as an appropriate criterion for determining the tax consequences of the receipt of a profits interest for services.\(^\text{360}\) Under this standard, it is unlikely that the profits interest received by the service provider involved in a recharacterized service contract will escape income inclusion unless some protective measures are taken.\(^\text{361}\)

The cautious planner should assume that *Diamond* and section 83 will apply when a service contract is characterized as a partnership for

\(^{353}\) See *Campbell v. Commissioner*, 943 F.2d at 822; *see supra* notes 301-02 and accompanying text.

\(^{354}\) See *Campbell*, 943 F.2d at 821; *supra* note 300 and accompanying text.


\(^{356}\) See I.R.C. § 83 (1992); discussion *supra* part II.D.

\(^{357}\) Jacoby, *supra* note 321, at 518.

\(^{358}\) See *supra* notes 294-96 and accompanying text.

\(^{359}\) *Campbell v. Commissioner*, 943 F.2d 815, 822 (8th Cir. 1991).

\(^{360}\) See *supra* notes 203-20 and accompanying text.

\(^{361}\) *Roundtable, supra* note 347, at 47.
tax purposes. Thus, the value, if any, of the profits interest will be included in the service provider's income when received unless the interest is not vested.362 If the profits interest is subject to a substantial risk of forfeiture and nontransferable, taxation may be deferred until either restriction lapses.363 Inclusion at a later date, however, when the interest may have significant value, also has potential adverse tax consequences.364 It is best, therefore, to structure the service provider's interest so that it is of little or no value when received, regardless of whether or not it is vested. Even the value of an interest that is not vested can be included in income upon receipt if the service provider makes a protective section 83(b) election.365

Unfortunately, additional uncertainty abounds as to how the profits interest will be valued should that become necessary. If the liquidation method is used, as it has been in the majority of cases,366 then as long as the profits interest is pure and the service provider's interest is not contemporaneously sold or assigned,367 the profits interest will be valueless without taking any precautionary steps. Since the contract involves rendering substantial services, as a business matter it probably would be desirable to have some prohibition or restriction on transfer anyway. If the inherent risk approach to valuation is used,368 then absent a contemporaneous sale or assignment, a low or no value determination would depend upon the extent to which the venture is perceived as speculative.369 This approach seems akin to the concept of risk of forfeiture set forth in section 83,370 and thus value could be defeated by including a forfeiture clause. Once again, considering that the contract is premised on the service provider providing future serv-

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363. See supra note 171 and accompanying text.
364. Not only is the owner of an interest that is not vested deemed not to be the owner, but also the value of the interest when it vests is included in ordinary income. Thus, appreciation is converted from capital gain into ordinary income. Compare Treasury Regulation sections 1.83-1(a)(1), (b) (1978) (treating income upon vesting or prior sale as compensation income) with Code section 741 (1992) (generally treating gain on sale or exchange of partnership interest as from sale of capital asset).
365. The drawback of a protective election is that it could be argued that the election indicates that the service provider believes he or she is a partner of the proprietor. Whether a partnership exists for tax purposes may be questionable and such characterization may be undesirable. The election may be considered evidence of partnership intent. See supra notes 2-48 and accompanying text.
366. See supra note 286 and accompanying text.
367. See, e.g., Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974); see supra text accompanying notes 89-95.
368. See supra note 286 and accompanying text.
369. This type of analysis seems to have influenced the Eighth Circuit to decide Campbell's interest had no value. See supra notes 310-12 and accompanying text.
370. See I.R.C. §§ 83(a)(1), (c)(1)-(2) (1992); see supra note 170 and accompanying text.
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icес, such a clause would have a substantial business purpose. Once the two aforementioned safeguards are utilized, one is not far from a step that would minimize or eliminate value under section 83. Under section 83(a), the value of a profits interest can be substantially diminished by subjecting it to a nonlapse restriction.371 An appropriate choice would be a provision requiring that if the service provider ever withdraws from the joint venture, his or her profits interest must be sold back to the proprietor at a predetermined or formula price. During the first year, this price would be very low or perhaps nothing, indicating a low initial value of the interest.372 If the approach in Campbell is used to value the interest,373 the position that the profits interest had little or no value when received will be enhanced if the service provider and proprietor are involved in a new enterprise or one with a poor profits history.374 However, the use of projected tax savings from the pass-through of projected losses, deductions, and credits as a factor in using this future benefits approach should be anticipated.375 The riskiness of the venture and the aggressiveness of the tax projections may, however, minimize the value of the projected benefits.376 Nonetheless, the technique of anticipating immediate taxation of the service provider and structuring the service provider’s interest to the extent possible to have little or no value, at least alleviates, and at best eliminates, the adverse tax consequences of double taxation and deduction and the incompatibility of section 83 and subchapter K.377

IV. Conclusion

At this point in time, it is difficult, if not impossible, to be certain of the potential tax consequences of a recharacterization of a service contract that provides for contingent compensation measured as a percentage of profit. There can be little doubt that the prospect of partnership characterization is very real where the Internal Revenue Service determines that other indicia of a partnership relationship in addition to profit sharing are present. The presence of some of these

372. See Willis et al., supra note 53, § 46.12.
373. See supra notes 310-11 and accompanying text.
374. See supra notes 310-11 and accompanying text.
375. See supra notes 274-82 and accompanying text.
376. See supra notes 290-92 and accompanying text.
other indicia can almost always be found in a service contract providing for contingent compensation.

