Partnership Profits Share for Services: An Aggregate Exegesis of Revenue Procedure 93-27 (Part 1)

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PARTNERSHIP PROFITS SHARE FOR SERVICES: AN AGGREGATE EXEGESIS OF REVENUE PROCEDURE 93-27 (Part 1)

by John Lee

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I. Introduction

Rev. Proc. 93-27\(^1\) states that, generally, the Internal Revenue Service will not treat the receipt of a partnership profits interest\(^2\) in exchange for the provision of services, by a person in a partner capacity or in anticipation of being a partner, to or for the benefit of a partnership as a taxable event to either the service-rendering partner or the partnership. Is Sol Diamond dead at last? And did he die quietly?\(^3\) Not quite! The revenue procedure also sets forth three exceptions to this grant:

1. if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. if within two years of receipt, the partner disposes of the profits interest; or
3. if the profits interest is a limited partnership interest in a 'publicly traded partnership' within the meaning of section 7704(b)...

Rev. Proc. 93-27 does not specify whether nonrealization or nonrecognition applies; rather, it stipulates that the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership. The appropriate treatment of the receipt is nonrealization if the rationale is either (1) that the profits interest has no determinable fair market value (or character) in year 1, or the sometimes related notion that a mere promise to pay is not income, or preferably (2) that receipt of a profits interest subject to entrepreneurial risk for partner capacity services constitutes a common law nonrealization admission to the partnership. The appropriate treatment is nonrecognition if the rationale is an exchange under section 721 of property for a partnership (profits) interest.\(^4\) The Service similarly presented no rationale for either the general rule or its inevitable exceptions. Rather, a "Background" section recited without commentary the following conflicting judicial positions: (1) receipt of a partnership profits interest for services is not taxable (the Eighth Circuit's Campbell dictum,\(^5\) since the Campbell court came to rest its decision on an inability to value the speculative profits share) versus current


\(^{2}\)Capital interest" is defined using a present liquidating value on date of receipt of profits share. Id. sec. 2.01. A "profits interest," usually called a profit share in this article, is defined as any "partnership interest other than a capital interest. Id. .02. The regulations already define "capital interests" in other contexts. Treas. Reg. section 1.704-1(e)(1)(v); cf. section 1.721-1(B)(1). "Partnership" rules out creditors of the partnership having a profits interest. Actually, in the eyes of some, creditors would have a "disguised" capital interest, but that's another story. See GCM 36702 (April 12, 1976) ("We see no reason why the corporate cases and the [debt-equity] principles developed therein cannot be applied to partnerships."); accord, GCM 38275 (Feb. 7, 1980); GCM 36031 (Oct. 1, 1974); TAM. 8802007 (Sept. 30, 1987). How about the mirror-image genesis of sections 351 and 721? Or the fact that corporate debt-equity litigation arose predominantly in the context of back door integration (avoidance of taxation at corporation and investor level on funds earned by the corporation and winding up in the hands of the investor), which partnerships already have access to via the front door?


\(^{4}\)After having thought this through, I discovered pleasing confirmation in GCM 10092, XI-1 C.B. 114 (1932), revoked on other grounds, GCM 26379, 1950-1 C.B. 58. (The reason and import of the revocation are discussed at notes 172-73 and accompanying text.) The Service was helped in the 1920s and 1930s as it formulated its partnership tax rules by the stark simplicity of the taxing statute here prior to the 1954 code. (1) The partnership reported an information return and did not pay federal income tax, (2) a partner reported her share of partnership income, and after 1934 (3) a (still) unhelpful definition of partner, and (4) a carryover basis provision for contributions of property to a partnership by a partner applied. Thus, Treasury argued in 1933 that "the tax law seems to take the same view which is taken by the law generally — that a partnership is not a separate entity but that it is to be regarded as consisting of the various partners doing business as individuals. . . . [T]he partnership is not a legal entity but is simply an aggregation of individuals."

\(^{5}\)Campbell v. Commissioner, 943 F.2d 815, 821, 822 (8th Cir. 1991) (Campbell II) ("The commentators generally agree that the nonrecognition principles of section 721 do not apply to a service partner because a service partner does not contribute property in exchange for his partnership interest. . . . We also agree . . . Probably more relevant to our analysis, however, is section 707 of the Internal Revenue Code, which supports Campbell's argument [that a service partner who receives a profits interest in exchange for services provided to a partnership does not realize income upon receipt of such interest and therefore no taxable event occurs].") String cites of the undying literature can be found in Cuff, "Campbell v. Commissioner: Is There Now 'Little or No Chance' of Taxation of 'Profits' Interest in a Partnership?" 59 Taxes 643, 644 n.2 (1991); Section of Taxation, Los Angeles County Bar Association, "Comments on Taxation of the Receipt of a Profits Partnership Interest for Services," n.1 (May 4, 1991), electronically reproduced 91 TNT 130-26 ("1991 LA Bar Report") (Cuff principal author); Horstenstein & Ford, supra note 3 at 880 n.1; updated in Friedman, "Partnership Securities," 1 Fla. Tax Rev. 522 at n.4 (1993), electronically reproduced 93 TNT 226-166 (Nov. 3, 1993). To these lists must be added the useful "Colloquium on Partnership Taxation," 47 Tax L. Rev. 247-312 (1991). For a tight, thoughtful policy analysis of the little exploited treatment of the partnership itself upon admission of a service partner, see Gunn, "Partnership Interest for Services: Partnership Gain and Loss?" 47 Tax Notes 699, 705 (May 7, 1990) ("One of the few general principles that seem to have governed the drafting of subchapter K is this: Partners do not recognize gains and losses upon dealing with their partnerships unless recognition is needed to avoid negative basis or some other departure from fundamental tax principles.").
taxability under section 83 (the Tax Court in *Campbell* and the district court in *St. John*); and (2) most courts found the value of such an interest too speculative to be taxable (Eighth Circuit in *Campbell* and the district court in *St. John*), but the Seventh Circuit, in the landmark *Diamond* decision almost two decades ago, implicitly choosing an entity approach to the problem, found the value of such a profits interest readily determinable when it was sold three weeks after receipt. **Professor Davis** in his article “Discretionary Justice—A Preliminary Inquiry,” posits just such a first step in rulemaking when the agency is not yet certain about the general principle. Rather the IRS’ National Office is more certain than some courts about the principles of subchapter K as well as its detail in this context, but a stream can rise no higher than its source, unless damned.

