Reforming Subchapter K: Compensating Service Partners

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I. INTRODUCTION

This article proposes major changes in the rules governing compensation of partners who provide services to the partnership. It proposes that a compensatory allocation to a partner be treated as salary paid by the partnership. The allocation would be income to the recipient and the partnership would deduct or capitalize the expense. This rule would apply to an allocation of current earnings and to an assignment of an interest in partnership capital for services, including compensatory increases in capital accounts of existing partners. These changes measure the income of service partners and other partners, as well as it can be measured given the current rules on deferred compensation and capitalization outside of subchapter K. The rules do not diminish a partnership’s ability to arrange compensation in innovative ways; they merely define the tax consequences of compensation arrangements. The rules are simple and workable; indeed, they are similar to the rules that now govern compensation by an S corporation of a shareholder who provides services to the corporation.

This proposal accompanies proposals to reform subchapter K set forth in two other articles.¹ I have called for elimination of special allocations and a requirement that partnerships allocate all items in accordance with the relative value of partners’ capital accounts. This would prohibit an allocation of income from capital for services and so gives rise to the proposal here: A partnership may pay a service partner income from capital only as salary. I also proposed to treat certain distributions of assets as taxable exchanges and to tax a partner on gain on his investment in the partnership (measured by the difference between the basis in his interest and his capital account) on distributions not out of his share of earnings or his share of debt. While

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that proposal would strengthen the proposals here in various ways, it
is not essential to them.

Section II criticizes the historic arguments for compensating a ser-
vice partner with a profits allocation. The best argument for this rule
is that it often makes no difference for income tax purposes whether a
partnership pays a service partner salary or allocates and distributes
profits to him, but this proposition holds only when a partnership pays
a partner out of current service-based income for services that pro-
duce current income to the partnership. Sections III and IV examine
two cases where the treatment of compensation does make a differ-
ence and shows that a rule treating a profits allocation as salary results
in more accurate measurement of the income of the service partner
and the partnership. Section III examines payments out of current
profits for services that produce assets of future value to the partner-
ship. Section 707(a)(2)(A) addresses an aspect of this problem, dis-
guised compensation arrangements. Section IV examines payments
out of future profits for services that produce income for the partner-
ship currently or in the future. Diamond v. Commissioner and
Campbell v. Commissioner, perhaps the two most notorious partner-
ship tax cases of all time, pose this issue. Section V explains the pro-
posal in more detail.

II. THE HISTORIC BASES FOR COMPENSATING SERVICE PARTNERS
THROUGH PROFITS ALLOCATIONS

Usually, a partnership compensates a service partner by allocating
and distributing a share of profits to him. This rule has two historic
bases: The aggregate theory of a partnership and a common law pre-
sumption regarding compensation of service partners. An early case
held that amounts paid a service partner were not salary under the
aggregate theory, reasoning that "[a] partner devoting his time and
energies to the business of the firm is in fact working for himself and
can not [sic] be considered an employee of the firm. . . . It follows,
therefore, that he can not [sic] be paid a salary by the firm out of
earnings." A common law presumption denied compensation be-
yond his share of profits to a partner who performs services for a
partnership.

Neither point suggests how partnership compensation ought to be
taxed. The aggregate and entity theories are models borrowed from

2 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).
3 59 T.C.M. (CCH) 236 (1990), aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir.
4 Tilton v. Commissioner, 8 B.T.A. 914, 917 (1927).
5 E.g., Pauli v. Commissioner, 11 B.T.A. 784, 785 (1928).
the common law of partnership. Neither model is correct in the sense that it more truly describes the nature of a partnership—a partnership is both an entity and an aggregate of individuals. More importantly, the models are not relevant to the issue of how a partnership should be taxed. They are, at best, useful heuristic devices for explaining some tax rules. They should not divert us from the essential question: What rule best measures a partner's income?

In any event, the aggregate theory does not justify treating a service partner's entire profit share as his own earnings. If the aggregate theory were to be taken seriously, then part of the profits allocated to a partner ought to be treated as salary paid him by the other partners. Partners share returns from their labor and capital. In effect, each partner gives up a right to a part of his earnings for a right to a part of the earnings of other partners. Indeed, old authority breaks down the relation between partners in this fashion under the aggregate theory where a partner deals with a partnership in a nonpartnership capacity, treating part of the payment from the partnership as a payment of salary from the other partners and part as a payment by the service partner to himself.

The common law presumption that partners are paid for services out of profits also does not require treatment of compensation as a profits share for tax purposes. There is no necessary connection between the characterization of a payment for private purposes and tax

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7 Benjamin v. Hoey, 139 F.2d 945 (2d Cir. 1944). The court held that a partner who paid commissions to his partnership where it purchased securities for his account was not taxable on his distributive share of partnership income attributable to the commissions he paid. The court accepted the argument that under the aggregate theory the taxpayer paid this amount to himself. The other partners were taxable on the balance of the commissions. This position was rejected in Toy v. Commissioner, B.T.A. Mem. Dec. (Prentice-Hall) ¶ 42,452 (1942), which held that a partner who purchased property from his own real estate partnership would be taxed on his share of the income from the commission payment.

This issue also has been raised where partnerships pay partners for services performed in a nonpartnership capacity. In Pauli, the taxpayer argued that where he drilled wells for a partnership in a nonpartnership capacity, he ought not be taxed on the part of the compensation to his interest in the partnership since in effect he paid this amount to himself. He claimed this part of the compensation should be treated as a return of his capital. The court rejected the taxpayer's argument and ruled that the entire payment was compensation, treating the partnership as an entity. Pauli, 11 B.T.A. 784; accord Wegener v. Commissioner, 119 F.2d 49 (5th Cir. 1941). This and related issues involving leases and loans are discussed in some detail in J. Paul Jackson, Mark H. Johnson, Stanley S. Surrey & William C. Warren, A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft, 9 Tax L. Rev. 109, 136-39 (1954), and Little, note 6, at 54-61. The adoption of § 707(a) in the 1954 Code solved this problem by providing that a transaction between a partnership and a partner acting other than in a capacity as a partner is treated as a transaction between strangers. This rule treats the payment for drilling wells as compensation to the partner and a drilling expense to the partnership. IRC § 707(a) (before amendment in 1984).
purposes. In fact, the old cases held a payment was a profits share for tax purposes when the partners denominated it as salary in the contract.  

The one sound tax argument for treating compensation paid a partner as a profits share rather than as salary is that it often makes no difference for income tax purposes how compensation is characterized. This proposition generally holds when a partnership pays a partner out of current ordinary income for services that provide a current return in ordinary income to the partnership. In this case, allocating a share of income to the partner has precisely the same effect under the income tax as paying him salary which is deducted by the partnership. Under either approach, the partner is taxed on the amount paid him and the other partners are not.

Sometimes, however, it does make a difference how compensation is treated. Early on, it was recognized that compensation paid to a service partner in excess of total partnership profits (calculated without regard to that compensation) could not be treated as a distributive share of profits—for the simple reason that there are no profits to be distributed. A 1929 case solved this problem by treating a payment to a partner for services in excess of total partnership profits as, in effect, salary which is income to the recipient and deductible by the other partners to the extent that it results in a reduction in the other partners' partnership capital. The 1954 Code solved this problem by adopting § 707(c), which treats a payment for services as salary to the extent the payment is made without regard to partnership income.

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8 E.g., Pauli, 11 B.T.A. at 785; Tilton v. Commissioner, 8 B.T.A. 914, 917 (1927).
10 Lloyd v. Commissioner, 15 B.T.A. 82 (1929). This approach also was adopted in G.C.M. 6582, 8-2 C.B. 200 (1929) and proposed by the American Law Institute in 1954, see Jackson et al., note 7, at 115.
11 The two approaches differ. Lloyd automatically treats a payment as a distributive share of profits up to total partnership profits calculated without regard to the payment. It treats the balance of the payment as income to the recipient to the extent of the reduction in other partners' capital accounts. The partner treats the part of the payment matched by a reduction in his capital account as a recovery of capital. Section 707(c) treats the entire payment as salary which is income to the recipient and an expense to the partnership.

Example: A and B are equal partners, each with a capital account of $10. The partnership pays $5 to A as compensation in a year in which it has $3 profits before deducting A's compensation. Losses are allocated equally to A and B.

Under Lloyd, $3 profits are allocated to A, $1 is treated as a recovery of capital by A, and A has $1 income and B a $1 deduction for the remaining $1 paid to A. Under § 707(c), $5 is treated as salary paid A (if the payment was made without regard to profits). This results in a $2 loss to the partnership, $1 of which is allocated each to A and B. The results under the two approaches are the same as long as the profits are ordinary income and the salary paid A is currently deductible. Under either approach, A has $4 income, B has a $1 loss, and A and B both have a $1 reduction in their capital accounts. The two approaches produce different results if the salary must be capitalized.
More precisely, treating a payment for services as a distribution out of profits is equivalent to treating it as salary only if a partnership pays a partner currently for services that provide a current return to the partnership in ordinary income and the partnership has income of no other character and no offsetting losses. If any of these conditions is not met, then the two approaches are not equivalent, and in almost every such instance, a rule treating the payment as salary better measures the income of all concerned. For instance, a payment may exceed current income because the partnership earned less than expected from the services. Treating the excess payment as salary results in income to the service partner and a deduction to the other partners, which reflects the shift in wealth between them. Or, a payment may exceed current income because the partnership has other losses that shelter the services income from tax. If the losses are real, treating the excess payment as salary allocates the loss to the other partners, who bear the loss economically. If the losses are artificial, treating the excess payment as salary allocates the loss to partners who invest capital. This ensures that the loss does not shelter the service partner’s income (unless he also invests capital), which may be important if preserving the tax on compensation is desirable.

The recent history of problems in this area involves two other situations where the conditions of equivalence are not met. The first ex-

Compensatory payments probably may be structured to reach a result similar to Lloyd. Under § 707(c), a partnership agreement may guarantee a partner salary, but also provide that this will be paid out of profits to the extent available. Reg. § 1.707-1(c)(2) Ex. 2. The service partner also should be given a preference on profits up to the minimum guaranteed. A similar preference was respected in Rev. Rul. 67-158, 1967-1 C.B. 188. Thus, in our example, if the partnership had $5 profits apart from the salary paid A, the entire payment to A would be treated as a profits share. This is to the advantage of taxpayers if the salary payment otherwise would have to be capitalized. In the original example where profits were only $3, the partnership might try to characterize the $1 distribution to A attributable to the reduction in his capital as a § 731 distribution. This might be done by providing that A will receive a minimum of $5 from the partnership, first from profits to the extent they are sufficient, second as a return of his capital to the extent of his pro rata share of any excess over profits, and third as a guaranteed payment. This is to A’s advantage if the salary expense would have to be capitalized since he would not be taxed on a § 731 distribution assuming sufficient basis in his interest. This creates an undesirable discrepancy between A and B’s capital account. A would have a $4 capital account and B a $5 capital account. To balance the partners’ capital accounts, A should be allocated the first $1 of gain on the disposition of the asset he created by his services.

Another situation where the conditions of equivalence are not met is where a partnership pays a partner currently for future services. Ideally, in this situation, the payment would be treated as a loan, with interest imputed, and the service partner would receive salary that is used to repay the loan plus interest when the services are performed. Example: C is allocated $100 profits by AB in Year 1. C promises to perform services worth $110 in Year 2. The $100 profits in Year 1 ought to be taxed to the partners of AB Partnership in accordance with their capital interests. In Year 2, C ought to have salary of $110 and pays $10 interest to AB Partnership. AB Partnership ought to have $110 expense and $10 interest income.
ample is where a partnership pays a partner currently for services that produce an asset of future value to the partnership. Section 707(a)(2)(A) deals with an aspect of this problem. The second example is where a partnership pays a partner on a deferred basis by giving him an interest in future profits. The Diamond\textsuperscript{13} and Campbell\textsuperscript{14} cases pose this problem. The next section shows that in both cases treating compensatory allocations as salary better measures the income of the service partner and the other partners.

III. CURRENT PAYMENT FOR SERVICES THAT PRODUCE AN ASSET OF FUTURE VALUE

Taxing a service provider on a share of profits mismeasures both her income and partnership income when her services produce an asset of future value to the partnership. This may result in deferral of income to the service partner and/or to the other partners. Also, the partnership ends up with an asset with a basis below value, which may shift income, gain or loss among partners.

