1976

Compensating the Promoter-General Partner

Martin B. Cowan
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I. INTRODUCTION

When a promoter, whom we will assume also is the general partner, creates a new investment and offers it for sale to prospective limited partners, he expects to be compensated adequately for his efforts in putting the deal together and making it work, and for assuming the various risks inherent in the preliminary stages of the venture. One major objective is to keep the overall tax costs of that compensation to an absolute minimum.

Obviously, the smaller the tax cost to the partners as a whole, the more value there will be to divide up among the partners. Less obvious is the fact that the benefit of any increment in tax savings usually will inure to the promoter, whether the tax reduction appears on his tax return or on the tax returns of the investors. This fact is readily apparent if his individual tax bill is reduced directly, e.g., by converting what otherwise would be ordinary income into capital gain, or by deferral. But the promoter also benefits when the tax cost to be borne by the investor is reduced, or the tax benefits he is to enjoy are increased, e.g., by converting part of the purchase price into ordinary deductions: the greater the tax benefit promised the limited partners, the more they will be willing to pay the general partner as a promoter's profit when they make their initial investment.

Thus, there are two basic approaches to the problem. One focuses on the general partner's receipt of income, and tries to make that receipt a non-taxable event. Usually, the general partner is given an interest in the partnership or its assets. By carefully shaping the form of the interest, it is hoped that the general partner will be required to report its value as income at some future time rather than when he receives that interest—and, if he is fortunate, as a capital gain. This technique is the subject considered in cases like Diamond and Frazell, which involved interests in future profits and deferred interests in capital.

The other basic approach focuses on the payment by the limited partners, and attempts to give them immediate deductions from ordinary income for part, all, or (where borrowed money is used) possibly several times their actual cash investment. This is done without affecting the amount or nature of the income reported by the general partner—his compensation will be ordinary income in the nature of a promoter's profit in any event. However, by making the payment deductible, he increases the amount the limited partners

1 Diamond v. Comm'r, 56 T.C. 530 (1971), aff'd, 492 F. 2d 286 (7th Cir. 1974).
will be willing to pay him. In effect, the promoter takes advantage of the investors' higher tax brackets to increase the amount of his compensation.

With one significant exception, we will not consider compensation for services rendered by the general partner in connection with the actual operation of properties after they have been acquired (by purchase, construction, or otherwise). Reasonable fees paid to the general partner for managing properties in a trade or business or held for investment seldom present difficult tax questions. However, we will compare the use of guaranteed payments with one or two alternatives that may be preferable in light of recent decisions and legislation.

II. DEDUCTING AMOUNTS PAID TO THE PROMOTER-GENERAL PARTNER WHILE ACQUIRING THE PROPERTY

What makes the deduction problem acute during the initial phases of acquiring an investment is the prohibition against any deductions for capital expenditures. With one minor exception in connection with organization expenses, this prohibition has been reinforced by various provisions of the Tax Reform Act of 1976. In most cases, the ultimate question is whether the expenditure by the limited partners or by the partnership is not, in substance, a capital expenditure of one form or another. To a lesser extent, the issue is also complicated by the reported position of the IRS on material distortions of income during the first two taxable years of a partnership.

A. Guaranteed Payments

1. Payments for services during construction or other acquisitory phases.

Under §707(c) of the Code, prior to the amendment made by the 1976 Act, there was some basis for claiming that a "guaranteed payment" made by a partnership to a partner was always deductible by the partnership. Notwithstanding some technical support for that view in the legislative history and the regulations, most practitioners doubted that §707(c) gave carte-blanche to the conversion into ordinary deductions of unlimited amounts of capital and other non-deductible items, when the issue was litigated, the courts also refused to accept the argument. The 1976 Act appears to have settled the issue.

Under §707(a), a payment to a partner "other than in his capacity as a partner" was considered as though made to a person who was not a partner. The legislative history reveals that this provision was aimed, inter alia, at resolving certain questions that had arisen under

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the 1939 Code as to the deductibility of amounts paid as salaries, commissions or other forms of compensation to partners who rendered services similar to those that would be rendered by employees or independent contractors, or paid as interest on loans from partners. The regulations properly interpret §707(a) to cover payments to partners as compensation for services or as interest on loans.5

The regulations distinguish between a “payment” to a partner in consideration for services and a “distribution” to a partner. Similarly, the regulations distinguish between transfers of property to the partnership as loans and transfers of property as contributions of capital. Contributions and distributions are made by or to partners acting in their capacity as partners; as a result, §707(a) does not apply to those transactions.

It usually is possible to determine whether a transfer of property to a partnership is a loan or contribution of capital (e.g., in the case of a loan, there will be a maturity date and a fixed obligation to pay regardless of the profits of the partnership), although even these criteria may become hazy in some circumstances. However, distinguishing payments for services rendered in a capacity other than as a partner from distributions to partners who are obligated to render services in their capacity as partners still seems to be a formidable task, and neither the statute nor the regulations offer any assistance on the question.6

Subdivision (c) of §707 states a further rule which, when applicable, overrides subdivision (a):

“Guaranteed Payments.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital, shall be considered as made to one who is not a member of the partnership, but only for the purpose of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).” [Prior to 1976 amendment.]

This subdivision has always puzzled the analyst. For example, its operative provisions do not refer to a “guarantee”, other than in the sense that the payment may be required under the partnership agreement even if there is no income to supply the necessary funds. The reference to a “payment” for the use of “capital” is inconsistent with the distinction between “payments” and “distributions” attempted in the regulations under subdivision (a). There is no clear indication of

5 Reg. §1.70701(a).
6 Several years ago, a subcommittee of the Committee on Partnerships of the New York State Bar Association’s Tax Section, attempted to recommend possible legislation to clarify the definitional problems of §707. After a full year of discussion among a number of experienced practitioners, it was not possible to develop a consensus either of what the law was or of what it should be, and no recommendation emerged. The major conceptual obstacle was trying to determine when a partner was acting in his capacity as a partner, either generally or in specific instances.
what "income" is meant. And the scope of the cross-references to §§61 and 162 is so ambiguous that it has been the subject of litigation on numerous occasions.7

Instead of being helpful, the regulations only confuse the issue further. For example, if a partner is entitled to 30% of the profits, but is guaranteed a minimum payment of $3,000, only the portion of the $3,000 that is in excess of 30% of the profits is deemed a guaranteed payment.8 Thus, if the partnership earns more than $10,000, no part of the distribution to him is governed by §707(c); if the partnership has a loss, the entire $3,000 falls within §707(c); in the remaining cases, only part of the payment comes within §707(c). Contrary to the statutory direction that guaranteed payments are payments made "without regard to the income of the partnership," under the regulations, it is impossible to tell whether there is a guaranteed payment or how much it is, without taking into consideration the partnership income.