—Footnote 12 continued in next column.—

**A. Admission to a Partnership — Sections 707 and 721 and the Common-Law Way**

Three avenues to becoming a partner by rendering (or promising to render) services are implicit in the authorities:

(1) From the 1954 code on, the first, and usually only, mode of judicial analysis of taxation of receipt of a profits share for services has been to apply section 721 governing contributions of property to a partnership in exchange for a partnership interest. The sticking point in this scenario has been that “services” do not constitute “property” for purposes of the purportedly comparable section 351 governing contributions of property to a “controlled” corporation in exchange for a stock interest in the transferee corporation.
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(2) Apart from a sale or exchange of property analysis, 1939 code cases fashioned a test based on an aggregate analysis for determining whether a partnership existed for tax purposes in the family partnership area, where typically one family member provided services and another might provide capital (often originating as well with the service provider). Commissioner v. Culbertson, a landmark 1949 Supreme Court family partnership decision, confirmed that the test for this purpose was whether the parties — in good faith and for a business purpose — contributed services or capital to the present conduct of an enterprise. The power of this federal common law concept of a partnership can be seen in its adoption elsewhere, where partnership status is determinative for federal nonrevenue statutes. While the specific Culbertson context of family partnerships has been codified (but not preempted) since 1951 by the predecessor to section 704(e), the Service and the courts have frequently relied (under the 1954, and now the 1986, codes) on Culbertson's contribution of goods or services to the partnership while participating in the community of profits and losses to determine whether "the common-law concept of the partnership relation" my initial and later writings touching on assignment of income. See Lee, "Section 482 and the Integrated Business Enterprise," 57 Va. L. Rev. 1376, 1409-10 (1971); Lee & Bader, "Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income," 12 J. Corp. L. 137, 187-96 (1987). In any event, family partnership issues arise from section 704(e) still arise where capital is not a material income-producing factor. Conversely, section 704(e) determines partner status in a nonfamily context where capital is a material income-producing factor. Evans v. Commissioner, 447 F.2d 547, 549 (7th Cir. 1971).

137 U.S. 733, 742 (1949). The standard was first fashioned in Commissioner v. Tower, 327 U.S. 280 (1946), but Culbertson is more frequently cited. For detailed discussions of the determinative Culbertson factor of objective to carry on business for joint profit (consonant with an aggregate analysis) see Bergford v. Commissioner, 93 TNT 264-10 (9th Cir. Dec. 21, 1993); GCM 36961 (Dec. 21, 1976); GCM 36436 (Sept. 25, 1975); TAM 8802007 (Sept. 30, 1987); PLR 9249016 (Sept. 8, 1992). The similarity between this test and Justice Frankfurter's sine-discredited dictum "goods or services" definition of a trade or business (see Commissioner v. Groetzinger, 480 U.S. 23 (1987); Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347, 452-64 (1974) ("Lee, Section 183") (criticizing "holding one's self out" doctrine along lines later reinvented by the Supreme Court because overlooked by all commentary at the time seeking to shape the Court's direction) has gone unnoticed in the cases, rulings, and the literature, according to my research and searches of the data bases.

Connors v. Ryan's Coal Co. 923 F.2d 1461, 1466-67 (11th Cir. 1991) (Employee Retirement Income Security Act liability of joint venturer); accord, Central States Pension Fund v. Winstead, 991 F.2d 387, 392 (7th Cir. 1993); Burke v. Friedman, 556 F.2d 867, 869 (7th Cir. 1977) (partner is not employee for purposes of unfair employment practices under Tower/Culbertson goods or services for conduct of venture with community of interest in profits).