Consider a case where it generally is agreed that compensation should be treated as salary: A partnership pays a partner for work done in a nonpartnership capacity that creates an asset of future value to the partnership. Section 707(a) treats the entire payment as compensation paid to a nonpartner. This rule apparently was adopted for

\begin{itemize}
\item Under current law, C is taxed on the Year 1 profits and the partners of AB Partnership are taxed on the income from C's services in Year 2, or whenever the services produce a return. This allows the partnership to shift income to C, and so allows the partners to defer income at C's expense. This result may be preferable to treating the profits allocated to C as salary, assuming the salary is capitalized. In that case, C and the partnership both would be taxed on $100 in Year 1. This overtaxation is a result of the rules for taxation of prepayments for services.
\item Current law is more problematic where cash is distributed to a service provider with a zero basis interest in advance of the earning and allocation of profits to him. The distribution is capital gain to the service provider under § 731(a) and, if a § 754 election is in effect, the partnership may increase the basis of its assets by the amount of gain. The service provider has ordinary income when the profits are allocated to him, and eventually, will have a capital loss on dissolution of the partnership or sale of his interest because its basis will exceed its value by the amount prematurely distributed. The effect is to give the service partner an artificial capital gain for the life of his interest. If a § 754 election is in effect, the inside basis adjustment may create artificial losses for the other partners, or allocation of such losses to the service partner may offset the artificial gain. If a service provider has a basis in his interest equal to or greater than the distribution, these problems do not arise. Then the distribution is not taxed and the service provider is taxed on the profits. This is similar to treating the transaction as a loan, but interest is not imputed. The rules for imputing interest on loans from employers to employees do not apply to loans by partnerships to partners. See Gergen, Special Allocations, note 1, at 14 n.56.
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\textsuperscript{13} 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).
\textsuperscript{14} 59 T.C.M. (CCH) 236 (1990), aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).
reasons of administrative convenience. A more fundamental reason exists for the rule in § 707(a). The rule prevents income deferral by the service provider and income shifting from the service provider to the other partners. If the expense of producing an asset is capital in nature, treating part of the expense as a return of capital to the service provider results in a discrepancy between the basis in his interest and the value of his interest and results in a low basis in the asset he produces.

Example 1: A and B are equal partners in AB Partnership. The partnership has $100 in cash. A and B each have a $50 capital account and a $50 basis in their interest. The partnership pays A $100 to produce an asset worth $100. Assume that the part of the payment out of A’s share of capital is treated as a recovery of capital. A has $50 ordinary income and a $50 distribution that is not taxed under § 731. The partnership has a $50 capital expense. A’s capital account is reduced by $50 on the distribution, but it is increased by $50 on the “revaluation” of the asset from $50 (its book value after $50 is capitalized) to $100 (its true value). A ends up with a capital account of $50 and a basis of zero in his interest. The asset has a value of $100 and a basis of $50.

The discrepancy between value and basis may be eliminated by allocating extra taxable income from the asset to A. This results in A’s deferring income. If such an offsetting allocation is not made, income from the asset temporarily may shift from A to B.

Section 707(a)(2)(A) was adopted in 1984 to address a related problem. A partnership may cast a payment to an independent service provider as a profits allocation to avoid capitalization requirements and other restrictions on deduction of the compensation. Again, the
general problem is deferral. Here the other partners defer income by allocating profits to the service provider that otherwise would have been taxed to them. If the services produce an asset with value beyond the current year, the partnership is left with a low-basis asset.

**Example 2:** A and B are equal partners in *AB Partnership*. The partnership owns unimproved land worth $1,000 that earns $100 rent per year. The basis of the land is $1,000. The partnership employs C to improve the land and agrees to pay him $100. The cost of the improvement would be capitalized. Rather than pay C $100 in salary, A and B make C a partner and allocate to him the next $100 of partnership profits. A and B defer tax on $100. The improved land has a basis of $1,000 and is worth $1,100. The $100 income is deferred until the land is sold or until the improvement depreciates in the production of income.

**Example 2** is not a true case of income shifting because C would have $100 income in Year 1 in any event.

Section 707(a)(2)(A) recasts the distribution of profits to C in **Example 2** as a payment to a nonpartner. The statute asks whether C truly acts as a partner when he performs the services and is paid.\textsuperscript{19} If he does, the allocation and distribution of profits stands. If he does not, the allocation and distribution are recast as a payment to a nonpartner. Whether C acts as a partner turns on several factors. These include the risk of nonpayment, the term of C's interest in the partnership, the proximity in time of the services and the payment, the existence of a tax motive for casting the payment as a profits share, and the proportionality of the allocation and distribution in question with C's continuing interest in the partnership.\textsuperscript{20} In **Example 2** C loses on all these counts.

\textsuperscript{19} I state the issue this way and not in the more simple form, "Is C a partner?" because of the possibility that C may be a partner for other purposes, but perform these services and receive these payments in a nonpartnership capacity.

\textsuperscript{20} Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 227-28 (Comm. Print 1984) [hereinafter 1984 Bluebook]. Section 707(a)(2)(A) also covers contributions of property. In this regard, it overlaps with § 707(a)(2)(B), the disguised sale rule. There are two formal differences in subparagraphs (A) and (B). First, subparagraph (A) applies to a transfer of property and a related "allocation and distribution." Subparagraph (B) applies to a transfer of property to a partnership and a related transfer of property back to the partner. Because of this, one might have thought the government had to attack disguised sales done through special allocations and without distributions under subparagraph (A) rather than
Section 707(a)(2)(A) has two fundamental problems. The line it draws relates poorly to the real policy concern, and the line is poorly drawn. Asking if the service provider truly acts as a partner does not directly relate to the problems of deferral and income shifting. Deferral and income shifting may occur where a partnership allocates profits to a true partner for the creation of a long-lived asset.

Example 3: A and B are equal partners in AB Partnership. The partnership owns unimproved land worth $1,000 that earns $100 rent per year. The basis in the land is $1,000. The partnership employs C to add an improvement to the land worth $100. The improvement is permanent and is expected to increase the rent on the land to $110 per year. C is made a partner and is given a 15% interest in profits for ten years. This interest has approximately the same present value to C as a payment of $100 at a 10% interest rate.

The allocation of profits to C will be respected under § 707(a)(2)(A) and A and B will defer income. After ten years, AB Partnership expects to own land worth $1,100 free and clear of any obligation to C with a basis of $1,000. A and B defer tax on the $100 income allocated to C during the ten-year period.\(^2\)

\(^2\) Example 3 raises other issues that are dealt with in Section IV. These are how to tax C when he receives deferred compensation for services in the form of a profits interest and how to tax A and B when they buy an asset by giving up a future income stream.
Some of the statutory factors defining disguised compensation indirectly relate to the problems of deferral and income shifting. Several factors go to the term of the interest. This is relevant because the longer the term of an interest given for services, the less opportunity for deferral of income by the other partners. Extending the term of an interest, however, eliminates deferral by the other partners only if the interest is coterminous with the life of the asset the services create. Further, the shape of the income stream of both the interest and the asset must be the same. For example, if a partnership gives a five-year interest in profits in exchange for a nondepreciable asset it sells after five years, the other partners defer income from Years 1 through 4 to Year 5. If Treasury adopts moderate term-length requirements (for example, two to five years) as a safe harbor in the § 707(a)(2)(A) regulations, significant deferral is possible on all but the most short-lived depreciable assets by casting a payment for services as a profits share.

Risk, the most important statutory factor, has no direct connection to the problem of deferral.

Example 4: ABC Partnership forms to develop a real estate project. As the project nears completion, the partnership asks D, a real estate broker, to find a tenant to sign a long-term lease. In return, the partnership gives D a right to 25% of its net profits for two years. Those profits are highly speculative and depend upon D signing a tenant to a favorable lease.

D probably would be considered a partner under § 707(a)(2)(A). The allocation of profits to D (if there are any profits) understates the income of the other partners, who relinquish profits for two years to obtain a long-term asset, the lease. Risk does not alter the expected value of deferring income if the “bet” is fairly priced, that is, if D’s

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22 The second factor—whether the interest is transitory—obviously is concerned with time. So, too, is the third factor—the closeness in time between the performance of services and the allocation and distribution, and the fifth factor—whether the value of the service provider’s continuing interest is small in relation to the allocation. The legislative history observes, “[t]his is especially significant if the allocation for services is for a limited period of time.” 1984 Bluebook, note 20, at 228.

23 The regulations use a two-year test as a presumption distinguishing normal contributions and distributions and those that are part of a disguised sale. Reg. § 1.707-3(c), (d). Example 1 in the legislative history recasts as compensation a two-year gross income allocation to an architect. 1984 Bluebook, note 20, at 229.

24 Example 1 in the legislative history supports upholding a two-year gross income allocation to an architect where the project is a “spec building.” 1984 Bluebook, note 20, at 230.
interest is such that his expected return equals his normal fee once all possible outcomes are discounted for probability, time and risk.

Some defend the statutory line on the ground that it preserves for partners a privilege they enjoy as individuals. This is the privilege not to be taxed on wealth in the form of self-created assets.\textsuperscript{25} For example, if a taxpayer builds a house for himself, he does not include the value of the house in income on completion.\textsuperscript{26} Even assuming this privilege deserves preservation, the argument misunderstands the issue when allocations of current profits for services that create long-lived assets are recast as salary. The issue is how we should tax other partners when they divert income to a service provider for the creation of an asset. In \textit{Examples 3} and \textit{4}, for instance, it is hard to see how a practice of not taxing self-created assets justifies not taxing \textit{A} and \textit{B} on income they divert to \textit{C} to acquire an asset \textit{C} creates. It is \textit{C} who may complain about being taxed on the value of a self-created asset, \textit{if} \textit{C} is taxed on receipt of the interest. This issue is addressed in Section IV.

Section 707(a)(2)(A) is a bad provision for another reason. The line it tries to draw, in asking whether a service partner truly is a partner, is poorly drawn. Part of the problem is that the statute defines partner in terms of risk of payment, term of interest and nontax motive, but these factors are not necessary characteristics of a true partnership interest. Not all partnerships are risky or long-term ventures. For example, a partnership may be formed to construct a single building under a turn-key project with a secure buyer. Risk is minimal and the term is short. Still an architect who takes a share in the project in return for services presumably is a partner. Motive cannot be determinative either. For example, a broker who performs syndication services for a partnership may take a partnership interest as compensation. There is a strong tax reason for doing this because payments for syndication services provide no tax benefit whatsoever to the partnership.\textsuperscript{27} Notwithstanding this, the broker probably is a partner.


\textsuperscript{26} Noël B. Cunningham & Deborah H. Schenk, How to Tax the House that Jack Built, 43 Tax L. Rev. 447 (1988).

\textsuperscript{27} Rev. Rul. 89-11, 1989-1 C.B. 179 (partnership may not deduct loss under § 165 for syndication expenses though the syndication fails). Presumably a partner receives some tax benefit for syndication expenses because such amounts are included in the basis of his partnership interest. Section 705(a)(2)(B), which provides for a reduction in basis for nondeductible expenditures (such as political contributions), applies only to payments that are not “chargeable to capital account.” Syndication expenses are capitalized. Reg. § 1.709-2(b). Reg. § 1.704-1(b)(2)(iv)(i)(2) is consistent with this. It provides that § 709 expenses which have not or cannot be amortized are treated as § 705(a)(2)(B) expenses “solely for purposes” of adjusting capital accounts. This implies that no basis adjustment is necessary. Revenue Ruling 81-153 holds that a partner’s basis in his interest includes...
may even be a partner if the partnership is short-lived and low risk, so long as his interest is on a par with those of other partners.

An additional factor would help distinguish false from true partners: equivalence of interests. Risk and term may vary in a partnership, but a true partner is one who bears the same risk and is there for the same term as other partners. The legislative history of § 707(a)(2)(A) suggests equivalence of interests is relevant. In the discussion of risk, "capped" allocations of income and preferences in the form of gross income allocations are singled out for condemnation.\textsuperscript{28} Caps and preferences vary partners' risks. Caps limit upside potential; preferences limit downside risk. Another factor asks "whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question."\textsuperscript{29} This factor aims at special allocations that vary interests in a partnership.

The legislative history also makes clear, however, that absolute equivalence of interests is not required. An example suggests that an architect who receives a short-term (two year) preference in the form of a gross income allocation may be a partner if the project is a "spec building."\textsuperscript{30} The architect bears risk, but considerably less risk than other partners because of the preference and the term limitation. Once absolute equivalence is not required, it is difficult to know where to draw the line.

This raises the other problem with the way statute draws the line. Even where the cited factors seem relevant to characterization of a partnership interest as false or true, it is not clear where to draw the line. For example, what if an architect takes a ten-year interest in profits in a large, diversified real estate development partnership in return for planning a building? Is this a long enough term? Is there enough risk? Is a five-year interest sufficient? Or two years?

The § 707(a)(2)(B) rule on disguised sales involves a similar line-drawing problem, and the regulations under that section suggest what may be expected under § 707(a)(2)(A).\textsuperscript{31} The regulations contain a

\textsuperscript{28} 1984 Bluebook, note 20, at 227-28. The two examples of disguised compensation involve preferences. In Example 1, an architect is given a gross income allocation. Id. at 229. In Example 2, an investment adviser is given a gross income allocation in an investment partnership. Id. at 230.