Another pervasive difficulty with §707(c) lies in trying to determine whether the amount received is part of a partner's share of profits and losses. If it is, a partner who receives a guaranteed payment may discover that his share of profits and losses varies each year, depending on the partnership results. This result can create numerous uncertainties, both outside9 and within subchapter K. The worst possible disaster might lurk in the rules relating to the allocation to limited partners of the basis attributable to nonrecourse indebtedness under §752. If the amount of the guaranteed payment is deemed part of a partner's percentage interest in profits, that percentage will vary annually, and there is a constant "flip-flop" problem, with possible constructive distributions of "hot assets" (e.g., depreciation recapture) under §§752(b) and 751(b) every year.10

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8 Reg. §1.707-1(c), example (2); see, also, Rev. Rul. 69-180, 1969-1 C.B. 183.

9 E.g., §401(c)(3)(B), defining "owner-employee" and §4946(a)(1)(C)(ii), defining "disqualified person" Subsequent to the delivery of this paper, the Tax Court held, in Hill, Farber & Burrill v. Commissioner, 67 T.C., No. 33 (1976), that for purposes of §401(c)(3)(B), a partner in a law firm is deemed to be an owner-employee if he receives more than 10% of the profits for the year as a result of the allocation to him of a share of the fees paid by a client which he had introduced to the firm. Part of the firm's profits was allocated according to a fixed profit-sharing formula pursuant to which no partner in the nineteen man firm was entitled to 10%; the other part, the amount of which depended, among other things, on profitability, was allocated to the attorneys who were responsible for producing the business, and this extra amount caused different attorneys in different years to receive more than 10% of the profits. Four judges dissented, on the grounds that the latter, contingent portion should be disregarded for this purpose. This is the first case to consider the issue, and the payments appear to be outside the scope of either §707(a) or §707(c). It is not clear whether the same rule would apply to payments under §707(a) or (c).

Section 707 is derived primarily from a draft of a model income tax statute prepared by the American Law Institute in February, 1954. The ALI Comments (the equivalent to the legislative history) specifically stated that payments to partners would be deductible by the partnership only if they were ordinary and necessary, and not capital in nature. The Congressional Committee reports on §707 adopted almost all of the ALI language except for the deletion of this particular statement. It is not clear whether the Congressional draftsman thought that the rule should be different, or that it was self-evident and, therefore, unnecessary to state the obvious. The problem was compounded by what may have been some inadvertent phrasing in the regulations, which seemed to say that any payment that met the definition of §707(c) was automatically deductible. Nevertheless, hardly anyone seriously thought that Congress consciously intended partnerships to be able to deduct payments of a type that would not be deductible by any other kind of taxpayer.

Yet, to the tax bar's surprise, the IRS so ruled privately a few years ago, leading everyone to try this route to the creation of extra deductions. All that had to be done was to provide in the partnership agreement that the partnership would pay the general partner $X during its first taxable year. If the private ruling and the premise on which it was based was correct, X could be any number under the sky, and in practice it usually equalled a major portion of the promoter's profits for setting up the deal.

As soon as it realized what had happened, the IRS reversed field, but many taxpayers were already committed. The issue was decided against the taxpayers in Cagle, Jr. Moreover, §707(c) has been amended by the 1976 Act to make it clear that, effective for years ending after 1975, a partnership may not deduct guaranteed payments unless they meet all of the Code's other requirements for deductibility. This amendment effectively forecloses the use of guaranteed payments to create large front-end deductions for the promoter's fees.


12 Id. at 385-386.


15 63 T.C. 86, aff'd, 539 F.2d 409 (5th Cir., 1976); see, also, Rev. Rul. 75-214, 1975-1 C.B. 185. Other cases are pending in the courts, raising the same issue. E.g. Blitzer v. U.S., Ct. Cl. No. 426-76. The Conference Committee Report to the 1976 Act seems to state that Congress did not intend the 1976 amendment to affect the outcome of the pre-1976 cases. See Statement of the Managers, H. R. Rept. No. 94-1515, 94th Cong., 2d Sess. 421 (Senate Amendment No. 13).

16 Although the statute is still slightly ambiguous, the Committee Report is quite
2. Subsequent to acquisition

Notwithstanding the judicial and legislative circumscriptions on the use of guaranteed payments to create deductions for capital expenditures, they still may seem attractive as a means of compensating the general partner out of deductible dollars for services to be rendered in operating the property or supervising the partnership and its assets after acquisition.

If the amounts are reasonable in relationship to the services to be performed, and would be terminated if those services were not performed properly, a guaranteed payment as consideration for services presents no particular problem of deductibility. However, if the amounts are excessive or are unrelated to the services required, not only may the payments become non-deductible, but the initial creation of the interest itself may be taxable.

For example, suppose a real estate partnership agreement provides that the general partner will receive a fee in consideration of his services as manager and supervisor of the partnership's assets, payable as follows after completion of construction:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of Gross Rent Roll</th>
</tr>
</thead>
<tbody>
<tr>
<td>First taxable year</td>
<td>50%</td>
</tr>
<tr>
<td>Second taxable year</td>
<td>25%</td>
</tr>
<tr>
<td>Third through tenth taxable year</td>
<td>10%</td>
</tr>
<tr>
<td>After tenth taxable year</td>
<td>7%</td>
</tr>
</tbody>
</table>

The payment in the first year seems so far out of line that it calls for careful scrutiny to see whether, in substance, it is really in consideration for something other than post-construction management services. In fact, it is probably a slightly delayed promoter's fee, and in large part should be disallowed. The same reasoning applies to the second year's payment. The 10% payment starting in year three also seems large, and if the usual fee paid to independent managers is only 6%, the excess should be non-deductible under Cagle and §707(c), as amended. The 7% fee after year ten may stand up, but probably only because the abuse has been reduced to a level where an agent is likely to shrug his shoulders and look to fight elsewhere.

But the agent might also argue that the present worth of all of the guaranteed payments, to the extent they are in excess of 6%—and this includes the additional 1% each year after the tenth—discounted to the date the partnership agreement is signed, constitutes income at that time within the meaning of Diamond.\textsuperscript{17} To the extent specific that guaranteed payments are deductible only if ordinary and necessary.

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\textsuperscript{17} Note 2 supra. Compare the arguments made by the IRS in the retained leasehold-condominium cases; Lakeside Garden Developers, Inc. v. Commissioner, T.C. Memo 1976-290. See Emanuel, "Condominium Development and IRS—The Florida Story", 2 Real Estate Law J. 760 (Spring 1974).
Diamond requires the present fair market value of an interest in future profits received in consideration for services to be taxed when that interest is received (an issue discussed later in this article), it would seem to apply just as well to the full amount of an interest in the partnership cast in the form of a guaranteed payment. However, as explained hereinafter, §83 might restrict the amount that must be recognized to the portion that would be non-forfeitable if the general partner failed to perform substantial services.

A serious question also exists as to whether the fees in this example would even qualify as guaranteed payments to begin with. According to the Tax Court in Pratt, a payment measured by rents cannot qualify as a guaranteed payment because rents are a form of gross income; therefore, the payment is determined with regard to income, contrary to the requirement in §707(c).