Arguably, Blair v. Commissioner, 300 U.S. 330 (1937) (owner of capital by gift or otherwise is taxable on income it contributes) was codified, not Culbertson (which held when a partnership must be recognized). Stanback v. Commissioner, 271 F.2d 514, 518 (4th Cir. 1959). I think both are manifestations of a more general substance-of-the-transaction/anti-assignment-of-income principle or standard. PLR 8943014 (May 23, 1989); cf. TAM 8802007 (Sept. 30, 1987) (citing Tower). The starting point in researching "assignment of income" has been Professor Eustice's many articles, as acknowledged by the Service in Action on Decision S.C. Johnson (October 7, 1975) ("author of the leading articles in the assignment of income area," citing Eustice, "Contract Rights, Capital Gain, and Assignment of Income — The Ferrer Case," 20 Tax L. Rev. 1 (1964)); accord, GCM 34152 (June 26, 1969) (same article); see also GCM 39252 (July 3, 1984) (citing Lyon & Eustice, "Assignments of Income: Fruit and Tree as Irrigated by the F.G. Lake Case," 17 Tax L. Rev. 295 (1962); accord, GCM 3056 (Sept. 26, 1972) (same article). I, too, started with Eustice in (Footnote 17 continued in next column.)
exists in the following contexts: (a) what is the proper tax entity to make elections,19 (b) whether the other purported venturer was incurring specially treated (developmental) expenditures,20 (c) whether “principals” in an accounting firm were partners,21 (d) whether a partnership existed under the “not very helpful”22 code defini-

702, 707 (1971), acq., 1971-2 C.B. 3; Hyman Podell, 55 T.C. 429, 431 (1970).” (Footnote combined with text). Freeze v. United States, 455 F.2d 1146, 1151 (10th Cir. 1972), insightfully speaks of the “joint venture quality” of the actual relationship of the alleged partners “contemplated by . . . Culbertson.” I like the succinct PLR 8330706 (May 10, 1983): “From the many tax cases defining the relationship which gives rise to partnership classification, one may distill the following objective indicators of requisite intent: (1) the parties must express an intent that a business venture be established; (2) the parties share in profits and losses of the venture as proprietors [and proprietresses] and (3) the parties have made a contribution of capital or services to the venture.” See also GCM 35709 (March 6, 1974).

19 Demirjian v. Commissioner, 457 F.2d 1, 5 (3rd Cir. 1972); PLR 8916034 (January 23, 1989) (section 1033 election).


21 Rev. Rul. 77-346, 1977-2 C.B. 483 (test whether “the person has contributed money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business, and participates in the community of interest in the profits and losses.”), considered in GCM 36307 (June 13, 1975) (spells out significance of participating in such community); accord, TAM 80010008 (Oct. 1, 1979); cf. TAM 8753003 (Sept. 29, 1987) (secretarial services of one spouse for other CPA spouse did not amount to partnership); TAM 8742007 (June 26, 1987) (performance of secretarial and general agricultural services for 10 hours a week plus allowing personally held land to be farmed by spouse did not amount to joint venture); TAM 8648006 (Aug. 25, 1986) (contribution of services by one party and of orchard by the other together with mutual control of orchard growing operations did not constitute partnership not sharing of mutual proprietary interest in the net profits or of control over income and withdrawals). Case law sometimes does not reach the same results. Craig v. United States, 451 F. Supp. 378 (N.D. S.D. 1978), Action on Decision CC-1979-46 (facts close to TAM 8742007; held partnership).

22 GCM 37077 (April 1, 1977) (unusually detailed, helpful analysis of common law factors of Luna v. Commissioner, 42 T.C. 1067 (1964), the major alternative precedent to Culbertson used by the Service in determining partnership status); see also GCM 36113 (Dec. 19, 1974) (because partnership is so broadly defined in section 7701(a)(2) that existence of a partnership does not lend itself to statutory analysis). For additional detailed, helpful consideration of Luna factors, see GCM 36961 (Dec. 21, 1976); GCM 36436 (Sept. 25, 1975) (ultimately turned on lack of mutual control; evaluation of substantial hazards of litigating position). I am beginning to believe that such mutual control often goes to the essence of the aggregate notion of “like a proprietor.” For one thing, active conduct of a rental real estate business by tenants-in-common constitutes a partnership. Treas. Reg. section 1.761-1(a); Rev. Rul. 75-374, 1975-2 C.B. 261 (“additional services . . . furnished by the co-owners or through their agent”); PLR 8916034 (Jan. 23, 1989); PLR 8330093 (April 29, 1985). Management or operational activities go to the heart of active conduct of a trade or business, a question on which my scholarship has been recognized by those who matter. See GCM 36387 (August 25, 1975) (citing Lee, “Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty,” 27 Tax L. Rev. 453 (1972)); GCM 36205 (March 21, 1975) (id.); GCM 36069 (November 5, 1974) (id.); as has my scholarship on aggregate-entity Subchapter K niches such as the level for determining profit motive, GCM 37190 (July 7, 1977) (citing Lee, “Section 182,” supra note 15); GCM 36076 (Feb. 3, 1976); and on profit motive requirement for trade or business status generally, Portland Golf Club v. Commissioner, 497 U.S. 154, 171 at 174 (1990) (Kennedy, J., concurring and pointing to Lee, “Section 183,” supra, on case-law origins of section 183 regulation factors) (taxpayer’s central argument based on id. as to “profit,” see petition for certiorari).