\textsuperscript{29} Id. at 228.

\textsuperscript{30} Id. at 230.

\textsuperscript{31} I discuss the regulations in more detail in Gergen, Contributions, note 1, at 188-96.
vague multi-factor standard supplemented by numerous regulatory
safe harbors and shoals. The regulations do not provide clear gui-
dance in hard cases. The central presumptions (in particular the pre-
sumption that contributions and distributions more than two years
apart are not part of a disguised sale)\textsuperscript{32} are weak. Most of the safe
harbors are subject to vague anti-abuse rules.\textsuperscript{33} Thus, they are not
completely safe harbors. The regulations had to use vague, mul-
tifactor standards because no clear line distinguishes true partnership
transactions from false ones. The regulations are complex with nu-
merous safe harbors and shoals to delineate "easy" cases, cases that
Treasury has thought about and knows are on one side of the line or
the other. The complex provisions are supplemented by vague anti-
abuse rule because Treasury fears sophisticated taxpayers may find
ways to take advantage of errors and ambiguities in the description of
these "easy" cases.

As I have said elsewhere, this is a perverse way to administer tax
law.\textsuperscript{34} It makes it costly both for honest taxpayers to comply with the
law and for the government to enforce the law. At the same time, the
law does not prevent abuse. Complexity invites aggressive taxpayers
to look for and exploit holes in the regulations. The vagueness and
complexity of the law means that aggressive positions cannot be pe-
nalized because they do not clearly violate the law.

Treating allocations of profits to service partners as salary would
largely solve the problems of deferral and gain shifting where a part-
nership pays a partner to create an asset of future value by requiring
capitalization of the salary. Capitalizing the salary correctly measures
the income of the other partners, who ought to be taxed on the profits
paid to the service partner because the asset he creates enriches them.
The question that vexes § 707(a)(2)(A), whether the service provider
is truly a partner, would never arise because the rule treats payments
to partners and nonpartners the same.

This rule would not ensure perfect measurement of income because
of flaws in the rules on capitalization and cost recovery. Rarely, how-
ever, would the rule produce a worse measure of income than does

\textsuperscript{32} Reg. § 1.707-3(c), (d). These presumptions can be overcome by facts and circum-
stances "clearly" to the contrary. The two-year presumption for debt is absolute. Debt
assumed by other partners on a contribution of property subject to debt is never consid-
ered part of a disguised sale if the debt was incurred more than two years prior to the
contribution.

\textsuperscript{33} For example, the safe harbor rule for guaranteed payments that are reasonable in
amount is only a presumption and may be overcome if facts and circumstances indicate
that a guaranteed payment (even if reasonable in amount) is part of a disguised sale. Reg.
§ 1.707-4(a)(1)(iii). This rule is applied in Example 2, where a reasonable guaranteed pay-
ment is deemed part of a disguised sale. See text accompanying notes 18-20.

\textsuperscript{34} Gergen, Contributions, note 1, at 196-97.
the rule allowing a partnership to allocate profits as compensation. If an expense, which ought to be capitalized, is deducted currently, then the rule I propose produces the same result as the current rule. Under both rules, the other partners reduce their income by the amount paid the service provider. If a capitalized expense is written off too quickly, the rule I propose produces a better measure of income. It at least ensures capitalization and some deferral of deduction. If a properly capitalized expense is written off too slowly, the comparison is more complicated. Which rule produces a better measure of income depends upon whether the delay in recovery is so onerous that an immediate deduction of the expense would produce a more accurate measure of income. The current rule clearly better measures income only in the rare case where a current expense must be capitalized. Of course, even when the rules on capitalization err, one could argue that partnerships ought not be given special dispensation from those rules.

The introduction of risk creates a more serious problem with my proposed rule, though the rule still better measures income than the existing rule. The following example alters Example 4 to add risk and to eliminate the temporal element.

**Example 5: ABC Partnership** forms to develop a real estate project. As the project nears completion, the partnership asks D, a real estate broker, to sign a tenant to a long-term lease. In return, the partnership gives D a right to 25% of its net profits in first year. Those profits are highly speculative and depend upon D signing a tenant to a favorable lease.

Two things occur in Example 5: ABC purchases D’s services and then they make a side bet on the first year’s profits. Ideally, these two elements should be accounted for separately. Assume two possible returns to D, $750 and $250, of equal probability. The value of D’s services to the partnership is the value of this bet: $500 if D is risk neutral and the payment is instantaneous. In theory, the partnership ought to have $500 income and a $500 capitalized expense when it gives D his interest. D ought to have $500 income on this part of the transaction. When the bet pays off, D should have an additional $250 gain or a $250 loss.

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35 It is not clear whether D would be considered a partner under § 707(a)(2)(A). His return is risky, but very short term. I eliminate the temporal element to clarify the problem posed by risk. Deferred payments are considered in Section IV.

36 For the moment, I assume that the value of the services to the partnership is independent of the payoff on the bet. This probably is not true in Example 5. This assumption is relaxed later.
The following table compares the ideal result with the results if the payment to $D$ is treated as a share of profits or as salary under both outcomes.

<table>
<thead>
<tr>
<th>Ideal Treatment</th>
<th>Treatment As Profits</th>
<th>Treatment As Salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250 paid to $D$</td>
<td>$D$ has $250 income.</td>
<td>$D$ has $250 income.</td>
</tr>
<tr>
<td>Partnership has $500 income and $500 capital expense.</td>
<td>Partnership has $250 income and $250 capital expense.</td>
<td></td>
</tr>
<tr>
<td>$750 paid to $D$</td>
<td>$D$ has $750 income.</td>
<td>$D$ has $750 income.</td>
</tr>
<tr>
<td>Partnership has $500 income and $500 capital expense.</td>
<td>Partnership has $750 income and $750 capital expense.</td>
<td></td>
</tr>
</tbody>
</table>

Both approaches tax $D$ appropriately in both outcomes. Treating the payment to $D$ as a profits share understates the partnership’s income on both outcomes. Treating the payment as salary understates the partnership’s income by $250 if $D$ is paid $250 and it overstates the partnership’s income by $250 if $D$ is paid $750.

The mismeasurement of partnership income if a contingent payment were treated as salary may not be troubling for two reasons. First, the errors offset. There is an equal chance that income would be overstated or understated by $250. The expected value of the tax to be paid would be the same as under the ideal approach, subject to one caveat. Thus, overall tax revenues are not diminished because of the error. Further, if taxpayers are risk neutral, the allocation of resources ought to be the same as under the ideal approach, again subject to one caveat.

The caveat has to do with the realization rule. Expected returns under the ideal approach and an approach treating a contingent payment as compensation may differ because the partnership may dispose of the asset if income is overstated to take advantage of the embedded loss and retain the asset if income is understated to avoid recognition of the embedded gain. This diminishes the expected cost of the overstatement of the partnership’s income under the high-value outcome.
and increases the expected return on the understatement of the partnership's income under the low-value outcome.

There is a second reason the discrepancy may not be troubling. In many cases, the outcome on the bet will be positively correlated with the value of the services to the partnership. In Example 5, for instance, a high payoff probably means that D obtained a very favorable lease. This might increase the wealth of the other partners. The other partners' greater income and capital wealth would reflect this enrichment. Conversely, a low payoff to D might mean that the other partners have done worse than expected. This is relevant for two related reasons. First, it suggests that the apparent over- or understatement of income reflects a real change in the partnership's wealth. Second, it suggests that there may be no embedded gain or loss because the stated value of the asset will approximate its real value.

IV. DEFERRED PAYMENTS FOR SERVICES

Often a partnership compensates a partner for services on a deferred basis by promising to distribute money or assets to her in the future. This may be done in two ways. First, a partnership may give a service provider a capital interest, that is, a share in existing partnership capital. The service provider will receive profits earned on that capital and the capital on liquidation. Second, a partnership may give a service provider a profits interest, that is, a right to share in future profits or any increase in the value of partnership assets. The distinction between the two types of interests is simply this: A holder of a profits interest looks only to future income or appreciation for her return, whereas a holder of a capital interest has an interest in existing partnership assets. To test the nature of an interest ask whether the holder would receive anything on an immediate liquidation.37

How to tax an exchange of existing partnership capital for services has long been settled. It is treated as if the partnership exchanges a share of its assets for the services and the service provider retributes those assets to the partnership.38 The service provider has income on the exchange, and the partnership has an expense in the same amount plus gain if it holds appreciated assets.

Example 6: AB Partnership owns raw land worth $4,000 with a $2,000 basis. The partnership employs C to improve the

38 1 McKee et al., note 25, ¶ 5.07-08; Mark P. Gergen, Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital, 44 Tax L. Rev. 519, 525-26 (1989) [hereinafter Joint Ventures].
land. The improvement increases the value of the land $1,000 and is nondepreciable. The partnership makes C a partner and gives him a $1,000 interest in capital when the improvement is complete. C has $1,000 income and a $1,000 basis in his partnership interest. AB Partnership has a $1,000 capital expense and $400 gain (it exchanges land worth $1,000 with a $600 basis). The partnership is left holding land worth $5,000 with a $3,400 basis.

The transaction is treated like an exchange by a S corporation of stock for services. There is one significant difference: The partnership recognizes gain on the exchange if it holds appreciated assets; corporations have an expense but no income when they exchange their stock for services. Later I address the issue whether it is appropriate to require the partnership to recognize gain at this time.

How to handle an exchange of a profits interest for services has been one of the most vexing questions in partnership tax, though a recent revenue procedure should eliminate most concerns for practitioners. Elsewhere, I have argued that the theoretically correct rule is to tax the service provider on the value of the interest when his services are substantially complete. I propose a simpler solution to the

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39 The cost of the improvement should be included in the basis of the land for purposes of determining the partnership's gain.
40 IRC § 1032; Reg. § 1.1032-1(a). I explore some problems with the subchapter S rule in Gergen, Joint Ventures, note 38, at 534-37.
41 See text accompanying notes 106-08.

The major theoretical arguments can be summarized by comparing three cases:

Case 1: A performs services in establishing an investment partnership. The partnership's only assets are ten-year, interest-bearing bonds. In return for his services, A is given a small interest in the profits of the partnership. This represents interest on a bond. The partnership cannot liquidate without A's consent.

Case 2: B and C form a partnership. C contributes undeveloped land and B contributes services to improve the land. The services are performed in Year 1.
problem here. I would treat the grant of a right to future profits to a service provider as contingent compensation. A partner would have no income on receipt of a profits interest and all profits allocated to him would be taxed as compensation. Before I explain why this is the best practical solution to the problem, I explore the two most recent turns in the twisted tale of the taxation of an exchange of a profits interest for services.

A. Recent Developments

1. Revenue Procedure 93-27

Revenue Procedure 93-27 should allay most concerns practitioners have about the taxation of partnership profits interests exchanged for services. It holds that such an exchange is not a taxable event for the recipient or for the partnership except in limited circumstances. The exceptions are for interests in “substantially certain and predictable” streams of income, interests sold within two years of receipt and interests in publicly traded partnerships. The first and third exceptions cover the cases where taxation of receipt of an interest seems

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The value of the unimproved land is credited to C's capital account. C has a preference on rent equal to the expected rental value of the undeveloped land. Additional rent and gain on sale of the land is shared by B and C.

Case 3: D and E form a law firm. They agree to share work and profits. All profits are distributed currently.

Those who believe the receipt of a profits interest ought not be taxed look to Case 2 and Case 3. They argue that D should not be taxed in Case 3 because his profits interest mostly represents his own future earning potential and human capital is not taxed. B should not be taxed in Case 2 because his interest is of speculative value. Further, self-created assets are not taxed. Also to tax B on the receipt of the interest and on profits is double taxation.

Those of us who believe that receipt of a profits interest ought to be taxed look to Case I and Case 2. We argue that A ought to be taxed in Case I because he is in the same position as someone who receives cash and buys a 10-year annuity. The interest is easy to value. Valuation is more difficult in Case 2, but a fair value can be assigned by asking how much B normally charges for his services. Risk is the only difference between Case 2 and Case I, and risk is subsumed in value. This is not a self-created asset because B works for a separate entity, the partnership. Although this is double taxation, that is the nature of an income tax. Income is taxed once when it is earned and again on its earnings when it is reinvested. A is protected adequately from double taxation if the partnership is allowed to amortize an amount equal to the income realized by A on receipt of the interest against his share of profits. D should not be taxed in Case 3, and he will not be taxed under § 83 so long as his right to profits depends upon substantial future services.