3. Alternatives to Guaranteed Payments for Services

Instead of making a guaranteed payment, it may be possible to allocate income to the general partner equal to what the guaranteed payment would have been. In the example given above, let us merely allocate gross rental income equal to 50% of collections the first year, 25% the second year, and so forth.

According to Pratt, gross rent is an item of partnership income, at least for purposes of §707(c). Presumptively, it is also an item of income within the meaning of §704(a), and the allocation of that item of income to the general partners should be valid. It also has "substantial economic effect" because it in fact is equal to the amount to be paid the general partner — it affects the actual dollars payable to him. Moreover, the source of the payment is the rental income allocable to him — if there is none, there will be no payment.

Allocating an item of income to the general partner removes it from the computation of partnership taxable income or loss allocable to the other partners; therefore, it has the same "bottom line" impact as a deduction — except that it need not run the gamut of §162 as an ordinary and necessary business expense.

Does this solve all the problems? It does not, since the Diamond issue is left hanging over the partnership. Moreover, the assignment of future income to pay for current services or otherwise satisfy obli-

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18 64 T.C. 203 (1975), on appeal (5th Cir.). Pratt also held that payments for managing the property were made to the general partners in their capacity as partners, thereby making §707(a) inapplicable. This part of the decision at first seems to frustrate the Congressional intent for §707(a), which was to avoid the necessity of resolving that issue, but as noted above (see note 6), this may be an inherently insoluble problem.

19 Reg. §1.704-1(b)(2). It may even be possible to allocate gross income in excess of the cash available for the payment, if the excess is credited to the general partner's capital account for future distributions when available. This would still seem to have "substantial economic effect".

20 See Reg. §1.704-1(b)(2).
gations creates problems even outside the partnership area. For ex-
ample, if rental real estate is sold and the buyer conveys back to the
seller a $2,500 year rent-free right of occupancy in the premises, the
rental value of the right of occupancy is treated as constructively re-
ceived and applied to the purchase price. 21 To the extent that the
limited partner's proper share of future income is to be diverted to
the general partner, assignment of income rules might well super-
sede the usual subchapter K rules. In addition, it is not clear whether
specially allocated income affects the allocation of basis under §752.
Finally, even assuming all of the other problems are overcome,
the income allocation method works only if there is sufficient gross
income to allocate. This limitation may force the parties to spread
the allocation into the second or third taxable years. The loss of
value caused by the deferment can be compensated for by increasing
the total amount so allocated. On balance, allocating income in lieu
of making a guaranteed payment does not solve all of the prob-
lems, but it eliminates the principal obstacle, which is §162.

4. Payments for use of capital

Section 707(c) also provides a deduction for payments made to
partners for "the use of capital." Under the 1939 Code, it had been
held that interest payments to partners were not deductible because
no indebtedness could exist between a partner and the partnership.
Section 707(c) was intended to reverse this result.

As noted above, a careful examination of the statutory language
and the regulations indicates that interest on indebtedness between
a partner and a partnership is governed by subdivision (a) of §707.
Subdivision (c) covers distributions with respect to capital contribu-
tions of partners, which are distinguishable from loans. For example,
if the limited partners contribute $100,000 of capital to the partner-
ship and the general partner contributes only nominal amounts,
the partnership agreement may provide that the limited partners
will receive a 6% return on their capital investment before the balance
of the profits are divided. This 6% return is not interest, because
there is no debt — there is no obligation to pay, no maturity date,
and no priority over or parity with other creditors. Subdivision (c)
applies to the payment. If there were more indicia of indebtedness,
subdivision (a) would apply. 22

where the taxpayer paid 100% of the drilling expenses in a well, and received only a
50% interest. He was allowed to deduct only one-half of the intangible drilling expenses.
The other half was deemed the purchase price for his one-half interest. Although analogies
from the oil and gas field to other areas of the tax law are often tenuous, the prin-
ciple of the ruling (and its antecedents) suggests that a non-pro rata division of income
and expenses may often be viewed as a substitute for part of the purchase price of the
property interest involved.

22 Another noteworthy feature of §707(c) as it applies to payments for use of capi-
tal is that deductibility is determined under §162, relating to business expenses, rather
However, in *Pratt*, supra, the Tax Court, in what was probably only dictum, stated that interest on indebtedness to a partner is a guaranteed payment. The issue had not been researched or argued by the attorneys, who merely assumed that this was the correct result, and the court accepted their assertions to this effect.

Where the general partner has contributed property, such as a contract to purchase real estate, it may be possible in certain cases to give him a guaranteed payment under §707(c) for the use of his capital. There does not seem to be any specific limit on the rate of return. Thus, conceivably it may be permissible to pay him at a rate that would be considered usurious if the relationship were truly that of a debtor and creditor. If interest is a §707(c) guaranteed payment, as indicated in *Pratt*, the rule also would apply to any loans a general partner makes to the partnership.

However, under the 1976 Act amendment, it is clear that guaranteed payments are now subject to the “ordinary and necessary” limitations in §162. Notwithstanding continuing deficiencies in the statutory language, this stipulation should cover interest-type payments as well. This may be sufficient to limit deductions for “usurious” payments.

As in the case of all other types of payments to the general partner, questions of substance over form will continue to exist: is the guaranteed payment in fact for the use of capital, or is it a disguise for something else, such as a promoter's fee? And if the payment is deemed excessive, the present discount value of the excess may be deemed an interest in profits within the meaning of *Diamond* case.

**B. Supervisory and Consulting Services**

Many partnerships categorize payments to the general partner during the acquisitive and organizational stages as fees for consulting and supervisory services. Typically, the general partner-promoter agrees to “supervise” the partnership’s affairs and render various consulting services about proposed acquisitions and their financing, the employment of attorneys, architects, engineers and accountants, the availability of tax abatements and subsidiaries, techniques for obtaining zoning variances and similar matters. Now that it is clear that guaranteed payments do not automatically produce deductions, it

than §163, relating to interest expenses. Thus, the restrictions on “investment interest” in §163(d) seem to be inapplicable. The Committee Reports indicate that it was the legislative intention to subject all guaranteed payments to the same criteria for deductibility as payment to third parties. See S. Rept. 94-938, 94th Cong., 2d Sess. 94 (1976); H. R. Rept. 94-658, 94th Cong., 2d Sess. 120 (1976). Payments to third parties for the use of money would be subject to §163 and the restrictions on the deductibility of “investment interest” The regulations may have to address themselves to this inconsistency.

Not all usurious interest payments are non-deductible. See Arthur R. Jones Syndicate v. Comm'r, 23 F.2d 833 (7th Cir. 1927).
may be expected that many partnerships will increase their efforts to claim that these items are deductible under §§162 or 212.

In *Idaho Power Co. v. Commissioner*, a utility company used its own construction and transportation equipment in the construction of a new facility. It conceded that wages paid employees involved in construction had to be capitalized, but claimed that it did not have to capitalize depreciation of the equipment. Under the rules of the FPC and the Idaho Public Utility Commission, the depreciation had to be capitalized. The IRS stipulated or conceded that motor vehicle taxes, social security taxes and contributions to qualified pension plans could be deducted during construction (this was before the 1976 Act changed the rules for taxes during construction).