23 Tam 8220008 (Feb. 24, 1982) (arrangement to construct, operate, and maintain multistory office building constituted partnership under section 761 and Culbertson), considered in GCM 38856 (May 19, 1982); TAM 8105030 (Oct. 29, 1980); TAM 8001018 (Oct. 1, 1979) (starting point under sections 761 and 7701(a)(2) is Culbertson standard: “whether all the facts regarding X and Y’s relationship reveal that X was established for the purpose of carrying on a trade, profession, or business and that Y has contributed money, goods, labor, or skill to X further such a purpose and participates in the community of interest in the profits and losses.”); GCM 37193 (July 13, 1977) (“a person must contribute either capital or services to be recognized as a partner”); GCM 36984 (Jan 8, 1977); GCM 36113 (Dec. 19, 1974) ("the common-law concept of the partnership relation allows the partners maximum flexibility in determining what each will contribute, how the operation will be run, and how the gains or losses will be allocated. The code itself accommodates this flexibility by providing for the recognition of the partners' shares of income, gain, loss, deduction, or credit as expressed in the partnership agreement, unless the principal purpose of that allocation is tax avoidance or evasion."); TAM 8030010 (Sept. 27, 1979) (professional corporation could be member of professional partnership); GCM 36961 (Dec. 21, 1976) (good discussion of mutual profit-sharing requirement in film production shelter context); see also PLR 8948002 (Sept. 1, 1989).

24 Freeze v. United States, 455 F.2d 1146, 1151 (10th Cir. 1972).

25 Tam 8413003 (Nov. 30, 1983).

26 Rev. Rul. 77-119, 1977-1 C.B. 177 (Horst precludes retroactive allocations to new partners); TAM 7605299220A (June 29, 1976) (Culbertson precludes such retroactive allocations), considered in GCMs 36778 and 36835 (June 29 and Sept. 7, 1976, respectively) (“To interpret code section 761(e) as providing that persons who are partners at the time of a modification are also to be viewed as partners for the entire year to which the modification relates would thus be a direct reversal of the result in Culbertson” since neither goods nor services had been supplied by the partner all through the year). The shift from Culbertson to Horst reflects Rodman v. Commissioner, 542 F.2d 845, 857 (2d Cir. 1976).
such contributions of services or capital as being made pursuant to section 721 granting nonrecognition to exchanges of property for a partnership interest; they never said one way or the other. But the toll of taxation triggered by that provision’s inapplicability to services would not have rung true when compared with the practical approach that the Culbertson progeny seem to have sought. The idea that Culbertson’s “common law partnership relation” rests on a common law nonrealization upon performing or promising to perform partner capacity services in exchange for an entrepreneurial risk profits share only rings more true. In any event, Culbertson more recently has been so read, particularly in the context of the legislative history to the 1984 amendments to section 707, which rests on an aggregate approach to entry of a services partner for a profits share. That is the evolving third avenue for nonrealization upon receipt of a profits share for services to the partnership.

(3) The legislative history to the 1984 amendments to section 707 governing transactions between a partner and her partnership not only rests on an aggregate methodology, but contemplates that a person performing partner-capacity services for a partnership in exchange for a partnership allocation of partnership income and subsequent distribution subject to entrepreneurial risks (presumably of profits rather than of distributions) will be treated as becoming a partner under Treasury regulations defining “partner” with rules to prevent abuses. The Treasury staff further explains in the 1984 Blue Book that

[The regulations should provide rules for when persons who formally become partners after performing services for...the partnership are to be treated as partners at the time of the provision of services...]

The drafters of the 1984 amendments to section 707 intended that where the services were not rendered in

27 A computer search of cites for Culbertson or Tower or Luna within 25 words of section 721 yielded only one entry and it was p. 721 of a cited authority. Actually, Culbertson itself was determined under the 1939 code, which contained neither a nonrecognition nor a nonrealization provision governing contributions to a partnership. There was only a judicial and administrative practice. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 68 (1954) (“Contributions to a partnership will have the same effect under the proposed provisions as under present practice.”) (Emphasis added); Hearings on Revenue Revision before the House Committee on Ways and Means, 83rd Cong., 2d Sess. 1381 (1953) (describing ABA proposed nonrecognition upon contribution of property to a partnership in exchange for a partnership interest as “codified...[a]t (a) of what is generally recognized as present law.”) (Statement of Mark Johnson, for ABA).

28 Diamond I pointed out that section 721 simply didn’t apply to a contribution of services because “a contribution of services is not a contribution of ‘property.’” 56 T.C. at 545. The central thesis of this article is that a common law admission yields nonrealization apart from section 721 as to contributions of services, just as the better common law or administrative “practice” yielded nonrealization as to contributions of either property or services under the 1939 code and earlier revenue acts. Section 721 codified only the contribute-property part of that “practice.”

29 The Supreme Court in United States v. Bayse, 410 U.S. 441, 449 (1973), a partnership tax authority in its own right, read Culbertson as illustrating “a foundational rule, which this Court described as ‘the first principle of income taxation; that income must be taxed to him who earns it.’” Accord, PLR 8934014 (May 23, 1989). Bayse may illustrate Professor Gunn’s insight as to Subchapter K’s bias toward nonrealization, Gunn, supra note 5 — what I would call an aggregate approach — in this case in the context of partner-partnership dealings unless departure is needed to avoid a more grievous departure from a fundamental tax principle. Subchapter K always has been along precisely this fault line. This analysis is close to that adopted in American Law Institute, Federal Income Tax Policy, Subchapter K, Proposals of the American Law Institute on Taxation of Partners 523-32 (ALI 1984) (adopted 1982) (“1982 ALI Proposals”). Bayse also can be read as limiting entity to information gathering and reporting, which might include assignment of income up to the partnership’s door. The aggregate approach as embodied in Culbertson policies assignment of income within the partnership. See note 17 supra.