44 The ruling does not put to rest entirely questions about the proper treatment of a profits interest exchanged for services. In addition to the exceptions (which are limited and strictly defined), the ruling leaves some important questions open. For instance, how should a capital interest that carries a right to disproportionate future profits be taxed? The receipt of such an interest is taxable, but is the part of the interest's value derived from the disproportionate claim on future profits also taxable?

most appropriate because of the liquidity and the ease of valuing an interest. The second exception combats quick conversion of ordinary income into capital gain by rapid sales of profits interests (the problem many thought was posed in the Diamond case).  

The ruling leaves another door slightly ajar for the government to argue that receipt of an interest should be taxed. This is found in the definition of a capital interest, which is taxable on receipt. The ruling states that the determination of whether an interest is capital or profits “generally is made at the time of receipt of the partnership interest.” This opens the possibility that the determination of the character of an interest may be made some time after its receipt, which means that an interest which would give a partner nothing were a partner liquidated upon its receipt, might nevertheless be taxed as a capital interest. I suspect that the case the ruling’s authors had in mind was where a partner performs services for an interest in anticipation of a capital contribution in the near term funding her interest. Such subtleties surely will be disregarded by taxpayers, who will take the position that receipt of an interest is tax-free unless it is clearly within one of the exceptions.

The government’s concession that receipt of a profits interest is usually not taxed brings new issues to the forefront, in particular the issue of how profits allocated to a service partner pursuant to a profits interest ought to be taxed. Such an allocation of profits seems more clearly to be compensatory when the receipt of the interest itself is not treated as compensation. Failure to treat such an allocation of profits as compensation means that service partners may avoid social security taxes imposed on compensation or shift such taxes to other partners, they may convert what would be ordinary income into capital gain by selling an interest, and they may even avoid tax on compensation entirely by taking property in-kind from a partnership in return for a right to profits as yet unrealized at the partnership level.  

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46 Diamond v. Commissioner, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1972) was the first (and still the only) case to tax a partner on receipt of a profits interest for services. Diamond was promised a share of gain on an investment in a building in return for help in obtaining financing. He sold the interest shortly after he received it for $40,000. The issue was whether this income was capital or ordinary. The Tax Court and the Seventh Circuit found it ordinary by holding the receipt of the interest taxable. Diamond caused quite a stir (it was widely assumed that a partner was not taxed when he received a profits interest for services), but it did not turn out to have a significant impact. Cowan, note 42, at 178-83. In an unpublished ruling, Treasury suggested that it thought the case an aberration and that Diamond’s interest really was a capital interest, as evidenced by its quick sale for a gain. G.C.M. 36346 (July 23, 1975).


48 See note 105.

49 See text accompanying notes 97-100.
2. Campbell v. Commissioner

The ruling was prompted by concerns raised by *Campbell v. Commissioner*. The issue in the case was whether a tax shelter promoter had income equal to the value of an interest received in limited partnerships for forming and syndicating the partnerships. The interests mostly carried a right to tax benefits from the shelters. The Tax Court held the interest taxable following *Diamond*; the Court of Appeals held that it was not. The Tax Court decision surprised the tax bar and Treasury because since *Diamond*, no court had found taxable income on an exchange of a profits interest for services. The

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50 59 T.C.M. (CCH) 236 (1990), aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).

51 They also carried a small share in profits and sale proceeds, but the right to such profits was of highly speculative value because Campbell was to receive cash only after the other partners received a 10% return on their investment. Campbell received a 1% or 2% interest in profits and losses in the shelters. In one deal, Campbell's share of losses in the first year of the shelter was projected to be almost $13,000. 59 T.C.M. (CCH) at 239. Over 10 years, the losses were projected to be $128,280 offset by $26,120 income. There were also $10,151 in tax credits. Id. at 240. Under the government's method of valuation, the total value of Campbell's interest in this partnership (the Phillips House) was $42,084. Of this, $16,665 was attributable to projected cash distributions. Id. at 253. The remainder was tax benefits.

52 59 T.C.M. at 253. The Tax Court valued the profits interest by discounting the tax benefits and cash distributions projected in the prospectus to present value using a discount rate very favorable to Campbell. Id. at 253-56. To determine a discount rate, the government calculated the implicit discount rate in the amount an outside investor paid for an interest. The government took the value of projected tax losses and cash distributions on an interest and determined a discount rate using what an investor actually paid for such an interest. This produced a discount rate varying from 14.35% to 26.8% for the three partnerships. Campbell argued that the discount rate should be 30% or more (he multiplied the Baa corporate bond rate by 2.5) and that a value should be assigned only to the projected cash distributions. Id. at 254. The Tax Court rejected the government's method of valuation because Campbell did not have the same right to cash distributions as the investors. It rejected Campbell's approach because no value was assigned to the tax benefits. The Tax Court used Campbell's suggested discount rate to discount projected tax benefits and cash distributions. It further discounted one of the shelters because financing had not been secured in the year in question. Id. at 256. In one partnership (the Airport), the court's method produced a value of $15,000. Campbell valued the interest at $4,207. The government valued the interest at $20,683. Id.

53 943 F.2d. at 823.


55 The *Diamond* issue had been raised in *Campbell* by an enterprising government attorney without Treasury's knowledge. One official said, "It's kind of an ugly-looking thing that you find under the tree. The big question right now is: Is this a gift that the IRS wants to take home with it?" Treasury Tax Legislative Counsel Robert Wootton, as quoted in Joe Spellman, Partnership Interests Exchanged for Services: Implementing Campbell, 48 Tax Notes 1212 (Sept. 3, 1990).

56 Later decisions undercut *Diamond* by using liquidation value to value a profits interest. They valued an interest by asking what the service partner would receive if the partnership liquidated as soon as he received the interest. The answer is always zero if an
Court of Appeals decision was remarkable because of its stated reason—the court found that the interest was of too speculative value to be taxed. A taxpayer may exclude property from income on receipt if it has no ascertainable value in “rare and extraordinary cases,” but other partners paid substantial amounts for interests similar to what Campbell received, and I know of no other case holding property to be without ascertainable value where this was true. Other textual

interest is a true profits interest. National Oil Co. v. Commissioner, 52 T.C.M. (CCH) 1223 (1986); Kenroy Inc. v. Commissioner, 47 T.C.M. (CCH) 1749 (1984); St. John v. United States, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1983). In Mark IV Pictures, Inc. v. Commissioner, 60 T.C.M. (CCH) 1171 (1990), an interest received for services was held taxable with value measured by the liquidation approach. In United States v. Pacheco, 912 F.2d 297, 302 (9th Cir. 1990), a tax shelter partnership was denied a deduction when it gave a profits interest to a promoter. The deduction was claimed as a corollary to the rule in Diamond that the service partner had income on receipt of the interest. The court concluded that the value of the interest was too speculative.

Reg. § 1.1001-1(a). This regulation applies to determine gain on the sale of an asset where property other than cash is received as consideration. Presumably a similar rule applies under § 83 where property is received for services. Both § 83(a)(1) and § 1001(b) tax property at its “fair market value.” For an old case applying this rule to property received for services, see Sullivan v. Commissioner, 2 B.T.A. 1012, 1016 (1925).

The Court of Appeals thought this unpersuasive evidence of value because Campbell had a lesser right to cash distributions. The Tax Court recognized this and as a consequence, chose a discount rate very favorable to Campbell. Probably even the Tax Court was too generous to Campbell. Projected cash returns are not a significant source of value in highly leveraged tax shelters such as those in Campbell. In any event, the difference in interests could not justify placing no value on Campbell’s interest. Even using assumptions highly favorable to Campbell, it is clear that the outside investors paid a significant amount for the projected tax benefits, in which Campbell was to share fully. One way to get a rough sense of how much was paid for the tax benefits is to take the projected cash distributions and discount them using some interest rate. This would roughly identify the amount paid by investors for cash distributions. Assumptions highly favorable to Campbell would take all projected cash distributions and use the discount rate for low risk investments. For example, in the Phillips House it was projected that each class A limited partner would receive a distribution of approximately $10,229 in 1984, $13,114 in 1985 and $13,143 in 1986 through 1989. I derived these figures by dividing the aggregate projected cash distributions reported by the court in Campbell v. Commissioner, 59 T.C.M. (CCH), 236, 239-40 (1990) by the number of units (35). Id. at 238. An interest cost $99,250 in 1979. Id. Using the Baa corporate bond rate in 1979 of 12.22%, id. at 254, these projected cash distributions had a value of $32,209 in 1979. Even on these highly favorable assumptions, over two-thirds the price of an interest was for tax benefits. No doubt the cash projections were far riskier than Baa-rated corporate bonds, and so a higher discount rate would be appropriate and a lower value would be assigned to the cash distributions.

Recent cases where property was held to have no ascertainable value include McShain v. Commissioner, 71 T.C. 998 (1979) (second mortgage note on property, where earnings and value were projected as insufficient to pay the first mortgage and there was no market for second mortgages); Bolles v. Commissioner, 69 T.C. 342 (1977) (right to contingent consideration on sale of stock where payment depended upon buyer acquiring 50% interest in corporation, which was unlikely, and upon high appraisal of value of stock). Of historical interest are a number of cases involving the valuation of notes taken on the sale of inimproved land (often swamp land) in the boom in Florida in the early 1920’s. There was no market for these notes even during the boom years. Despite their highly speculative nature, several cases held these notes taxable either at their face value,
and doctrinal arguments made for not taxing the interest are no more convincing.\textsuperscript{60}

\begin{itemize}
\item Burman v. Commissioner, 23 B.T.A. 639 (1931), or at a discounted value, Ives Dairy, Inc. v. Commissioner, 23 B.T.A. 579 (1931), aff'd, 65 F.2d 135 (5th Cir. 1933); Georgia-Florida Land Co. v. Commissioner, 16 B.T.A. 1253 (1929). Cf. Wells Amusement Co. v. Commissioner, 70 F.2d 208, 212 (4th Cir. 1934) (notes received on sale of theatrical properties taxed though value was speculative and they could not be marketed or pledged). Some cases held Florida land notes not to be taxable because they had no market value. Walter W. Rose Investment Co. v. Commissioner, 24 B.T.A. 215 (1931); Miami Beach Improvement Co. v. Commissioner, 14 B.T.A. 10 (1928). These cases present stronger facts for the taxpayer than does Campbell because other investors were not paying cash in lieu of giving notes.

The Court of Appeals emphasized the fact that the projected tax benefits eventually were denied. Campbell v. Commissioner, 943 F.2d 815, 823 (8th Cir. 1991). This fact plainly should have been treated as irrelevant: The value of an asset is assessed on facts known when the asset is received. See, e.g., Pessin v. Commissioner, 59 T.C. 473, 484-85 (1972) (breeding interest in stallion is valued on the basis of facts known when it was received and not hindsight); Bartlett v. Commissioner, 28 B.T.A. 285 (1933), aff'd, 71 F.2d 601 (4th Cir. 1934) (stock received shortly before market crash is taxed on value on receipt rather than post-crash value). On the related issue of determining the useful life of an asset, actual experience is treated as irrelevant. See Banc One Corp. v. Commissioner, 84 T.C. 476, 499-500 (1985), aff'd per curiam, 815 F.2d 75 (6th Cir. 1987).

One howler is the argument based on § 707. The argument is that a partner receives taxable compensation from a partnership only in the limited circumstances described in § 707(a) and (c), that is, only if he is paid other than as a partner or if he is paid without regard to profits. Because the receipt of a profits interest by Campbell does not come under either § 707(a) or (c), the argument concludes, it is not taxed as compensation. Campbell, 943 F.2d at 822. The argument was made by amicus. Brief of the American Film Marketing Assoc., et al., Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991) No. 90-2730. The brief is authored by William McKee and William Nelson. The argument also is made in their treatise. 1 McKee et al., note 25, ¶ 5.02[1][b], at 5-13 to 5-14. For another response to this argument, see Cunningham, note 42, at 265-67.

This argument confuses two issues. One is how a payment to a service provider is treated. Sections 707(a) and (c) provide that it is treated as a distribution if the service provider is truly a partner and the payment is contingent on profits. Whether the service provider should have income when he receives an interest is a different issue. The legislative history of § 707(a)(2)(A) recognizes that receipt of a partnership interest may be taxed though the distributions to the holder are not treated as compensation. See 1984 Blue- book, note 20, at 227 n.9. (McKee and Nelson fail to refer to this important bit of legislative history in their treatise and their brief in Campbell. Instead they say in the treatise that “there is no evidence that the relationship of § 707(a)(2)(A) to the taxation of a compensatory transfer of a profits interest was considered by Congress.” 1 McKee et al., note 25, ¶ 5.02[1][b], at 5-14.) It is true, under the § 721 regulations, if a service partner receives a capital interest the receipt of that interest is taxed under § 707(c) as a guaranteed payment. Reg. § 1.721-1(b)(2). Receipt of a capital interest fits within the guaranteed payment model because the service partner has a right to be paid his share of capital without regard to the income of the partnership. But there is no logical reason to deduce from the fact that receipt of a capital interest is taxed under § 707(c) that receipt of a profits interest must be taxed under § 707(a) or (c) or not at all. Textually and historically § 707(a) and (c) serve functions that have nothing to do with the taxation of compensatory exchanges of interests for services.