As to all other items, the Supreme Court upheld the IRS and noted:

> "There can be little question that other construction related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. . . .when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital assets so acquired. . . ."

Under this approach, if a corporation constructs a building, it should allocate a portion of its overhead, including salaries of its executives and home offices expenses, and capitalize it.

In *Cagle*, the general partner engaged in supervisory and consulting activities:

> "The services actually performed. . . were a feasibility study of the office-showroom development which included economic forecasts, market potential, budget and project costs, and anticipated rents; work with the architects on the preliminary plans of the office-showroom complex; work with the construction general contractors with respect to the cost of the project and coordination of the architecture and construction thereof; and the arranging of financing using his own credit to some extent. No portion of the management...

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25 In fact, the Uniform System of Accounts required by most regulatory agencies requires utilities to capitalize all overhead and indirect costs during construction, including construction loan interest. If the utility does not use borrowed money during construction, it must capitalize the value of the use of its own money. See, e.g., 16 N.Y. Code, Rules and Reg. §168.3(17).
27 63 T.C., at 89.
fee was for managing the property after it was completed. Rather it was for work done at the inception and during the development of the office-showroom complex. . .”

The Tax Court specifically followed Idaho Power in holding non-deductible payments for these items, including payments for “supervision and administration” during construction, advice “with respect to economic planning, feasibility, market analysis and the approach and appeal with respect to the development of the . . . property” and the providing of “techniques regarding financial, accounting and other technical aspects applicable to the development and operation of the property.”30 In practice, overhead and similar indirect expenses are probably not capitalized except by utilities, but there certainly does not seem to be any authority for deducting supervisory and consulting services during construction.

C. Rent-Up Fees

A common attempt to use deductible dollars to compensate the general partner in real estate deals is the payment of leasing commissions or fees for obtaining tenants for the premises. The general partner agrees to rent up the new property in consideration of, say, 8% of the annual rental provided in the leases. This could well represent a major portion of the investors’ purchase price.

If the leases are for more than one year at a time, leasing commissions must be amortized. In general, there does not seem to be any specific requirement that the cost of leasing a property for one year or less where the lease term goes beyond the close of the taxable year must be allocated between the two years.31

However, even assuming that the leases are all for terms that expire in the taxable year in which they are executed, or that they are all for one year or less and the costs of such leases can be deducted immediately, several questions persist:

1. Is the amount of the commission reasonable — i.e., what would an independent third party charge?
2. Do the general partners in fact render the services, or do outside renting agents do the work and also charge commissions?
3. Is renting-up an entire building an ordinary and necessary expense, or is it capital in nature? Since an empty building cannot

30 To the extent the services related to financing problems, Cagle held that they had to be capitalized and amortized over the term of the loan.
31 Reg. 1.461-1(a)(1) states that “[i]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.” (Emphasis added.) Annual insurance premiums do not have to be allocated between the current year and the succeeding year. Kauai Terminal Ltd., 36 BTA 893 (1937) (acq.); I.L. Bell, 13 T.C. 344 (1949) (acq.). It would seem that, under ordinary circumstances, annual leasing commissions on one year leases should be treated the same way.
produce income, it still may be incomplete and the initial cost of installing tenants may be regarded as part of the cost of creating an economic asset of value. Thus, mortgagees usually regard initial rent-up expenses as part of the cost of construction.

(4) Even if the leases are all for short terms, can the expectancy that most will be renewed make their useful lives indeterminate and require their costs to be amortized over the life of the building?

As in most other cases, the IRS may not challenge the deductions as long as the individual amounts are comparable to the amounts paid third parties for equivalent services and the total is modest, but overreaching may spur the Government to develop countervailing principles, including, perhaps, the material distortion of income approach and the capitalization of rent-up costs.

D. Cash Flow Guarantees

In several instances, partnerships have paid the general partner for guaranteeing to contribute capital if the operating revenues are insufficient to pay expenses and debt service and, perhaps, provide a minimum return to the investors. Some support for this approach seemed to be created by the lower court decision in *Tulia Feedlot, Inc. v. United States.*

The stockholders of the corporation, in proportion to their holdings, guaranteed a bank loan to the corporation, for which the corporation paid them 3% of the indebtedness annually. There was some evidence that the bank would not have made the loan to the corporation at the agreed interest rate without the guarantees. The lower court held that 3% was a reasonable fee and that the corporation could deduct it in the year paid as a business expense. The appellate court reversed on the grounds that there was insufficient proof of reasonableness; it also was somewhat skeptical about the substance of the payment, suggesting that it looked like a dividend. The opinions leave open the possibility that a partnership could deductible comparable payments, such as fees for guarantees of sufficient cash to pay debts and expenses, if reasonableness were established.

In *Cagle,* the court stated that payments to the general partner for use of his personal credit in arranging financing were not deductible, since the mortgage was nonrecourse and it was obvious that his personal credit was not involved. On the other hand, if the agreement to pay the mortgage is sufficient to make the general partner liable, the limited partners might lose credit for the mortgage in computing their basis under §752, a result that the partners would find least desirable. Possibly, the general partner could restrict his guarantee in some way so that he is not deemed to be liable on the

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33 There are some earlier Tax Court cases cited in *Tulia Feedlot* that would also support the deduction.
mortgage, or on so much of it that would destroy the deductions of the limited partners.

The principal argument for deductibility is that the payment is in the nature of insurance against loss of income and, therefore, qualifies as a business expense under §162 or as a comparable deduction under §212. The argument against deductibility of any payment for guarantees of the general partner is that the payment is merely part of the purchase price for the investment, and that there is no business need to pay the general partner separately for the guarantee. If the guarantee is made, not in the promoter's capacity as a partner, but as a seller or insurer, the payment should be treated as if made to a third party. Since a payment to a third party for income insurance presumably would be deductible, §707(a) requires that the payment for the guarantee be deductible even though paid to a partner.

The basic question is whether one can deduct the cost of a guarantee made by an unrelated seller, or whether the cost would be deemed part of the purchase price of the asset. Several years ago, a number of excise tax cases raised a similar question. In General Motors Corp. v. United States, the leading case, a refrigerator manufacturer charged a separate amount for a 5 year warranty and claimed that that charge was not part of the purchase price for the refrigerator subject to the manufacturer's excise tax. The Court of Claims held that it was taxable as part of the price, because it was the custom in the trade to include a warranty of the refrigerator when it was sold. If the analogy is applicable to tax shelters, deductibility would depend on whether it is customary for general partners to agree to provide the cash needed to cover operating deficits for several years. While many promoters will enter into such agreements, others do not, and it is difficult to conclude that there is any custom.

Even if it qualifies as insurance rather than as part of the purchase price, a premium for more than one year of coverage should be amortized over the life of the "policy", and the costs must be reasonable in relation to the duration and amount of coverage. The parameters remain unclear on this type of deduction.