30 1984 Bluebook, supra note 18, at 226.

31 See notes 222-234 infra and accompanying text. My understanding here is shared by the drafters of the American Bar Association, “Proposal to Amend the Regulations under Internal Revenue Code of 1986 to Define a Partnership Capital Interest and a Partnership Profits Interest, and to Clarify the Tax Treatment of Compensatory Transfers of Both Forms of Partnership Interests” (April 17, 1987), electronically reproduced 87 TNT 92-24 (May 11, 1987) (“1987 ABA Section of Taxation Report”). I have heard this aggregate analysis derived from the 1984 legislative history described as the Hortenstine approach, presumably after Hortenstine & Ford, supra note 3 at 908-10 (appears to argue both sides quite well, though). I had the idea earlier when I came back to partnership taxation in 1986 after a 10-year absence, but didn’t publish it first and who knows when they first had the idea. If I were to pick an individual’s name as the first to bring these notions out in print, it would be Charles Egerton from his work on the above report. This 1987 report contained the thought in embryonic form. I find the Tax Section’s 1992 report, also primarily prepared by Egerton, the best professional treatment of this analysis of the profit shares for services problem. American Bar Association Section of Taxation, “Report on the Tax Consequences of the Receipt of a Partnership Profits Interest for Services” (July 31, 1992), electronically reproduced 92 TNT 223-40 (November 5, 1992) (“1992 ABA Tax Section Report”).


33 1984 Bluebook, supra note 18, at 233.
a partner capacity or the allocation-cum-distribution was not subject to entrepreneurial risk as to payment, the rendering of services and the payment for them would be treated as occurring between a third party and the partnership—i.e., the entity approach, which is entirely proper here since the partner is not behaving “like a proprietress,” the policy standard for aggregate treatment. But what about the service provider who passes the “like a proprietress” standard on both the performance and payment ends? The drafters of section 707(a)(2) in 1984 envisioned a Culbertson-like test under which the aggregate face of an invigorated section 707 would effect nonrealization events as to the partner and the partnership, i.e., her other partners, with respect to her performance of the services and her receipt of the profits share. Such a receipt is not “payment.” The proof can be found in the following passage from the 1984 committee reports: The committee does not intend that this provision [section 707(a)(2)] will apply in every instance in which a partner acquires an interest in a partnership and also performs services or transfers property to the partnership. In particular, the committee does not intend to repeal the general rule under which gain or loss is not recognized on a contribution of property in return for a partnership interest (sec. 721) or to apply this new provision in cases in which a partner receives an allocation (or an increased allocation) for an extended period to reflect his contribution of property or services to the partnership provided the facts and circumstances indicate that the partner is receiving the allocation in his capacity as a partner [emphasis added].

Observe the following parallelism: (1) contribution of property and applicability of section 721, and (2) contribution of services and (a) inapplicability of section 707(a)(2)(A) separate entity and hence “payment” treatment, but also implicitly (else why the duplicate predicates), (b) inapplicability of section 721’s nonrecognition shield, yet (c) implicit non-recognition, since recognition would in effect mean applicability of section 707(a)(2). What does apply to contribution of services? The committee report answers this conundrum: Legislative regulations are to determine whether “the service performer or property transferor is actually a partner.” The committee report goes on to list six factors to be “considered” in making such determination, which are discussed in section II.A.2 of this article. But the report also sketched the functional policy standard for determining partner status relating to the performance of services: “nonabusive allocations that reflect the various economic conditions of the partners.” And the passage italicized above itself echoes the following High Court Culbertson/Tower standard for determining whether a partnership exists:

“... when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is a community of interest in the profits and losses.”

McKee, Nelson & Whitmire believe that an apparent premise of new section 707(a)(2)(a) “is that the service provider is not taxed under sections 61 and 83 upon receipt of an interest in partnership profits.” This would seem to be the case as long as a “like a proprietress” standard is met with the rendering and payment for the services, and the above quoted committee report confirms such a premise.

The path suggested by this reading of the 1984 legislative history was less an innovation and more a codification (this time in the legislative history) of the Service’s understanding of the current law or “practice.” Seven years earlier, General Counsel Memorandum 37193 (sanctioning a retroactive allocation to a service partner of 5 percent of an unexpected partnership profit of $400,000, or $20,000, for discovery, promotion, and preliminary contract work he performed prior to the partnership’s formation) provided a road map to the common law “admission to a partnership profit of $400,000, or $20,000, for discovery, promotion, and preliminary contract work he performed prior to the partnership’s formation) provided a road map to the common law “admission to a partnership.”