Professor Leo Schmolka offers a new argument why receipt of a profits interest ought not to be taxed under § 83. As I understand the argument, it is that an expansive interpretation of § 83 to cover all valuable rights received for services cannot stand given the fact that § 83 was never thought to cover interest free loans from employers to employees. From
These are no longer concerns. The Treasury ruling that an exchange of a profits interest for services is not ordinarily taxable makes the Tax Court decision in *Campbell* an historic oddity and makes it unnecessary to concoct (and futile to rebut) textual or doctrinal arguments for the Court of Appeal's decision. Ironically, this ruling might not apply to Campbell's situation because he may have performed the services for his corporate employer rather than for the partnership (the government argued this theory on appeal in *Campbell*). Still two aspects of *Campbell* deserve note. The case raises an interesting timing issue. When Campbell actually received his interest in the partnerships, they were of little value. He and his coworkers were initially the only partners. The value of their interests depended upon finding suitable investment properties, investors and financing. In the Tax Court, Campbell argued that the interest had no taxable value beyond his small capital contribution when he received the interest. Any other value represented his earning potential—that is, human capital, or "sweat equity" as Campbell called it. The Tax Court con-
cluded Campbell really received the interest once his work was complete and the shelters were up and going.

There is something to be said for the Tax Court's resolution of this issue. It forecloses the possibility that a person who performs services that are instrumental to the success of a venture in return for a share of the venture may avoid tax on his gain by claiming that the interest was received before the services were performed when the interest is worth little. Nevertheless, this part of the opinion is not on solid legal ground. The Tax Court relied on the principle that the substance of a transaction governs over the form. This implies that Campbell was given an interest in an empty shell of a partnership purposefully to avoid gain. This is unlikely since Campbell's tax adviser thought that receipt of a profits interest was not taxable in any event.

The lack of solid legal ground for this part of the Tax Court's opinion can be seen in its more far reaching implications. The court's reasoning suggests, for example, that in a "flip-flop" where a service provider is given a small interest in a partnership initially, and is promised a much larger interest if his work proves fruitful, the taxable event occurs when his work bears fruit. Or, to take the point even further, it suggests that if two persons form a partnership to develop an idea, their income on receipt of the interest is measured when their work is done. Later I argue that this is the correct result in these cases and propose rules that impose tax after completion of the work in at least the first case. This proposal, however, is a significant change in the law.

One other aspect of Campbell merits brief comment. It is ironic to label Campbell's interest a profits interest because the real value of

64 I propose such a rule in Gergen, Joint Ventures, note 38, at 552.

65 Campbell, 59 T.C.M. (CCH) at 250.

66 Id. at 237-38. The Tax Court might instead have relied on the rule that property received for services is not income until the property no longer is subject to a condition of forfeiture. IRC § 83(a)(1), (c)(1). The fact that Campbell had to work to make the interest valuable is analogous to a condition of forfeiture. One effect of this rule is to prevent the taxation of human capital by deferring tax on income that depends upon future labor until the labor is complete. The court's decision in Campbell that the interest could not be included in income until the services were performed and the shelters up and going has the same effect.

The analogy to § 83 is not very helpful. First, the interest was Campbell's to keep; his services only affected its value. In the normal § 83 case, the property has value independent of the services (the paradigm is stock in a publicly held corporation) and the issue is whether the taxpayer has done the work necessary to own the property. Second, a taxpayer may elect to include property in income although it is subject to a condition of forfeiture. IRC § 83(b). The rule that property is not taxed if it is forfeitable is not an anti-abuse rule and the Tax Court was concerned with the abuse of early inclusion.

67 The shift in interests seems not to be considered a taxable event. See Gergen, Special Allocations, note 1, at 38 n.152.

68 See text accompanying notes 109-12.
the interest to him was in tax losses he could use to shelter income. The interest in losses was probably of value to Campbell. The value is the interest he could earn by deferring tax from the year of the loss deduction to the year of the offsetting income.

This aspect of the case raises some interesting problems. Happily, these problems are mostly of intellectual interest because Revenue Procedure 93-27 plus the demise of the tax shelter industry means there will be few future cases like Campbell. There is a threshold question: Does receipt of a valuable right to losses constitute income? The answer to this question ought to be yes. The definition of income encompasses any accession to wealth and Campbell was richer because he expected to pay less taxes. It is well established that gain is recognized on the exchange of tax-exempt bonds, showing that an increase in wealth due to a tax preference that attaches to an asset may be taxed on an exchange of the asset although the income on the asset itself is not taxable because of the preference.

There is a second theoretical problem. Under the usual model for taxing a profits interest, it was necessary to make a proper inside basis adjustment to ensure that the recipient of the interest was not double taxed. When a true profits interest is exchanged for services, an inside basis account must be created and amortized against the service partner’s future profits. This ensures profits earned and allocated to the service provider are not taxed twice. Where a “loss” interest is exchanged for services, it is not clear theoretically whether some similar adjustment must be made to avoid double taxation of the service part-

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69 A compensatory allocation of losses is impossible under the rules I propose for allocations. Tax losses could be allocated to a service provider only by giving him a capital account since all tax items are allocated in accordance with relative balances in capital accounts. The service provider would have income on receipt of the capital account and thereafter would be treated as a partner.

The value of the interest may exceed the nominal value of partnership capital. It is possible that investments in the partnership earn above normal return because tax benefits are not fully capitalized in the price. In this case, the value of the interest will exceed the nominal amount of capital invested by the other partners. Assume a 40% tax rate and a prevailing interest rate of 10%. A group of partners invests $1,000 in Shelter Partnership. This $1,000 is deducted currently and will earn $1,100 in one year. This is a 10% after-tax rate of return, which is higher than the normal 6% after-tax rate. The promoter is given a 5% interest in capital in return for organizing the partnership. This interest is worth $51.13 rather than $50. It produces $20 currently in tax savings and $33 in after-tax income in Year 2. Discounting this by the 6% after-tax rate of return, the Year 2 return is worth $31.13 in Year 1. The expected value in Year 1 is $51.13. On receipt of the interest, the promoter would have $51.13 income.

ner, and, if some adjustment is to be made, it is not clear what form it should take.\textsuperscript{72}

\section*{B. Why an Allocation of Profits Should be Taxed as Compensation but not an Exchange of a Profits Interest}

The ruling that an exchange of a profits interest for services is not ordinarily a taxable event\textsuperscript{73} is a step towards the best practicable solution to the problem of taxing such exchanges. But another step needs to be taken: compensatory allocations of profits must be taxed as compensation. That is, if a partner performs services for a profits interest, and profits later are allocated to her in the form of earned income or an increase in her capital account to credit her with a share of unrealized gain, that allocation or increase should be treated as ordinary income to her and as an expense by the partnership. This section explains why this solution is probably better than taxing the exchange of a profits interest for services.\textsuperscript{74}

The decision not to tax the exchange of a profits interest for services arguably compels taxing allocations of profits as compensation. Otherwise, partners enjoy extraordinary privileges. They may receive compensation without ever paying social security tax if the partnership’s income is not service-based, or if the partnership’s income is partly service-based other non-service partners may bear the tax for them.\textsuperscript{75} They may receive compensation without ever paying tax at ordinary rates if the profits allocated to them represent capital gain or if they sell their interests in unrealized profits. Indeed, as discussed below, they may receive in kind compensation without paying any tax, something that is otherwise impossible.

\textsuperscript{72} An interest in tax losses that will be offset by later income is equivalent to the receipt of interest on the amount of taxes saved for the period of deferral. The value of a loss interest is the present value of the expected earnings on the temporary tax savings. If the partnership interest is taxed on receipt, some deduction must be made against the interest earned on tax savings so that the partnership interest is not taxed twice. For example, assume that $T$ receives a partnership interest at time zero that will provide him a $100 deduction at time one and $100 income at time two. $T$’s tax rate is 40\% and the pretax interest rate is 10\%. This interest is worth $3.31 to $T$ at time zero, which is the value at time zero of the interest $T$ expects to earn from time one to time two by deferring $40 tax over that period (assuming the $4 interest is paid at time two). Assuming $T$ is taxed on the value of the partnership interest at time zero, when he earns $4 interest at time two he should be taxed on only $0.69 because he already has paid tax on $3.31.

\textsuperscript{73} Rev. Proc. 93-97, I.R.B. 1993-24 (July 6).

\textsuperscript{74} I took a different position in Gergen, Joint Ventures, note 38, at 555-56.

\textsuperscript{75} See note 105.
1. Futility

It is futile to try to tax an exchange of a profits interest for services because taxpayers easily may evade such tax by paying a service provider deferred salary on a contingent basis. The tax becomes elective, which means that taxpayers may choose between a profits interest and contingent compensation to minimize their tax.

A cash method taxpayer has no income on receipt of an unfunded, unsecured promise to pay money or property in the future. Partners may freely recast an interest in profits as deferred compensation when the payment of profits is not subject to significant risk. Under § 707(a)(2)(A), risk is the most important element defining a true partnership interest. Of course, payment rights with little risk are the most easily valued. Thus, in the cases where valuation of an interest is least difficult, a tax on receipt of a profits interest is easiest to avoid by recasting the interest as deferred compensation.

Partners probably may recast risky profits interests as deferred compensation without fear of recharacterization, at least as long as the service provider does not also contribute capital. A few cases recharacterize nominal partnerships as employment relationships where the "partner" bears too little risk. To my knowledge, no case ever has recharacterized a nominal employment relationship as a partnership because the "employee" bears too much risk on payment of compensation. Several cases do recharacterize nominal sale, loan and lease arrangements as partnerships where the seller, lender or lessee bears too much risk on payment. The government could analogize to these cases and argue that risk of payment makes a nominal employee a partner, but cases holding that contributions of capital with risky returns make the contributor a partner do not extend easily to contributions of services with risky returns. Contributions of services are treated differently from contributions of capital. Old authority holds that a person who contributes services to a venture and

76 Reg. § 1.83-3(e).
77 See notes 19-24 and accompanying text.
78 If the partner does contribute capital, it is difficult to tax receipt of an interest because it will not be clear what part of the interest is given for services and what part is given for capital.
79 Dorman v. United States, 296 F.2d 27 (9th Cir. 1961); Estate of Smith v. Commissioner, 313 F.2d 724 (8th Cir. 1963). See 1 McKee et al., note 25, § 3.03[1]. Of course, this now is governed by § 707(a)(2)(A).
80 There are many cases in the corporate area recharacterizing compensation paid shareholders as dividends. However, these mostly turn on the fact that the compensation is excessive. See, e.g., Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983).
81 Hartman v. Commissioner, 17 T.C.M. (CCH) 1020 (1958), is representative. Hartman "lent" $5,000 to a ferry company in return for all profits until he recovered this amount plus interest. He also received a share of any further profits.
receives a contingent share of profits cannot be a partner if he invests no capital in the partnership and is not liable for losses. Although this is no longer true, these cases still may be cited as authority for the proposition that one who contributes only services for a share of profits need not be treated as a partner. The substantive law of partnership also has a presumption against treating service providers as partners. If the character of the relationship is not spelled out, one who contributes only services to a venture in return for a share of profits is treated as an employee and not a partner.

2. Indirect Taxation

In some cases, there is no need to tax an exchange of a profits interest to properly tax the service provider. Sometimes the service provider can be taxed indirectly by deferring the partnership's deduction of the expense for the services, an effect ensured by treating an allocation of a profits interest as deferred compensation. The possibility of indirect taxation is a familiar point in the literature on deferred compensation. Consider a simple illustration in the partnership context.

Example 7: ABC Partnership employs D to perform services that earn $100 in Year 1. In return, D is given an interest in the next year's rents that is expected to pay $110. The pretax interest rate is 10%. All partners have a tax rate of 40%.

By deferring $100 income from Year 1 to Year 2, D merely shifts the tax on that income to the other partners for one year. This is reflected by the fact that the net present value of this transaction to the partnership is -$2.26 using a 6% after-tax discount rate. This equals the savings to D from deferring tax on $100 for one year.