E. Commitment Fees

Commitment fees are deductible. It does not appear that the 1976 Act changes this treatment, even during construction. Can the partnership pay a "commitment fee" to the general partner for his agreement to obtain the financing? In Cagle, the court rejected a deduction, probably because it looked more like a brokerage fee for obtaining a loan than a commitment fee.

The rulings which hold commitment fees deductible are addressed mainly to amounts paid to lending institutions to keep funds on a

stand-by basis. Historically, lending institutions realized substantially lower yields on funds held on stand-by status, and the commitment fee was partially, if not entirely, in the nature of a substitute for that lost yield, or for the lending institution's "forebearance" from investing its own money in a higher-yielding but less liquid form. The same considerations do not apply to a general partner who has no funds standing by. Moreover, the cases and statute now make it clear that a fee paid to a partner may be deducted only if it is reasonable in amount. If the partnership would be able to obtain financing from a lending institution at no fee, or at a low fee, the general partner cannot justify charging the partnership any higher fee, unless he himself will supply a substantial part of the funds.

Thus, the commitment fee approach probably works only to the extent the general partner agrees to supply at a reasonable cost funds in excess of those to be supplied by the regular lending institutions — e.g., a second mortgage to cover cost overruns — and is in a position to fulfill that obligation if necessary.

F. Cost Overruns

If the general partner agrees to cover cost overruns, can he or anyone else at least deduct them? While this question does not involve compensation to the general partner, the issue is of equal importance and the deduction, if available, would have the same impact as the other deductions discussed herein.

At first glance, it seems that cost overruns are not deductible, since they are merely additional capital costs. However, assume that the general partner forms a separate subchapter S corporation to engage in the construction and sale of real property improvements. As its first (and perhaps last) transaction, it enters into a turnkey contract to construct the contemplated building for the partnership.

The corporation sub-contracts the actual construction, pays for any cost overruns, and delivers the completed building to the partnership at the contract price. It would appear that the general partner would be entitled to deduct the corporation's loss on the transaction when he contributes the additional capital to cover the loss to this corporation. Instead of contributing the cost of the overrun to the partnership, he has contributed it to the capital of his subchapter S corporation, but he has obtained a deduction for it.

Assuming that the arrangements are bona fide and that the cost overrun was not deliberately built into the transaction, this approach might well be successful.36 The bona fides of the arrangement might be supported by the fact that the general partner will receive no cred-

36 Care must be taken that, if this is deemed a turnkey contract, the partnership still is entitled to construction write-offs for interest, taxes and ground rents. It should own the land during construction and be the debtor on the construction loan. Take-downs on the construction loan can be advanced to the builder as deposits or other payments on the contracts, without interest.
it from the partnership, either in the form of an increased capital account or a larger share of profits and losses, for his contribution to the corporation's capital. Also, there must be a reasonable prospect for the subchapter S corporation to make and keep a profit on the construction contract.

Can the limited partners become additional shareholders of the subchapter S corporation and divert part of their purchase price into the cost-overrun deduction? While it may be possible to work out the mechanics, §§267 and 707(b) would prevent partners holding more than 50% of the partnership interests from participating; even then, the arrangement may be strong evidence of a lack of bona fides.

H. COVENANTS NOT TO COMPETE

Another technique with growing recent popularity is to pay the general partner not to compete with the partnership. Actually, in a real estate venture, a non-compete clause may be very valuable since many a housing project or shopping center has foundered because the same general partner has constructed too many other projects or centers in the same vicinity.

The issue is how much is reasonable for the agreement, and this may be almost impossible to determine. If the payment is for an indefinite period of time or for a period substantially equal to the estimated useful life of the property, it will probably stand up, but front-end payments will have to be amortized over the life of the covenant, or of the building, which creates no particular tax advantage. However, if the covenant only runs one or two years, the same issue of substance over form may arise. Is it in substance what it purports to be? Alternatively, as in the case of the rent-up fees, is it part of the cost of establishing a viable, fully rented property and, therefore, some form of good will?

In most contexts, the IRS and the courts will respect an allocation to a covenant not to compete because the parties to the covenant have opposing interests — what is good for one is usually unattractive to the other — and it is assumed, perhaps naively, that these competing interests will keep the allocations within reasonable bounds. Such countervailing interests do not exist in the partnership context; both parties to the transaction gain by allocating as much as possible to the covenant not to compete. Accordingly, it can be expected that the IRS is more likely to scrutinize the value placed on the covenant by the parties. Nevertheless, assuming that the covenant really hinders the general partner from doing what he might otherwise find very natural to do, it may be extremely difficult for the IRS to disallow the deduction, primarily because the covenant has real value to the partnership and, within rather liberal limits, there is no realistic way to dispute the value placed on it by the parties themselves. On the other hand, if the general partner is not himself in the construction business, or is not sufficiently experi-
enced to put together an entire project starting with site location, it may be difficult to justify any substantial payment to the general partner for such a covenant.

I. REDUCED RENTALS

In lieu of deducting the payments to the general partner, one approach often seen in major shopping center sale-leasebacks is the negative rent flow method. Technically, this method does not always involve compensation to the promoter unless he inserts himself in the chain of title, but, like the cost overrun point, it is discussed here because the objective and impact is similar to those being considered.

In simplified terms, the selling price is reduced, say, by mortgage amortization otherwise payable for the first five years. The mortgage is also reduced by this amount, and amortization during the first five years eliminated. The rent payable for the same period of time is reduced by an equal amount. The result is to reduce rental income and mortgage amortization equally, thus keeping the net cash flow to the purchaser the same, but reducing the reportable income for tax purposes.

The economic effect is to “deduct” that part of the purchase price equal to the amortization for the first five years. In some cases, this “deductible” portion does not have to be contributed by the limited partners until the subsequent years. The rent paid by the seller-lessee may not even be adequate to pay debt service, and the partners appear to be making capital contributions to pay the deficiencies.

In Alstores Realty37, the court required the parties to a sale-leaseback to treat the lump sum value of the difference between the fair rental and the actual rent as constructively received at the closing (because that is when it was effectively being applied to the purchase price).38 If a similar rule is applied to these transactions (and there is no reason why it should not be), the partnership would be required to recognize the full value of the rental. A major clue for the IRS that a bargain rental has been created is the negative cash flow or increase in rent after several years without any apparent economic justification from the lessee’s viewpoint for that increase, i.e., there is no corresponding enhancement in the value of the right of occupancy.

While these transactions do not seem to have been challenged by the IRS to date, they seem fairly vulnerable on these grounds.

37 Note 21, supra.
38 Other analysts are reported to have concluded that this arrangement is equivalent to a prepayment of interest on the mortgage. The effect is the same in either case.
Section 213(b) of the 1976 Act allows organization fees to be deducted over 60 months. Syndication fees still may not be deducted. Some promoters may attempt to allocate large amounts to the costs of organizing the partnership, but these arrangements are unlikely to stand up. Most start-up costs relate to the acquisition of the assets, the financing, and the offering of units. Relatively little is charged for actually preparing and filing the partnership's organizational documents. Therefore, it is unlikely that this will be a fruitful line to develop.