34Id., at 226. Technically, the Bluebook is written by staff, but so are the committee reports. The difference is the chairman signs off on the latter and may be expected to know all the bottom line decisions described in the Report. See 128 Cong. Rec. (Part 12) 16918 (Senate July 19, 1982) (unstaged colloquy between Senators Bob Dole, R-Kan., and Bill Armstrong, R-Colo.). I would not expect the chairman to be responsible for knowing all of the additional bottom line, hopefully much more narrow, decisions embodied in the Bluebook. Pending regulations, however, taxpayers and the Service should be able to rely on decisions reflected in either equally. Once interpretive regulations are promulgated, the different weight that ought to be given to decisions reflected in the Committee Report and additional decisions reflected in any accompanying Bluebook appears to me about right in the existing distinction drawn by the Federal Circuit between binding authority and contemporaneous interpretation of experts.

35See notes 79-84 infra and accompanying text.

36I support and advocate this approach because, in addition to the legislative intent, it fully comports with an aggregate approach to subchapter K’s problems, other than those strictly relating to collecting and reporting income. That exception has been read pretty widely though. Ford v. Commissioner, 6 T.C. 499, 501 (1946), acq., 1946-2 C.B. 2.

37See note 72 infra.


391984 Senate Report, supra note 32, at 227.

401984 Senate Report, supra note 32, at 226. Thus, “[a]n allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and fact of payment generally should be recognized as a distributive share and a partnership distribution....” Id., at 227.

41Culbertson, 337 U.S. at 740, quoting Tower, 327 U.S. at 286.

42McKee, Nelson & Witmire, Federal Taxation of Partnerships, para. 5.02[1][b] (2d ed. 1990).
partnership" notion through the subchapter K code sections.43

Footnote 43 continued in next column.)

The proposed revenue ruling holds that the payment is a distribution of part of the partner's distributive share and that, as such, is includable in his taxable year within or with which ends the taxable year of the partnership in which the income was earned. Int. Rev. Code of 1954, sections 702, 706(a), and 731 (hereinafter cited as Code). We agree with this conclusion. . . .

The primary concern of the proposed revenue ruling is whether the payment of $20,000 to A is (1) a distribution of part of his distributive share taxable under Code section 702(a), Code section 706(a), and Code section 731, (2) a 'guaranteed payment' under Code section 707(c), or (3) compensation for services rendered other than in a capacity as partner under Code section 707(a). Profits received by a partner are taxable in accordance with Code section 702(a), Code section 721(a), and Code section 731 unless Code section 707(a) or Code section 707(c) applies. Edward T. Pratt, 64 T.C. 203, 210 (1975), 'aff'd in part and rev'd in part, 550 F.2d 1023 (5th Cir. 1977).

Treas. Reg. section 1.707-1(a) provides in part that transfers of money or property by a partner to a partnership as contributions are not included within the provisions of Code section 707(a). In all cases, the substance of the transaction will govern rather than its form. This distinction between contributions of money or property and transfers to which Code section 707(a) applies is also recognized for purposes of Code section 721, which deals with nonrecognition of gain or loss on contributions. See Treas. Reg. section 1.721-1(a).

Although in applying this distinction, Treas. Reg. section 1.707-1(a) and Treas. Reg. section 1.721-1(a) expressly refer only to transfers of money or property, we see no reason why the same rule should not apply to the performance of services. When a partner performs services for a partnership and receives compensation therefor, Code section 707(a) should not apply if these services represent a contribution to the partnership and the compensation is merely a return upon that contribution.

In the proposed revenue ruling, A performed discovery, promotion, and preliminary contact work prior to the formation of the partnership. However, he transferred to the partnership all the rights and benefits attributable to that work. The fact that he performed the services prior to formation of the partnership might conceivably raise a question whether his transfer to the partnership consisted of property rather than services. As discussed above, however, this question should not be relevant in determining the application of Code section 707(a). What is relevant for purposes of that section is whether the transfer is in substance a contribution to the partnership.

In determining whether a transfer of money or property to a partnership constitutes a contribution, as distinguished from a sale, exchange, loan, or rental transaction, the same criteria used in connection with corporate debt-equity questions are to be applied. See Joseph W. Hambuchen, 43 T.C. 90 (1964); GCM 36702, *** 1-415-74 (April 12, 1976), GCM 36031 ***, 1-157-73 (Oct. 1, 1974). The regulations state that if a transfer of property by a partner to a partnership results in the receipt by the partner of money other consideration, including a promissory obligation fixed in amount and time of payment, the transaction will be treated as a sale or exchange under Code section 707 rather than a contribution under Code section 721. Treas. Reg. section 1.721-1(a). By analogy these criteria should also be applied in determining whether the performance of services for a partnership constitutes a 'sale or exchange' of such services or a contribution.

In the proposed revenue ruling, A receives no consideration for his services other than a share of the partnership profits. Although many factors must be considered in determining whether a particular transaction constitutes a contribution, the fact that a transferor of property or services receives only a right to share in profits should generally be given more weight than the other factors considered. Cf. GCM 36412, *** 1-324-73 (Jan. 20, 1975); see also, GCM 36702, supra; Portage Plastics Co. v. United States, 301 F.Supp. 684 (W.D. Wis. 1969), rev'd on other grounds, 470 F. 2d 308 (7th Cir. 1972).