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82 Dorman, 296 F.2d 27.
83 It is clear from § 707(a)(2)(A) that a capital investment or liability for losses is not essential to being a partner.
84 See, e.g., City of Wheeling v. Chester, 134 F.2d 759 (3d Cir. 1943); Mariani v. Summers, 52 N.Y.S.2d 750 (Sup. Ct. 1944), aff'd, 56 N.Y.S.2d 537 (App. Div. 1945); Bershad v. Roshke, 196 N.Y.S. 548 (App. Term 1922). Mariani is particularly instructive. The defendant contributed an idea that the plaintiff agreed to develop for a one-half share of profits and any rights, such as patents. The plaintiff was held not to be a partner though he had a voice in management of the venture and was promised an interest in the assets produced.
86 The partnership receives $60 after tax in Year 1 and gives up a right to $66 after tax in Year 2. Discounting at 6%, the net present value is -$2.26.
87 If D pays tax on the $100, he would have $60 in Year 1 and $63.60 after tax in Year 2. If D does not pay tax, he would have $66 after-tax income in Year 2. The difference is $2.40. Discounted at 6%, this equals $2.26.
should be passed back to $D$. The partnership could do this by paying $D$ $106 in Year 2. This would eliminate any effect from temporarily shifting income. Then the after-tax position of the parties is the same as it would be if the partnership paid $D$ $100 in Year 1 and $D$ lent $100 to the partnership for one year at 10% interest. $D$ has $63.60 income after tax in Year 2 and the partnership breaks even.

In Example 7, it does not matter whether the payment to $D$ in Year 2 is treated as a share of profits or as compensation. This is because $D$'s services produce income to the partnership in Year 1. It does matter how the payment is treated if $D$'s services produce an asset of future value to the partnership. In order to preserve indirect taxation, it is necessary to treat the payment as compensation so it may be capitalized and its deduction deferred.

Indirect taxation is not a perfect solution to the problem of deferral. One problem is that it requires that the partners have the same

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88 $D$ would end up with $63.60 in Year 2. He receives $106 in Year 2 and pays $42.40 in taxes. The partnership earns $60 after tax in Year 1. It pays $63.60 after tax in Year 2. The net present value to it is zero.

89 Both years are a wash for the partnership. $D$ has a net cash flow after tax of $-40 in Year 1. He receives $60 after tax from the partnership and gives it $100. The cost of this to $D$ in Year 2 is $-42.40. $D$'s after-tax cash flow in Year 2 is $106. The $100 loan repayment is tax-free and he pays $4 tax on $10 interest. $D$ is left with a net return in Year 2 of $63.60.

90 The point remains true even if risk is introduced. Assume $D$ performs services that produce $100 in Year 1. In return, the partnership gives $D$ the right to the return on a lottery ticket. The ticket has a 50% chance of paying zero and a 50% chance of paying $220 in one year. All other assumptions are the same. Ideally, $D$ would have $100 income and pay $40 in taxes in Year 1 for an after-tax return of $-40. He would have either a $100 loss or $120 income in Year 2. The after-tax returns are $40 and $172. This equals an expected return of $106 in Year 2. The net after-tax expected return in Year 1 is $60. If instead $D$ is taxed on payoff, the after-tax expected return to him in Year 1 is $62.26 ($220/2 x 60%, discounted at a 6% rate). The improvement to $D$ of $2.26 is matched by a loss to the partnership. The partnership earns $60 after tax in Year 1. The expected after-tax value of its payment in Year 2 is $66. (It either shifts zero or $220 income to $D$. The latter has an after-tax value of $132.)

91 It is fairly clear that the matching rule in § 83 applies to expenses that are capital in nature. Reg. § 1.83-6(a)(4). This also seems to be the rule under § 404(a)(5). That provision was amended in 1986 to eliminate a reference to expenses deductible under § 162 and § 212. Pub. L. No. 99-514, § 1851(b)(2)(C)(i), 100 Stat. 2085, 2863. The Senate Finance Committee Report observes, “This clarification is necessary to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation.” S. Rep. No. 313, 99th Cong., 2d Sess. 1013, reprinted in 1986-3 C.B. (Vol. 3) 1013.

92 The transaction in Section IV.B.3 illustrates another situation where indirect taxation may not work: where property is distributed to a service partner for an interest in as yet untaxed profits. To preserve indirect taxation, it is necessary that the partnership be given a low basis in the asset produced by the services. The basis in the asset, however, will be stepped up either on the distribution of the other property to the service partner (if a § 754 election is in effect) or on liquidation of the partnership.

Example: $A$ and $B$ form $AB$ Partnership. $A$ contributes stock he owns worth $100 with a basis of $100. $B$ promises to work for the partnership to develop an asset. $B$ is promised one-half the value of the asset he creates. $B$ creates an
tax rate in all relevant years. There is a second more subtle problem. If an expense is capital in nature, its recovery should be deferred past the normal time by a period equal to the period of deferral of the employee’s compensation.\textsuperscript{93} This is not required under current law.\textsuperscript{94} The following example illustrates this point.

Example 8: EFG Partnership employs H to perform services in Year 1 that are expected to produce $110 in Year 1. In return, H is given a profits interest that pays $110 in Year 2. The pretax interest rate is 10%. All partners have a tax rate of 40%.

If the $110 paid H in Year 2 is treated as a share of profits or is deducted by the partnership in Year 2, the other partners pay no tax on H’s deferred income. H is taxed on the $110 income in Year 2. H has an after-tax return of $66 in Year 2, which is greater than the appropriate return of $63.60. To tax H indirectly through the other partners, the partnership must be required to capitalize the amount paid H in Year 2 and to deduct that amount in Year 3. Under this rule, the partnership would lose $2.49 if it paid H $110 in Year 2.\textsuperscript{95} This would equal the value to H in Year 2 of deferring tax on his compensation asset worth $200. The partnership is liquidated and B takes the stock with a zero basis. A takes the asset with a $100 basis. If A sells the asset, he will have $100 gain. This represents his gain and not B’s.

A might be taxed on B’s gain if no § 754 election was in effect and the partnership did not liquidate after the stock was distributed to B. If the partnership sold the asset, it would have $200 income although its economic gain was $100. This excess gain would be offset by a loss if the partnership liquidated since A would have a $300 basis in his interest, but receive only $200 cash.

There is another solution. The partnership may be required to capitalize an amount equal to the present value of the deferred payment calculated using an after-tax discount rate. It also would get no deduction for the interest element of the deferred payment. See Daniel Halperin, Time Value of Money and Insurance Reserves—The Case for “Post-Tax Discounting,” 1986 Proceedings of the 79th Ann. Conf. on Tax’n of the Nat’l Tax Ass’n 171, 171-72.

\textsuperscript{94} If an expense is recovered through depreciation, this could be done by treating the expense as an improvement in the asset in the year the employee includes the expense in income. Assume, for instance, that an employer pays an employee in Year 5 for services performed in Year 1 to help acquire an asset with a five-year recovery period. This expense should be treated as creating a new asset with a five-year recovery period that is put in service in Year 5. Additions or improvements are treated as new assets and recovered as such. IRC § 168(i)(6). This is not the rule on basis adjustments. Proposed regulations under § 168 provide that when the basis of property is redetermined, the new basis is recovered over the original period. Prop. Reg. § 1.168-2(d)(3). Further, there is no mechanism for deferring recovery of nondepreciable expenses that are recovered on sale of an asset.

\textsuperscript{95} The partnership would have $110 income and would pay $44 tax in Year 2. This is offset by a $110 deduction and a $44 tax saving in Year 3. Discounting this saving by 6%, the after-tax interest rate, the partnership’s net loss in Year 2 is $2.49.
one year. In response, the partnership would decrease the amount it paid $H$ in Year 2 to $106. This would treat everyone correctly. $H$ would receive $63.60 after tax in Year 2 and the partnership would break even.96

3. In Kind Payment for an Interest in Unrealized Gain

Not taxing an allocation of profits for services as compensation creates the possibility that compensation may go untaxed if a partner takes property in kind for an interest in unrealized partnership gain. In some cases, there may be a better measure of income if the payment of profits is the taxable event rather than the grant of a profits interest.

Example 9: $D$, a large publicly traded corporation, wants to hire $E$, an individual, to develop computer software. $D$, $E$ and $F$ (a straw man) form DEF Partnership. $D$ contributes 1,000 shares of $D$ stock and cash. The stock is worth $100 per share and has a basis of $100. $F$ contributes a nominal amount of cash. $E$ promises to develop software which will belong to the partnership. $E$ is paid cash as salary and is given a right to any gain on the 1,000 shares of $D$ stock. $E$ may elect to liquidate his interest at any time. $E$ does this when the stock is worth $150 per share. His capital account is valued at $50,000. In liquidation of his interest, 333 shares of $D$ stock are distributed to $E$. $E$ takes a zero basis in the stock (this assumes that $E$ had no income on receipt of the interest). The remaining 667 shares of stock are distributed to $D$ at the same time. This leaves $D$ with a $33,300 basis in its partnership interest. After a decent interval, the software is distributed to $D$ in liquidation of the partnership and $D$ takes a $33,300 basis.97

This case is troubling because $E$ is able to get the $D$ stock without ever paying tax on its value. This is impossible in other forms. If $D$ gave $E$

96 The partnership would have $110 taxable income and would pay $44 tax in Year 2. This would be offset by a $4 receipt. The partnership's net expense in Year 2 would be $40. In Year 3, the partnership would have a $106 deduction which would produce a $42.40 tax saving. This saving would be worth $40 in Year 2.

97 $F$ is there as a shill and the partnership is continued after $E$ withdraws to increase $D$'s basis in the software. If the partnership liquidated on $E$'s withdrawal and the 666 shares of $D$ stock and the software were distributed to $D$ at the same time, the $33,300 excess basis would be divided between the stock and the software. IRC § 732(c). Basis in its own stock is of no value to $D$ because corporations do not recognize gain on their own stock. IRC § 1032.
a nonpublicly traded stock option instead, $E$ would be taxed on gain on exercise of the option.\textsuperscript{98} Gain is avoided in Example 9 because $E$ receives a noncash distribution from the partnership for an interest in gain as yet untaxed at the partnership level. If $E$ took cash instead of stock on liquidation of his interest, he would be taxed on the gain since the cash would exceed his basis in his interest.\textsuperscript{99} If the stock were sold before $E$ liquidated his interest, $E$ would be taxed on gain at that time.

In theory, $E$ ought to recognize income equal to the value of the interest when he receives it and gain or loss as the interest fluctuates in value. Ideally, this would be done periodically by revaluing the interest. Practically, this could be done by taxing $E$ on the value of the interest when it is received and on any gain or loss when he liquidates his interest. This is a stricter rule than applies to a stock option received for services. An employee who receives a stock option for services is taxed either on receipt of the option (if it is publicly traded or its value can be measured with reasonable accuracy) or on its exercise,\textsuperscript{100} but not on both events.

I argue that if $E$ is to be taxed either on receipt of the interest or on the distribution of the stock, it is better to tax him on the later event. The problem posed in Example 9 is better solved by taxing a profits allocation as compensation than by taxing the exchange of the interest. This may seem counter intuitive because deferral of tax is usually thought to be in a taxpayer's interest. In this one situation, however, deferral may be in the government's interest.

Start with two unrealistic assumptions. First, the interest will be valued accurately at all times. Second, there are only two possible recognition events—receipt of the interest (I call this the bet) and distribution of the stock (this is the payoff)—and they are mutually exclusive. Thus, if gain is recognized on the bet, additional gain on the payoff is never recognized. Further, gain recognized on the bet can never give rise to a loss although the payoff is less. Under these assumptions, it does not matter when the tax is imposed. Once those assumptions are relaxed, it may be in the government's interest to delay tax.

Assume an interest with two possible payoffs: $V$ or 0. The probability of $V$ is $P$. The tax rate is $T$. First consider a simultaneous bet and payoff. If the bet is taxed, the expected return is $VP - VPT$. If the payoff is taxed, the expected return is $(V - VT)P$. These are equal. The difference is whether the government shares in the gam-

\textsuperscript{98} IRC § 83(e)(3); Reg. § 1.83-7(a).
\textsuperscript{99} IRC § 731(a)(1).
\textsuperscript{100} IRC § 83(e)(3); Reg. § 1.83-7(a), (b).
ble. It does if the payoff is taxed; it does not if the bet is taxed. Deferring the payoff does not change the relationship. Assume the bet is at time zero and the payoff is at time one with an interest rate of $I$. The expected return if the bet is taxed is $VP(1/(1+I)) - VP(1/(1+I))T$. The expected return if the payoff is taxed is $(V-VT)P(1/(1+I))$. Again these are equal. They are equal because if the bet is taxed, the interest element in the payoff is not taxed. This is an illustration of the Cary Brown hypothesis, that is, excluding the value of an investment (here the bet) from income is equivalent to exempting the return on that investment (here the interest element in the payoff) from income.\footnote{See E. Cary Brown, Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin H. Hansen 300 (1948). For an explanation of the thesis and its scope conditions, see Michael J. Graetz, Federal Income Taxation 385-90 (2d ed. 1988).}

Now relax the second assumption that there are only two possible recognition events. This adds two factors. First, gain not taxed on the payoff may be recognized later. In Example 9, $E$ eventually may sell the stock he receives in a tax-free distribution. Second, gain recognized on the bet may give rise to a loss later. In Example 9, $E$'s profits interest may turn out to be valueless. If he had income on receipt of the interest, he will have a loss on its abandonment.