It is not exactly clear when the 60 months commences. The statute refers to "the month in which the partnership begins business." In the case of real estate construction, this probably means when construction starts, but the issue may not be completely settled.

Apart from the Diamond issue, discussed below, other difficulties can arise when future profits are allocated to a general partner in consideration for his services as a promoter:

(1) In the first Larson case, the Government claimed that one of the general partners was not a partner in the current year for purposes of determining whether the organization was taxable as an association because his interest in profits could not commence to pay out until several years in the future.

(2) As noted above, when profits interests shift, the reduction in the shares of the limited partner may create problems under §751(b) and §752.

(3) If the profits interest shifts only after substantial losses have been realized, even if the "substantial economic effect" test is satisfied because capital accounts have been duly credited or charged and control the distribution of cash and other assets, the courts might conclude that the shifting of profits and losses was a means of paying part of the purchase price, as in the oil and gas area.

Apart from the material distortion test, the main question in all these situations is whether, in substance, the payment is a disguised capital acquisition cost. Reasonableness of the payment for the services actually to be rendered after completion of the construction or other acquisition of an income producing asset is a key element in obtaining satisfactory tax results. As for the material distortion test, it is too early to tell whether the Government will be successful in

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39 65 T.C., No. 10 (1975), withdrawn 11/7/75.
40 The Government was probably wrong on the issue. See the discussion on the Frazell case, infra, with respect to the determination of an interest in profits.
41 See note 21, supra.
disallowing all partnership deductions during the first two taxable years in excess of the cash investment, or whether the IRS will even press the issue to litigation. As a general proposition, it seems patently wrong, since there may be many reasons why a bona fide business entity might lose substantial sums, and such losses often may exceed the invested capital. Yet the IRS has prevailed in other cases in which material distortion has been alleged on grounds that seemed just as weak; thus, it is difficult to predict where the courts would end up on this issue.

III. Partnership Interests in Consideration for Services

The second major approach mentioned at the beginning of this article for compensating a general partner is to give him an interest in the partnership in a form that will not trigger the recognition of its value as income when received. If this is accomplished, he will then be taxed on his distributive share of partnership profits and losses as they are realized by the partnership. If the partnership realizes and distributes capital gains, tax-free income or the non-taxable proceeds of a mortgage refinancing, the general partner will participate in that distribution and enjoy the same tax treatment as the other partners; if he sells his interest, he hopefully will report any profit as a long-term capital gain.

A. Interests in Capital

Prior to the decision in Sol Diamond,42 the conventional wisdom was that a partner could receive an interest in a partnership in consideration for his services and be taxed only to the extent that the receipt of the interest constituted a transfer to him of an interest in capital. This was based upon the apparent language of U.S. Treasury Regulation §1.721-1(b)(1), which carefully distinguished between interests in profits and interests in capital, and stated that the service partner would be taxed to the extent of fair market value of the interest transferred. The regulations further provided that if the transfer of the interest in capital was deferred until various restrictions lapsed or conditions had been satisfied, such as the rendition of future services, the fair market value of the capital interest when the restrictions lapsed or the conditions were satisfied would be recognized at that time. The fact that the regulation went out of its way to distinguish between interests in profits and interests in capital, and then only stated that the fair market value of the latter was taxable, seemed to be an acknowledgment that the value of the interest in profits was not itself taxable.

Section 721 of the Code provides that no gain or loss will be recognized by either the partners or the partnership upon the transfer of property to the partnership in exchange for an interest in the partner-

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42 56 T.C. 530 (1971), aff'd. 492 F.2d 286 (7th Cir., 1974).
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ship. This provision was intended by Congress to settle certain lingering doubts about the possibility that a contribution of appreciated property might result in the recognition of gain. Neither §721 nor any other Code provision covered contributions of services. The regulations under this section attempted to fill the void, and covered the tax treatment of services for interests in capital.

When the regulations were first proposed, no distinction was made between interests in profits and interests in capital. In response to the criticisms of the commentators, the final version of the regulations added the distinction between interests in capital and interests in profits. The Treasury Department draftsmen specifically represented to various outside parties acting as special consultants to the Treasury Department on the matter that the final regulations were intentionally drafted to exclude from taxable income the value of an interest in partnership profits.

Numerous events between 1954 and 1971 seemed to confirm the general understanding of the meaning of the regulations. Among other things, the Solicitor General argued this position to the United States Supreme Court while opposing a petition for certiorari in the Frazell case. The Tax Court, holding that a partner had no basis for an interest in profits, explained in a footnote that “[u]nder the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability.” As noted by the appellate court in the Diamond case itself, there was a “startling degree of unanimity” among the commentators as to the meaning of the regulation.

Accordingly, the usual planning technique, prior to Diamond, was to give the general partner or promoter an interest in the profits of the partnership, being careful that he not receive any interest in capital. The regulation required gain to be recognized unless the investors recouped their capital contributions before any distributions of capital were made to the general partner. Presumably, this did not prevent the general partner from sharing in distributions of profits before the investors had recouped their capital, nor did it prevent the capital

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43 Under §752, if property transferred to the partnership is subject to a mortgage, gain can be recognized, notwithstanding §721. See Reg. §1.752-1(c).
44 Prior to 1969, when §83 was added to the Code, there was no specific statutory provision applicable to the exchange of services for property.
46 Willis, Partnership Taxation §11.01 (1976). Mr. Willis was one of the outside consultants.
47 United States v. Frazell, 335 F.2d (5th Cir., 1964), reh. den. 339 F.2d 885, cert. den., 380 U.S. 961 (1967). The Solicitor General’s opinion is stated in the Brief for the U.S. in Opposition at 10, n.3
48 Herman M. Hale, T.C. Memo. 1965-274, n.3 (24 T.C.M. 1497, 1502).
49 492 F.2d at 289. For a more complete review of the pre-Diamond history of the regulation, see Cowan, “Receipt of an Interest in Partnership Profits in Consideration For Services: The Diamond Case”, 27 Tax L. Rev. 161 (1972). A similar review is contained in the subsequent edition of Willis, note 46, supra.
contributions of the limited partners from being reduced or eliminated by allocations of losses, although the regulation was not very specific about these points.

As an example, if a limited partnership consisting of G as a general partner and L as a limited partner was formed, G contributing only services and L contributing $100 of cash, and if the partnership agreement provided that each was to be allocated 50% of all profits and losses, but that L was entitled to the first $100 of capital distributions, G would not realize taxable income upon the formation of the partnership. If, however, G and L were entitled to share in all distributions equally, including distributions of capital, G probably would have to recognize as income the value of his 50% interest, or $100. The regulations recognized that if a partner realizes income as the result of a transfer of capital, the transferor partner or partnership may have a corresponding deduction.