Arguably, a person otherwise qualifying as a partner could receive an additional share of partnership profits for services performed as an agent of the partnership rather than as a partner. Cf. GCM 37077, *** 1-49-77 (April 1, 1977) and GCM 36961, ***, 1-277-76 (Dec. 21, 1976). Presumably, such services would not be considered contributions to the partnership and Code section 707(a) would apply. However, it is the partnership agreement that defines the scope of the partnership, that is, the contributions of the partners and their rights and obligations with respect to such contributions. Cf., Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977). Under the facts of the instant case, both the form and the substance of the partnership agreement, as amended, indicate that as consideration for his services, A was to receive an increase in his proprietary interest in partnership profits. Therefore, A should be viewed as having contributed these services, that is, as rendering them in a capacity as partner rather than as agent, so that Code section 707(a) does not apply.

In short, a 'guaranteed payment' represents compensation in addition to a partner's distributive share for capital or services contributed to a partnership. In this respect, a 'guaranteed payment' differs from a Code section 707(a) payment which is a payment to a partner for property or services that do not also entitle that partner to a distributive share, that is, a payment for property or services that were not contributed to the partnership.

We recognize that the approach herein adopted for distinguishing between Code section 707(a) and (c) payments will provide partners with some choice in determining which section will apply. The existence of such a choice is merely an extension of the principle that partners are generally free to decide what each will contribute to a partnership and what each will receive in exchange for his or her contribution. Of course, in determining whether a particular transaction is a contribution, substance must prevail over form. Treas. Reg. section 1.707-1(a) and Treas. Reg. section 1.721-1(a), "GCM 37193 (July 13, 1977); accord, TAM 8642003 (June 30, 1986) (if section 707(a) and (c) are inapplicable to distributions, "the distributions must be treated pursuant to sections 702, 703, 704 and 731 of the Code.").
the promise to perform such services in the future as creating "property" subject to section 721 with tainted specially allocated built-in gain. An alternative smaller step, more appropriate to a ruling than legislative regulations, would be to rely instead on tax accounting rules.

B. A Classic Open Transaction Solution: The Wrong Way

At first blush, the Rev. Proc. 93-27 rule and exceptions appear to rest on the valuation/open transaction approach. Clearly, neither a partnership with a highly predictable income stream nor a publicly traded partnership pose much of a valuation problem. The sale-within-two-years exception could be viewed as a bright-line test for a too-immediate sale, which presumably, under Diamond, alleviates the valuation problem as well. Many commentators have relied on the reed of the "open transaction" doctrine on the grounds that the value of a profits share was too speculative or was a "mere promise to pay." That doctrine should be sharply restricted to sales or exchanges under section 1001 due to the discrediting of the cash equivalency doctrine. The open-transaction doctrine under section 1001 — applicable to the receipt of property with no ascertainable fair market value — and the "mere promise to pay" doctrine for services under sections 61, 83, and 441 appear still viable, but conceptually questionable beyond stare decisis. After Warren Jones Co. v. Commissioner, the "cash equivalency" doctrine applied to sales of property should be dead, although some in the Service would erroneously limit Warren Jones to secured promises to pay. Overturning the cash equivalency doctrine as to dispossession of property even where the promise to pay is unsecured (as the legislative history pointed to in Warren Jones and the congressional tax policy articulated in the Installment Sales Revision Act of 1980 as to sales of property indicate we must).

**COMMENTARY / SPECIAL REPORT**

"For the perimeters of the debate, compare Cunningham, "Taxing Partnership Interests Exchanged for Services," 47 Tax L. Rev. 247 (1991), with Castleberry, Commentary: "Campbell — A Simpler Solution," id. at 277. See also Ordower, "Taxing Service Partners to Achieve Horizontal Equity," 46 Tax Law. 19 (1993). I have not thought much about the liquidation valuation approach, which in fact Rev. Proc. 93-27 adopts per the recommendations of the 1991 Chicago Bar Report, supra note 1, and thus have nothing to add to the debate."


"Similar two-year benchmarks are contained in sections 452(e) and 334(b)(2) and, closer, in section 732(d). The new section 707 regulations also contain a two-year benchmark. See notes 124-126 infra and accompanying text. For a two-year benchmark analogy underlying the problem of ordinary income/capital gains conversion, consider Treas. Reg. section 1.469-2T(f)(5), which provides, in effect, that unless property developed by the taxpayer is rented for at least 24 months prior to selling the property (or contracting for its sale), the taxpayer's gain from the sale will not be treated as passive activity gross income. See Preamble, 53 Fed. Reg. 5695 (Feb. 22, 1988). The Chicago Bar Report passed in harbor of no sale or other disposition within one year after receipt. If a prohibited disposition occurred within one year after receipt of the profits share and the return for the year of receipt had already been filed, the report called for amending the year 1 return. 1991 Chicago Bar Report, supra note 1."

"1987 ABA Section of Taxation Report, supra note 31, at Suggested Amendments to Regulations, (b) Partnership Profits Interest (2)."

"1987 ABA Section of Taxation Report, supra note 31; 1991 LA Bar Report, supra note 5, at Analytical Construct; 1991 New York City Bar Report, supra note 45, at II.C.1. For an excellent exposition of the classic open transaction doctrine, see Perry v. Commissioner, 152 F.2d 183, 187-88 (8th Cir. 1945)."