These factors have offsetting effects. If tax on payoff gain is deferred and not exempted, the expected return is better under a rule taxing the payoff and not the bet. This is axiomatic because taxing the bet and taxing the payoff are equivalent only if payoff gain is exempted from tax when the bet is taxed. How much worse the return will be if the bet is taxed instead of the payoff depends on the period of deferral between the payoff and recognition of the payoff gain. Conversely, if gain recognized on the bet can give rise to a loss, the expected return is better under a rule taxing the bet and not the payoff. This is axiomatic since taxing the bet and taxing the payoff are equivalent only if the taxpayer fully bears payoff risks when he pays tax on the bet in lieu of paying tax on the payoff. Allowing a deduction for losing bets shifts some of this risk back to the government.

The net effect of these two factors is difficult to predict in the abstract. Nevertheless, in a significant number of cases, taxpayers would be better off under a rule taxing receipt of a profits interest than under a rule taxing distributions. This is because the first rule would give the taxpayer more power over the timing of recognition of loss and gain. For instance, in Example 9, $E$ probably would prefer to be taxed on receipt of the profits interest in lieu of tax on the distribution. If the profits interest turned out to be worthless, he quickly
would abandon the interest and recognize a loss. If the interest turned out to be valuable, he would take the gain in the form of stock which he might hold indefinitely. The major constraints on holding publicly traded stock are the desire to consume or to adjust a portfolio (for example, by diversifying). These constraints are not significant if $E$ is wealthy.

There is another more obvious reason why taxing the distribution would be likely to produce a better measure of income than taxing the receipt of the interest. Profits interests are more likely to be undervalued than stock or other assets received in a distribution. Undervaluation has two fundamental causes: private information and uncertainty. The information needed to value a profits interest is more likely to be private than information needed to value stock or other assets received in a distribution. Thus, a taxpayer is more likely to think that he may undervalue the profits interest without being found out. The value of the profits interest also is more uncertain than the value of the stock. When I say that the value is uncertain, I mean that it involves contingencies of sufficient doubt that people with the same information and preferences might value the interest significantly differently. Most nonpublicly traded assets actually have a range of defensible values and uncertainty makes that range large. This is important, for a taxpayer will tend to choose a low number in that range when assessing his income. The more the uncertainty, the larger the range, and the bigger the likely deviation between reported value and median value.\footnote{102}

It is important to remember the limits to this point. It only shows that if the choice is between taxing a partner on receipt of his interest or on distribution of property in liquidation of his interest, it probably is better to impose a tax on the later event. This only makes the best of a bad situation. There still may be a significant reduction in tax because of deferral. As explained in the footnote, it is possible to eliminate this benefit through indirect taxation, but that requires rules that are radically unlike anything that now applies to compensatory exchanges of interests. Before undertaking such radical measures, it may be better to rethink the basic rules on deferred compensation.\footnote{103}

\footnote{102} I use median value as the reference point rather than actual value because there is no correct value in these cases. A fair value arguably is one that falls in the midrange of possible values. This uncertainty also may influence enforcement. Revenue agents may be reluctant to challenge valuation when it is uncertain because they cannot determine the likelihood of success. Revenue agents may prefer to spend their limited resources in ways that have a more definite return because of the way their performance is evaluated. In effect, they may be risk averse. If taxpayers expect agents to behave in this fashion, there will be a further downward bias in valuation.

\footnote{103} To preserve indirect taxation, the other partners, in effect, must pay a toll charge when the service partner's capital account is increased prior to the distribution. This toll
I propose to treat compensatory allocations as salary. This rule would cover allocations out of current earnings and increases in a service partner's capital account due to the revaluation of partnership assets. The salary would be income to the service partner and an expense to the partnership. This Section works through several implications of this change, including how to determine whether an allocation is compensation for services. It also examines the question of whether charge would equal the tax on the difference between the amount of the increase and that same amount discounted to the time when the services were performed using the partner's after-tax rate of return. The partners and the partnership get no other tax benefit for the expenditure. Conceptually, it is as if the partnership exchanged an asset for the services with a value equal to the account increase in a taxable exchange with its expense in producing the asset (and so its basis in the asset) equal to the value of the asset discounted to the time when the services were performed using the partner's after-tax rate of return.

**Example:** A invests $100 in AB Partnership. B agrees to perform services at the beginning of Year 1 to develop an asset. The $100 cash is spent in developing the asset and is capitalized. Under the partnership agreement, A is entitled to the first $100 income or proceeds on the sale of the asset. B is entitled to the next $100. Thereafter, income and gain are split equally. B produces an asset worth $220 at the beginning of Year 2. He liquidates his interest in the partnership at that time. A and B's marginal rate of tax is 40%. The pretax rate of interest is 10%. Prior to the liquidation of B's interest, his capital account is increased to $110. B has $110 income upon the account adjustment. A has $6.23 income on the increase. This is the difference between the value of the interest ($110) and that amount discounted one year at a 6% rate ($103.77).

That this produces the correct result follows from the point noted earlier that one way to achieve indirect taxation is to allow the employer an expense equal to the value of the compensation eventually paid discounted to when the compensation was earned using the employer's after-tax rate of return. See notes 85-90 and accompanying text. Here, that expense is recovered when the employee's capital account is adjusted to reflect the gain. I discount the cost of compensation to indirectly tax A on the value of deferring income to B, rather than defer A's recovery of that cost, because the conceptual problems that arise if A defers recovery of the cost of producing the asset beyond the time he effectively disposes of the asset by increasing B's capital account.

A similar result would follow if the grant of a capital account to B was treated as an exchange of a pro rata interest in all partnership assets for services rather than an exchange of an asset representing the gain from B's labors. Then A would have $8.11 gain on the exchange (the interest would be worth $110 and would have a basis of $101.89, on one-half of $100 plus $103.77) and another $8.11 gain when his interest was liquidated (he would receive assets worth $110 with a remaining basis of $101.89, which is the other one-half of $203.77). A's total gain would be $16.23. This equals his real $10 gain (he invested $100 and realized $110) and the $6.23 income he would have because he bore tax for B because of the deferral. This approach would tax only part of B's gain from deferring income on the account adjustment, but it also would tax part of A's gain on the investment in the asset.

Eliminating the benefit to B from deferring income is best attacked directly. This could be done, for example, by requiring B to pay a toll charge when his interest paid off equal to the amount that A paid under the first approach. This would avoid problems that would arise when A and B have different tax rates. Thus, this issue is best addressed outside of subchapter K in the general rules on deferred compensation.
the other partners ought to recognize gain when a partnership holding appreciated assets increases the capital account of a service partner.104

A. Implications for Service Partners

Treating compensatory allocations as salary in many cases would not alter the income tax consequences of operating a partnership. If a partner was paid for current services out of current income, the income tax consequences would be the same as under current law. The only difference would be that his income would appear as wages rather than as a share of profits from the partnership. Under this rule, pure service partnerships would have no taxable income. Their income would be offset by a deduction for compensation paid to partners.105

This rule requires separating control of a partnership from ownership of its capital. Control would depend on the partnership agreement and others factors that enhance a partner’s power. Ownership of capital might depend on other factors. A partner may have a greater capital account because he does not withdraw his share of profits. Or old partners may have greater capital accounts than new partners because their interests include appreciation on assets the firm has held for a long time. There is nothing odd in the separation of ownership of capital and control; they also are separate in subchapter S. The one class of stock rules require that shares give equal rights to income, but not equal voting power.106

104 See note 41 and accompanying text. In calculating gain on the exchange, the expense of the services should be included in the basis of partnership assets. Example 10 in the next section illustrates this. This ensures that the other partners are not taxed on gain that represents wealth inuring to the service partner.

105 These changes may have collateral consequences. One useful consequence is that they would clarify when payments to a partner would be subject to social security taxes. Partners pay social security taxes through the tax on self employment income. IRC § 1401(a). In a partnership, self employment income includes guaranteed payments plus a partner’s distributive share of income and loss. IRC § 1402(a). In calculating the distributive share of income, some things are disregarded, including rentals, dividends and interest, and gain and loss from the sale of capital assets or noninventory property. IRC § 1402(a)(1), (2), (3). This income is disregarded because it is not service based. If my proposed rules were adopted, taxable self employment income would be defined as compensation paid by a partnership. This would be less inclusive than current law in some respects. For instance, all partners are subject to self employment tax even if their interest is entirely passive. Reg. § 1.1402(a)-2(g). It would be more inclusive in other respects. For instance, a partner who was given a share of rents or gain on the sale of property in return for services in improving the property would be taxed on the rent or gain. Rents and gain on the sale of property are not subject to self employment tax under current law. In both instances, my approach better measures when income is service based. It recognizes that rents paid a service partner are service based while income from services that flows to a partner who invests capital is not.

106 Reg. § 1.1361-1(j)(1).
The system I propose for partnerships is very much like subchapter S. This, I think, decisively answers any criticism that what I propose is too complex for small partnerships. It has not proven too complex for S corporations. Under subchapter S, gain and loss must be allocated to shareholders pro rata. Under my proposals, gain and loss must be allocated to capital account holders pro rata. The difference is that capital account balances take the place of relative shareholdings. An S corporation cannot compensate a service provider who also is a shareholder by giving him a greater share of corporate profits. It must pay him compensation or give him stock, which is treated as compensation. I propose similar rules for subchapter K.

An increase in a service partner's capital account because of a revaluation of partnership assets also should be treated as salary. This rule would have important implications for a common transaction—a "flip-flop" where a service provider is promised a share of income or gain once partners who invest capital receive a stipulated amount.

**Example 10:** D and E form DE Partnership to develop computer software. D contributes $100,000. E contributes services and is paid a salary. One hundred percent of all losses and 100% of all income or gain are allocated to D until his capital account equals $100,000. Thereafter, income or gain is split evenly between D and E. A successful prototype is designed. F, a venture capital firm, agrees to contribute $1,600,000 in return for an 80% interest in the partnership and as working capital. Upon F's admission as a partner, the software is valued at $500,000. This is the partnership's only asset. The $100,000 invested by D has been spent and capitalized. D's capital account is increased from $100,000 to $300,000. E's capital account is increased from zero to $200,000. To equalize capital accounts, $100,000 is distributed to D.

Under the rule I propose, E would have $200,000 income when his capital account is increased on the admission of F.

This result would be consistent with general norms of income tax. E has been enriched by $200,000 because of the success of the project. The admission of F as a partner would be a convenient time to tax E on this gain as the software would be valued to adjust capital accounts appropriately. Further, F's contribution of cash would provide E funds necessary to pay the tax. Problems of valuation and liquidity are the major reasons for not taxing unrealized gains, but they would not hold here. This result would ensure that E's gain is treated as ordinary income, as it would be treated if he developed the software
on his own and sold it for cash.\textsuperscript{107} Conversely, $D$'s gain, whenever it is realized, clearly would be treated as capital and not ordinary. Under current law, it seems likely that the partners' gain would be of the same character, but it is not clear what that character would be.\textsuperscript{108} This result also would diminish the risk that income would be shifted from $E$ to $F$. If gain was not recognized and the basis of the software was not increased on the admission of $F$, the partnership would be left holding a low basis asset. If the software was amortizable, the low basis would mean that the partnership would have taxable income in excess of book income. If the § 704(c)-type allocations required by the § 704(b) regulations were not made (or could not be made because of the ceiling rule), $E$ would shift income to $F$ temporarily.

**B. Identifying Compensatory Allocations**

Under the rule I propose, it would be necessary to determine when a profits allocation was compensatory. When a service partner also contributes capital, it is necessary to determine whether a profits allocation is a return on capital or services. My proposal in an earlier article to require partnerships to allocate all items in accordance with relative balances in partners' capital accounts offers a solution to this problem.\textsuperscript{109} Under this rule, non-pro rata adjustments in capital accounts must represent returns other than on capital contributions. They may be compensation if a partner also provides services, rent if she leases property to the partnership or interest if she loans money to the partnership. Assume in Example 10, for instance, that $E$ contributes $10,000 of the $100,000 initial capital and gain is split 90-10 between $D$ and $E$ until initial capital accounts are restored. Thereafter, gain is split 50-50. When each partner's capital account is increased by

\textsuperscript{107} IRC § 1221(3)(A).