Once it is determined that a constructive partnership exists, the conclusion that the service provider has received a partnership profits interest in exchange for services naturally follows. The service provider's constructive interest by its nature can only be in the partnership's profits, and not in its assets.

It is at this point in the analysis that one finds oneself almost at a total loss. There can be no doubt that it is possible that the value of the profits interest will be found to be includable in income upon receipt. It is difficult to be certain of more than that. Will it matter whether the interest was received in exchange for future rather than past services? Will it matter whether the services are performed in a partner rather than a nonpartner capacity? If the interest's value is included in income, what valuation method will be used? Will it matter whether the venture is new and uncertain? Will it matter whether projections indicate that the partnership will soon generate profits rather than losses? Will it matter how aggressive the constructive partnership is in claiming tax benefits that give rise to tax losses? Once some amount is included in income, how will problems of double income to the service provider and double deduction to the proprietor be rectified? All of these issues and more continue to exist even after the Campbell decision and Revenue Procedure 93-27.

All of these unresolved questions amply demonstrate that the administrative complexity engendered by the inclusion in income of the value of a profits interest is simply not worth the benefit of including the present value of the profits in income now, rather than the actual profits in income later. While the solution does not appear to be in the nonrecognition provisions of the Code, one need not go that far to find an answer. Given the nature of a partnership profits interest, there is a substantial basis for concluding that income realization does not occur upon its receipt.

A partnership is essentially a pass-through entity. Through the vehicle of partnership, individual partners combine their capital and skills in a business venture. The ultimate profits reaped from this combination yield an income stream that is taxed only at the partners' level. Where an individual performs services in exchange for a partnership profits interest, there is no theoretical ground for currently taxing the mere receipt of the interest consistent with the flow-through nature of a partnership. The need for consistency in applying this fundamental principle of partnership taxation mandates that the profits partner be taxed only when profits are earned by the partnership.
Treating the receipt of a profits interest as a nonrealization event would be consistent with several notions underlying the development of tax policy. First, it would follow past, long-standing, IRS administrative practice. The IRS, from the time of the *Diamond* decision until *Campbell*, did not actively pursue the inclusion in income of profits interests received for services. Evidence of its administrative position of nontaxability are found in the regulations and proposed regulations under section 721\(^{378}\) and other administrative materials.\(^{379}\)

Second, the taxation of income should be grounded on essential notions of equity. One such notion is that of horizontal equity; similarly situated individuals should be taxed alike. The partner who receives a partnership profits interest for services is in no different position with respect to his or her interest in the potential future partnership profits from that of any other partner. Thus, it is impossible on grounds of horizontal equity to justify current taxation of a profits partner’s potential future income stream, when other partners are taxed as the income is earned by the partnership. Moreover, since the Code provides no mechanism for amortizing the profits partner’s “tax basis” in his or her interest, unlike the other partners, the profits partner will be taxed twice on the partnership’s income to the extent that it was already included in the value of the profits interest received. Such double taxation offends basic notions of tax equity.

It could be argued that for the purposes of a tax equity analysis, a profits partner should be compared to a capital partner who receives his or her interest for services, the latter of whom is taxed upon receipt of the partnership interest. Such a comparison, however, is inappropriate. The capital partner is not in the same position, from a taxability standpoint, as the profits partner. First, the capital partner has an immediate interest in the partnership’s assets. In the event of a sale or liquidation, the capital partner shares in the proceeds. Moreover, the value of a capital partner’s interest is not dependent solely upon the future income of the partnership. Thus, income inclusion does not result in conspicuous double taxation of the capital partner’s share of partnership income.

Concerns that an opportunity for abuse would be created by distinguishing the receipt of a profits interest from the receipt of a capital interest for services could be resolved. The distinction between a capital and a profits interest under regulation section 1.721-1(b)(1) could


be further developed to address more complex situations, such as where a partner contributes both capital and services, or receives interests in both assets and profits. Revenue Procedure 93-27's definitions are a step in this direction.\textsuperscript{380} Certainly the issues attendant to distinguishing these types of interests would be capable of resolution in a more equitable and administratively manageable way than resolution of the issues generated from the inclusion in current income of the value of a profits interest.

Finally, our federal system of income taxation does not support the current taxation of an individual's future earning capacity. Such capacity is not an appropriate measure of one's ability to pay income tax. If it was, a tax would be levied upon current accumulations of human capital. It is not, for many of the same reasons that receipt of a profits interest for services should not be currently taxed. Currently taxing the receipt of a profits interest for services is not fundamentally different from taxing earning capacity; it represents taxation of potential earned income. Such taxation is unacceptable if equitable principles are to guide the structuring of our system of income taxation.

The time is long past for Congress or the IRS to take definitive action in this area. The theory of nonrealization offers a sound basis upon which to act, one that will lead to an administratively manageable and equitable outcome. The recent ABA report goes a long way toward advocating this more realistic approach. It remains to be seen, however, whether Congress or the IRS will heed the call to deal definitively with this long-standing source of income tax uncertainty.