One difficulty with the regulation is determining exactly what is meant by an interest in profits as compared to an interest in capital. The decision in Frazell exemplifies the problem. The taxpayer was a geologist who had certain valuable oil and gas maps. In a contract which was found by the courts to constitute a partnership agreement, two investors agreed to advance the cash required to explore and develop a number of oil and gas prospects; Frazell agreed to contribute his maps to the venture and to render the necessary geological services. After the investors had recouped their cash investment, Frazell was to receive varying interests in the wells. If the agreement were terminated before the investors had recouped all of their money, Frazell was still entitled to his share of the wells to the extent their values exceeded the unrecouped cash investments.

The venture was successful and after a few years the investors had recovered substantially all of their investment, at which time the partnership was incorporated. Frazell received 13% of the stock of the corporation. He argued that he had transferred his partnership interest to the corporation in exchange for stock, a non-taxable transaction under §351 of the 1954 Code. The Fifth Circuit held, essentially, that the liquidation of the old partnership constituted a taxable event, regardless of the added factor that a tax-free incorporation was involved, because at that time, there had also been a transfer of an interest in capital conveyed to Frazell, and this was taxable under the §721 regulations.

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50 The computation is as follows: Since L received only a 50% interest in the partnership for his $100, the combined value of all of the partnership interests after G has contributed his services must be $200. Since G has a 50% interest in the total profits and losses of the partnership as well as in its capital, his interest must also be worth $100. In effect, G must capitalize, and is taxed on, the value of his own services, which in this case is $100.

51 The exact percentage in each well varied upon the type of well, its depth, the nature of the royalty interest acquired, etc.
On rehearing, Frazeli argued that he had had an interest in profits from the start, that his 13% interest in the corporation represented his share of the profits and, therefore, that there was no transfer of capital when the partnership incorporated. The appellate court rejected this argument on the grounds that all of the income during the life of the partnership had been allocated and distributed to the investors.

The Frazell decision was probably wrong on this last point. Frazell did have an interest in profits at all times. What he did not have was a right to withdraw his share of the profits. In effect, he was required to contribute his share of profits to the partnership's capital until the total of his capital contributions was proportionate to his share of the profits — a situation that would occur at "pay-out" for the investors. Therefore, he could withdraw his proportionate share the same as the others.

Most commentators define a partner’s interest in capital at any given moment as his right to receive a distribution of partnership assets at that time. By contrast, an interest in profits is a right to a share in any increase in the capital of the partnership over a period of time, either through revenues from outside sources or by reason of the increase in the value of the assets themselves; an interest in losses is the converse of an interest in profits. From this perspective, it is clear that Frazell’s equity in the partnership assets was in fact increasing gradually over the life of the partnership, and did not make a large quantum jump from zero to 13% only at the moment of incorporation. Had the partnership liquidated at any intermediate point, Frazell would have been entitled to approximately 13% of the profits, both realized and unrealized, of the partnership to that date. Apart from this and perhaps several other uncertainties in defining the exact parameters of what was meant by an interest in profits, most practicing attorneys familiar with the subject did not have any serious problems with the concept.

Once a partner had received an interest in profits, it seemed clear that he could share in long-term capital gains, distributions of mortgage refinancing proceeds and similar items in the same way as any other partner. There was some concern, especially after the decision

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54 Some semantic difficulty occurs here because financial statements usually reflect only book values (i.e., historical costs) of capital accounts, rather than fair market values, whereas the focus under Reg. §1.721-1 (and many other provisions of subchapter K) is on fair market values. In analyzing the tax and accounting concepts in subchapter K, it is important to keep this distinction in mind, and be aware of which one is meant in the particular context being considered.
in *Hale*,\(^{55}\) that a partner who received an interest in profits would recognize ordinary income rather than capital gains if he were to sell his interest to a third party. This raised the possibility that he would also recognize ordinary income upon the receipt of any distributions from the partnership.

This outcome seemed to go too far, however, in denying the service partner his right to receive capital gains treatment with respect to subsequent increases in the value of the capital assets of the partnership, including its good will. Where the owner of the profits interest was also burdened by a share of losses and was liable on his share of partnership debts, he was doing more than merely contributing services and receiving compensation for those services. He had a proprietary interest in the partnership, with both its risks and burdens. A sale of such an interest is more than a mere assignment of rights to income, and capital gains treatment is not inappropriate for a sale of a proprietary position.

The problem became acute if one attempted to distinguish between a partner who contributed only services, another partner who contributed a small amount of cash along with services, and a third partner who contributed a substantial amount of cash, and only a small amount of services. In *Hale*, the Tax Court found that a sale of an interest in profits resulted in the realization of ordinary income; the facts of that case, however, were somewhat complex and the court was able to invoke §751, so that the rule for more ordinary situations remained unsettled.

**B. Section 83**

In 1969, Congress added §83 to the Internal Revenue Code. Although aimed primarily at corporation executives who received restricted stock, §83 applies whenever property is used to pay for services. With certain exceptions not here relevant, the fair market value of the transferred property must be included in income when received unless the interest is forfeitable and non-transferable. If it is forfeitable and non-transferable, its value when the restrictions lapse will be ordinary income at that time. The taxpayer may elect under §83(b) to include the value of the interest in income when received even though it is forfeitable and non-transferable. The major advantage of making the election is to assure that any subsequent appreciation in value will be realized as capital gain.

Section 83(h) provides that the person to whom the services are rendered may deduct the amount included in the income of the person who performs the services. The proposed regulations under §83, insofar as they apply to partnership transactions, merely repeat the language of the regulations under §721, that the value of the capital

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\(^{55}\) Note 48, supra.
account would be deemed taxable when received. No mention is made of an interest in profits.

The proposed regulations under §83 also provide that when property is transferred in consideration for services, the transferee will not be deemed the owner of the property until he is taxed on its value under §83. Accordingly, if the interest is non-transferable and forfeitable and an election is not made under §83(b), any distributions received with respect to the property will be deemed additional compensation rather than income from the asset. Thus, dividends received with respect to stock would be deductible by the corporation as compensation paid, rather than as a dividend.

This seems to indicate that if a person receives an interest in a partnership under circumstances where he was not taxed under §83, he would not be recognized as a partner for purposes of subchapter K. As a result, he would not be entitled to deduct his share of partnership losses or claim his share of partnership credits, and he would have to pay ordinary income tax on any distributions made to him, even though they were his distributive share of partnership long-term capital gains, non-taxable mortgage refinancing proceeds, or tax-free interest, among other things.