\textsuperscript{108} There is nothing directly on point regarding characterization of gain or loss as capital on assets of the type described in § 1221(3)(A) that are developed by a partnership. Revenue Ruling 55-706 holds that film developed by a corporation is not an ordinary income asset under that section. However, the ruling emphasizes that the corporation was large and publicly held and that the people who actually made the film were paid full market value for their services. Rev. Rul. 55-706, 1955-2 C.B. 300. Example 10 is different because $E$ looks to the value of the asset for part of the return from his labor. The legislative history of § 1221(3) states that if three individuals join labor to produce an asset, gain on sale of the asset is ordinary to each of them. S. Rep. No. 2375, 81st Cong., 2d Sess. 84, reprinted in 1950-2 C.B. 543. See Howard J. Rothman, Capital Assets—Section 1221, General Definition, 21-22 (Tax Mgmt. (BNA) Portfolio No. 446 (1986)). Example 10 is also different because $D$ contributes capital and not labor. It is not clear how an asset is characterized if some partners contribute labor and some capital. Cases decided under § 1221(1), which covers sales of property in the ordinary course of trade or business, do suggest that this determination must be made at the partnership level. See Estate of Free-land v. Commissioner, 393 F.2d 573 (9th Cir. 1968).

\textsuperscript{109} Gergen, Contributions, note 1.
$200,000, $40,000 (10% of the $400,000 increase) of the increase in $E$'s capital account is treated as a return on capital and $160,000 is treated as compensation.

This solution is not perfect. One defect is that if both partners contribute capital and labor, returns on labor are masked. The extreme case is where partners contribute equal capital and labor. In this case, all returns would be treated as returns on capital. If all contribute capital and labor, but in unequal portions, returns on labor would be partially masked.\[10\] There is no good way to deal with these cases. Returns could be apportioned between labor and capital if a reasonable rate of return could be set for capital. Most ventures, however, where all partners contribute labor and capital are small and risky. In these situations, it is difficult to assign a fair rate of return on capital.

Also, the rule I propose could be manipulated to reduce compensation. One way to do this would be to make a preemptive small adjustment of capital accounts in anticipation of a larger adjustment later on. In Example 10, capital accounts might be adjusted before $F$ is admitted as a partner with the software valued at $200,000. On the adjustment, $D$'s capital account would become $150,000, $E$'s would become $50,000, and $E$ would have $50,000 compensation. When capital accounts were adjusted again on the admission of $F$, one-third of the increase in $E$'s account would be treated as a return on capital.

There is no clean way to prevent this. A return to a laborer may be a return on capital. For example, if a person improves land in return for a share of the resulting increase in value, the return to him may be both a product of his labor and a change in the market value of the land. The latter is a return on capital if the transaction is divided into an investment of labor at its current value and a side-bet on changes in the market for the land. Thus, it is wrong to assume that all returns paid a partner whose sole contribution is services are compensation for services. Failing that, there is no obvious place to draw the line. I draw it at adjustments of capital accounts that undeniably have a compensatory element.

Moreover, constraints exist on preemptive account adjustments. Partners who make preemptive adjustments give up the advantage of

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10 The amount that would be masked is a function of the smallest contribution of labor. For example, assume $A$ and $B$ each contribute $10,000 to a venture. $A$ devotes 20 hours a week to the venture and $B$ devotes 40 hours a week. $A$ is given a two-fifths interest and $B$ a three-fifths interest in any gain. The partners value $B$'s effort at twice $A$'s effort and value a $10,000 contribution as equal to devoting 20 hours a week. No increase in $A$'s capital account is considered a return on labor. Fifty percent should be so treated. One-sixth (16.66%) of an increase in $B$'s capital account is treated as return on labor (he receives 60% when his relative capital account entitles him only to 50%). Sixty-six percent of the increase in $B$'s capital account should be treated as a return on labor.
deferring tax on gain. They may do this if by undervaluing accounts on the first adjustment, they can avoid recognizing greater gain on a second adjustment. The adjustment by \(D\) and \(E\) of accounts in anticipation of the admission of \(F\) is illustrative, but undervaluation is easy to catch in this situation. A quick increase in the valuation of partnership assets strongly suggests undervaluation in the first adjustment. Finally, partners are not free under current law to adjust capital accounts. They must do so only on the entry of a new partner, a contribution or a distribution.\(^{111}\) They may do so at other times only if that is consistent with generally accepted accounting practices.\(^{112}\)

C. Consequences of Compensatory Assignments of Capital Interests to Other Partners

Under current law, partners recognize gain when they exchange an interest in existing partnership assets for services if those assets are appreciated.\(^{113}\) It is treated as if the partnership transfers an undivided share of its assets to the service partner in return for services, and then those assets are recontributed by the service partner to the partnership. If my proposal to treat compensatory adjustments in capital accounts as salary is adopted, then logically other partners ought to recognize gain on such adjustments.\(^{114}\) Thus, in Example 10, when \(E\)'s capital account is increased by $200,000 upon the admission of \(F\), it would be treated as if the partnership exchanges a two-fifths interest in the software for \(E\)'s services, which \(E\) then recontributes to the

\(^{113}\) See notes 34, 37-41 and accompanying text.
\(^{114}\) Most discussions of the tax consequences of exchanges of capital interests for services concern the admission of new partners. There is little discussion of the issue of whether a compensatory increase in the capital account of an existing partner ought to be income to the service partner, much less discussion of the issue whether the partnership ought to recognize gain. My guess is that most partnership tax experts would conclude that a partnership does not recognize gain when it increases the capital account of an existing partner. A consequence of such a rule, for example, would be to tax partnerships that develop assets and compensate service providers by giving them a share on completion of the asset when its value is first reflected in capital accounts, a result most probably think wild. But the result may not be as wild as some think. McDougal v. Commissioner, 62 T.C. 720 (1974), the leading case on the issue of taxing partnership gain on an exchange of capital for services, involved the joint development of an asset. The McDougals gave their horse trainer, McClanahan, an interest in the horse once it was proven. The McDougals were held to recognize gain on this exchange. Of course, McClanahan was made a partner after his work was done and the horse proven, and so the case is not authority for taxing those who transfer a profits interest before the work is done and the asset proven. There is no logical reason to treat these cases differently, since it makes a largely formal distinction crucial. It does not change the relationship between the McDougals and McClanahan to give him a profits interest in the horse at the outset instead of a promise of an interest if the horse proves a winner.
partnership. The partnership would have $80,000 gain on the exchange, which is allocated to $D^{115}$ Example 10 may seem different from the usual compensatory exchange of capital because $E$ is given an interest in an asset he creates rather than an already existing asset. But it is not clear why the fact that $E$ created the asset ought to effect our decision to tax $D$ on his share of the gain.

There are arguments for and against taxing partnership gain when capital is assigned for services. The argument for is this: If a partnership holds appreciated assets, an exchange of an interest in those assets for services is a convenient time to tax partners on at least part of that gain. The usual arguments for not taxing unrealized gains are valuation and liquidity problems, and at least the valuation problem is largely solved when a partnership grants a capital interest since such a grant requires valuing aggregate partnership capital. Further, recognizing gain when capital interests shift avoids gain shifting among partners. In Example 10, for instance, if $D$ does not recognize gain when $F$ is admitted and $E$'s capital account is increased, $D$ may shift part of his share of gain on the software to $E$ or $F$. This problem also can be solved by requiring that such built-in gain be allocated to $D^{116}$

The best argument against taxing partnership gain when capital is assigned for services follows from the observation that the tax may be avoided by using a circle of cash.$^{117}$ The service provider borrows cash, contributes the cash to the partnership, receives the cash back as compensation, and then repays the loan with the cash. Thus, in Example 10, shortly before the admission of $F$, $E$ would borrow $200,000, contribute that $200,000 to the partnership, receive the $200,000 back as compensation, and use that $200,000 to repay the loan. $E$ would have $200,000 income and a $200,000 capital account.$^{118}$ $D$ would not

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$^{115}$ The partnership exchanges an asset worth $200,000 with a basis of $120,000. The latter is two-fifths of the asset's total basis of $300,000, which represents $100,000 cash invested plus $200,000 expended on $D$'s services. At the end of the day, the partnership is left holding $1,500,000 cash and software worth $500,000 with a basis of $380,000. The software's original basis was $100,000. This was increased by $200,000 to reflect the cost of $D$'s services. Basis of $120,000 was used to offset gain on the exchange with $D$, leaving a basis of $180,000. The basis was increased by $200,000 when $D$ "recontributed" his two-fifths interest in the software with a cost basis. This ignores the distribution of $100,000 cash to $D$. Under current law, this distribution would not result in gain to $D$ and would not affect the basis of partnership assets. Under rules I propose in another article, $D$ would recognize $100,000 gain on the distribution and the partnership would increase the basis in the software by $100,000. Gergen, Contributions, note 1.

$^{116}$ Mark P. Gergen, Why a Partnership Should Recognize Gain on an Exchange of a Partnership Interest for Services, 47 Tax Notes 1487, 1490 (June 18, 1990).

$^{117}$ Alan Gunn, Partnership Interest for Services: Partnership Gain and Loss, 47 Tax Notes 699, 703-04 (May 7, 1990).

$^{118}$ The compensation would be structured as a promise to pay $E$ contingent compensation equal to one-half of any return on $D$'s investment in excess of $100,000. When $E$ contributes $200,000, the partnership would be considered to have $500,000 in assets—
recognize gain on the contribution by $E$ or on the payment of cash compensation to $E$.

That a circle of cash may be used to avoid partnership gain is relevant for several reasons. Tax would fall only on the unwary who do not know to use the circle of cash, something that is generally thought undesirable. Taxing partnership gain on a grant of capital for services while allowing tax to be avoided through the circle of cash makes for elective recognition, which is troubling because sophisticated taxpayers may structure their transactions to hasten loss recognition while delaying gain recognition. Thus, a capital interest would be assigned for services to trigger recognition if a partnership held loss assets or had other losses to use up; otherwise the circle of cash would be employed. Trying to close the circle by recharacterizing contributions too closely followed by return salary payments to the contributor as capital assignments allievates these problems, but creates other administrative problems in establishing and enforcing standards that define disguised exchanges of capital interests for services.

Because of these problems, it makes sense to forego the partnership level tax on an exchange of capital for services, particularly if other changes I propose are adopted. For example, allocation of built-in gain and loss to existing partners when a new partner was admitted would prevent gain and loss shifting, and so eliminate one reason for recognizing gain on the admission of a service partner with a capital interest. My proposal to tax distributions not out of profits when partners have gain on their investment in the partnership would close another possible gap. This rule would prevent partners from converting gain assets into cash without tax by assigning an interest in those assets for services that produce current income that is distributed to them.

**Example 11:** AB Partnership holds one asset, Blackacre, which is worth $100 and has a basis of $50. $C$ performs services that produce $50 current income to the partnership and the partnership grants $C$ a $50 capital interest. The expense is deducted currently and $50 is distributed to $A$ and $B$.

software worth $500,000 plus $200,000 in cash less the $200,000 liability owed $E$. $E$'s capital account would be $200,000; $D$'s capital account would be $300,000. The payment to $E$ should be capitalized. If the payment is deducted (perhaps as a research and development expense), there are two troubling consequences. Assuming the deduction is allocated in accordance with the partners' relative interests (60% to $D$ and 40% to $E$), $D$ would be allocated a loss in excess of his basis in his interest and $E$ would be able to shelter part of his compensation from tax. (The compensation could not be deducted until $E$ is paid. Even if $D$ uses the accrual method, and even if the contingent obligation is considered to become fixed and determinable before payment to $E$, $D$'s deduction is deferred until $E$ includes the payment in income under § 404(a)(5).)
Under current law, if A and B do not recognize gain on the exchange of the interest, they would receive the $50 tax-free. In effect, A and B convert a one-half interest in *Blackacre* into cash. Under my proposal, A and B would each have $25 gain on the distribution.

If the current rule on distributions is retained, it would help in *Example 11* to retain the rule that partners are taxed on gain on a grant of capital for services because the tax on gain cannot be avoided through a circle of cash. A contribution of $50 by C quickly followed by a distribution of $50 to A and B would be recharacterized as a sale by A and B of one-half their interests in the partnership to C.

VI. Conclusion

The proposals in this article grow out of my effort to solve the problems created by special allocations. In thinking about special allocations, I came to realize that the simplest solution was to put partnerships on a share system and require that all items be allocated in accordance with relative balances in partner’s capital accounts. This solution left service partners out in the cold since they could not be allocated profits as such as compensation for services. I solved this problem by having partnerships pay salary to service partners rather than allocate them profits. This article shows that this solution has independent value in the service area. It solves the two most vexing problems in that area—allocation of profits in lieu of paying compensation that otherwise would be capitalized and deferred payments for services through a grant of profits interest—as well as they can be solved, given the general rules on capitalization and deferred compensation.