C. Interest in Profits

With this background, the Tax Court's decision in Diamond came as an unwelcome surprise to the tax bar. In Diamond, a business associate of the taxpayer had a contract to purchase an office building. He offered Diamond a share of the profits in his deal if Diamond could obtain suitable financing for the acquisition. Diamond subsequently obtained 100% non-recourse financing, and received a 60% interest in profits. Less than three weeks after the closing, Diamond sold his 60% interest in the deal back to the business associate for $40,000. On his tax return, he claimed that this represented a short-term capital gain realized on the sale of a partnership interest, which gain was offset by long-term capital losses that he had realized from other transactions. The Government initially took the position, inter alia, that the sale of an interest in partnership profits produced ordinary income, not short-term capital gain, so that there could be no offset. In the Tax Court, Government counsel also argued that the arrangement amounted to a sham, in which a $40,000 brokerage fee to Diamond was disguised as an interest in a partnership. At no time prior to the end of the trial did Government counsel claim that the receipt of an interest in partnership profits was taxable as ordinary income. This argument was raised only at the very end of its post-trial brief, and in a very cursory manner.

The Tax Court declined to decide whether the transaction was a sham, or whether the sale of an interest in profits produced ordinary

income. It disposed of the case by holding that the receipt of an interest in profits was taxable as ordinary income and, in this case, the value of the interest received was exactly $40,000. On appeal, the Seventh Circuit acknowledged that the decision created numerous problems, such as the apparent double tax on the same income (once when the interest in profits was created and then again when the profits themselves were earned). Although it noted the analysts' uniform consensus to the contrary and their criticisms of the lower court's decision, the appellate court affirmed on the basis of the presumed expertise of the Tax Court and the IRS.

At no time did anyone at a policy-making level in the Treasury Department ever consciously take the position that the receipt of an interest in profits was taxable. That argument had been raised by a local attorney in the Regional Counsel's Office, and even then only cursorily, in an attempt to protect the revenue in a particular case, without adequate research and probably without even checking the master jacket in Washington on the intended meaning of the regulation. During the entire time the Diamond appeal was pending, which was over three years, the Treasury Department refused to issue any rulings on the Diamond issue; further, in every private ruling in which the issue might have been present, it expressly reserved judgment on the matter: to all intents, it confessed that, even after the Tax Court's decision, Treasury did not take the position that the receipt of an interest in profits was taxable. The Seventh Circuit confused arguments of counsel for expertise.

Assuming Diamond is correct, however, several conclusions appear inevitable, including the following:

1. After 1969, §83 applies to the receipt of an interest in partnership profits. If the interest is forfeitable and not transferable and no elections made under §83(b), actual distributions of profits to a partner will be taxed as ordinary income, regardless of the source of the funds, until the restrictions lapse.

2. Any time a partner receives an interest in profits that is proportionately larger than his contribution to capital, the excess may be deemed an interest in profits received in exchange for services and its value taxed on receipt.

3. Any increase in a service partner's share of profits is probably taxable.

4. Once the partner includes in income the value of his interest in profits, he should be deemed to have purchased the partnership interest for the cash equivalent of that income. Thereafter, he should be treated the same as any other purchaser of a partnership interest and, upon sale of his interest, he should be entitled to capital gains treatment.

An interesting situation arises when the interest in profits is transferred to a partner in a transaction that generates a deduction at the partnership level. For example, if the general partner is a driller in an
oil and gas partnership, the value of the interest conveyed to him may constitute an intangible drilling expense fully deductible by the partnership. In such cases, it would appear that the deduction can be allocated to the service partner himself.\textsuperscript{57} Where this can be arranged, the taxpayers come out far ahead under \textit{Diamond}. Whatever the value of the interest in profits may be is academic, because that amount is both included in the income of the service partner and deducted by him. Accordingly, the receipt of the interest results in a wash on his tax return. However, he now is deemed to have purchased his interest, and there should be no further doubt about his right to capital gain treatment upon a subsequent disposition. This is probably one reason why the Treasury Department has been reported to be considering a retreat from its victory in \textit{Diamond}; perhaps, as the Seventh Circuit itself suggested, this retreat will be effected by restricting the applicability of the decision to those cases where the services have been rendered completely prior to the receipt of the partnership interest and that interest can be easily valued.

Another planning possibility for avoiding the impact of \textit{Diamond} is to make sure that the interest in profits is received long before it has substantial value. One cause of the difficulty in \textit{Diamond} was the fact that the partnership was not formed until after the services were rendered and the interest had acquired substantial value. Had Diamond and his business associate formed the partnership before the financing had been actively sought, the interest in profits would not have had a significant value. Yet, this was merely a matter of semantics, controlled by the draftsman of the partnership agreement. The essential rights of the parties were not affected by when the partnership was deemed to have commenced, and a mere change in the language of the agreement, to provide that the partnership was formed immediately and would be dissolved if the financing were not obtained, would have avoided the whole problem.

Service partners also must now consider filing an election under §83(b) to include in income the value of a partnership interest in profits as soon as it is received in order to avoid the possible adverse effects of not being deemed a partner under subchapter K, and having to include as ordinary income any subsequent distributions or appreciation in the value of the interest.

Where the interest is received in a transaction that does not generate an immediate deduction to the partnership, it should create additional basis for some or all of the depreciable assets of the partnership. The additional depreciation deductions can be allocated to the service partner. His profits interest can be made non-transferable and forfeitable, and the restrictions on forfeitability and trans-

\textsuperscript{57}The suggestion that the deduction may be allocated to the service partner and that such an allocation has "substantial economic effect" were first made in this author's article in \textit{Tax Law Review}, note 49, supra. Numerous other authors have subsequently come to the same conclusion; Willis regards it as a matter of "common sense". Partnership Taxation §11.01 (1976).
Ferability could lapse at a rate approximately equal to the deprecia-
tion write-off period. This, again, would create offsetting items of
income and deduction, resulting in a wash on the tax return. A
similar result might be obtained by limiting the life of the interest in
profits and amortizing the service partner's basis in his partnership
interest over that limited life.

Another alternative is to avoid specifying the promoter as a general
partner to begin with. If he becomes an employee of the partnership,
the partnership can agree to pay him compensation for his services
measured by the profits of the venture. He will then be taxed only as
the profits are paid to him. The partnership probably could deduct
the payments as made, even though the services rendered by the em-
ployee normally must be capitalized, since the capitalized costs would
be amortizable at exactly the same rate as the pay-out. The only
disadvantage of classifying him as an employee is that he would fore-
go his right to favorable treatment on his share of long-term capital
gains, mortgage refinancing proceeds, and similar items. Also, if
a large capital gain is realized or a substantial distribution out of
mortgage refinancing is made, the partnership may have difficulty
sustaining the deduction under §162; even if it can show that the
amount paid was ordinary and necessary, the deduction may be too
large to produce a full benefit.

SUMMARY

It is still not clear whether Treasury will press its victory in
Diamond. In the meantime, tax planners have several techniques for
avoiding the adverse implications of Diamond and, in some cases can
make that decision work to the advantage of their clients.

38 Technically, there could be a problem in that the basis of the partnership assets
might be increased only by the amounts included each year in income by the service
partner, so that the additional depreciation allowable in the early years would be
negligible. However the principle of Associated Patentees, 4 T.C. 979 (1945) should
be sufficient to overcome this difficulty.
39 See Peter P. Risko, 26 T.C. 485 (1956) (acq. in result only).
41 See Associated Patentees, 4 T.C. 979 (1945).