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leaves only the lack of an ascertainable fair market value as the traditional barrier to current taxation of receipt of a promise to pay in the future. And the Service is notoriously hard-nosed in ascertaining a fair market value, even in contingent promises, except in rare and extraordinary circumstances. For instance, the Service has advocated valuing for purposes of section 1001 land contracts, grain sale contracts, private annuities for a term certain (with the same controversy over the relevance of security), guaranteed future payments and royalties for the right to publish a future book, and a nonassignable nontransferable deferred sales contract for public stock.

The Service is notoriously hard-nosed in ascertaining a fair market value, even in contingent promises, except in rare and extraordinary circumstances.

Do the above rules regarding unsecured promises to pay for property apply to mere promises to pay for services? Some in the Service have believed that sales of services and of other property should be treated the same. But a majority considering the issue in available public documents draw a stark line between sales of property and sales of services, with mere promise to pay ruling almost supreme as to unfunded deferred compensation — even if such promise had an ascertainable value. Some in the Service would extend the open transaction doctrine to accrual basis service providers so long as no note was given to evidence the recipient's obligation to pay for the services. But even as to deferred payment for services, some in the Service would tax the employee in the year of receipt of the mere promise to pay if he maintained too much "dominion and control." Although the legislative history to section 61 does not reveal quite the twists of section 1001 as to unfunded mere promises to pay, on the policy basis of horizontal equity and certainly vertical equity as well, unfunded promises to pay for 

64 GCM 36771 (June 28, 1976); accord, GCM 39252 (July 3, 1984) (no taxable event as to promise to pay a guaranteed amount for services as author, whereas identical mere promise to pay guaranteed amount for property, i.e., copyright, would be currently taxable); TAM 8639006 (June 5, 1986).


66 GCM 36998 (Feb. 9, 1977); accord, GCM 37014 (Feb. 25, 1977); GCM 37256 (Sept. 15, 1977) (Under "dominion and control" theory, "there must be a right of the taxpayer to the income, the existence of an option or right to defer receipt of income that would otherwise be paid in the year earned, a voluntary decision to defer the receipt of such income, and the dominion and control over the withheld amounts, which may be evidenced by the authorization of the employer to invest such amounts for the benefit of the taxpayer with the risk of loss and benefit of appreciation therefrom remaining with such person, or by reposing in the taxpayer control over investments of such funds.") (relates theory to assignment of income doctrine); PLR 851102 (Dec. 7, 1984); TAM 750930060A (Sept. 30, 1975). Scanning the 14 or so GCMs using the term "dominion and control" indicated that 60 percent or more involved estate and gift tax, about 25 percent deferred compensation. The thrust here appears to be ownership rights other than right to receive (which would trigger the constructive receipt doctrine) and not economic benefit in the form of security beyond a mere promise to pay (which would trigger the economic benefit doctrine). Well-reasoned GCM 37812 (Jan. 5, 1979) also tied the theory into Helvering v. Clifford, 309 U.S. 331 (1940) (retained strings made grantor taxable on income of family trust), which I find a better analogy than an assignment of income doctrine bottomed on dominion and control over disposition rather than on the earning of the income. Again in a populist vein, I feel the first version of the assignment of income doctrine rests too much on ownership of capital rather than who earned the income. Cf. Lee & Bader, supra note 17, at 187-89. In practice 15 to 20 years ago, the ploy to taxation in such impure "deferral" cases was to tack on some forfeiture clause, usually in terms of future participation in deferrals. All of this appears suspect under the reasoning of GCM 36998, supra at pp. 31-32, and the more strict scrutiny of section 83(a) as to "substantial risk of forfeiture."

67 Vertical equity would call for like tax treatment of all compensation, current and deferred, except for some overriding policy such as encouraging qualified retirement plans. Vertical equity would especially require this when the benefits of the special tax treatment are concentrated at the top. This is absolutely the case with "nonqualified" deferred compensation plans, which to avoid ERISA coverage, vesting, and funding requirements can cover only "top hat" employees — ironically a signature characteristic of the

Footnote 67 continued on next page.)
goals and for services should be treated alike. The Tax Reform Act of 1969 and the Revenue Act of 1978 show that the distinction is far more political than conceptual or policy-based. This should come as no surprise, since nonqualified deferred compensation rules principally subsidize top management, a core constituency of the Republican party, and the Republicans in Congress supplied the bulk of the votes of the "Conservative Coalition" in the House, which passed key elements of the Revenue Act of 1978 in uncommon exceptions to the closed rule.

Much has been written about the application of section 83 to the receipt of a profits share for services. The short answer is that if the aggregate tests are met as to the performance of the services and the partnership allocation and distribution, the receipt is not a "payment," but instead is a nontaxable event under Culbertson, so that section 83 is never triggered. This analysis supports the exclusion of "mere promises to pay" from the reach of section 83 by regulations section 1.83-3(e) as not constituting "property."

The Republicans in Congress supplied the bulk of the votes of the "Conservative Coalition" in the House, which passed key elements of the Revenue Act of 1978 in uncommon exceptions to the closed rule.

Therefore, the "mere promise to pay" doctrine should not be extended to receipt of a partnership profits share for partner-capacity services. Nor does the classic (indeterminable amount) open-transaction doctrine under Burnet v. Logan fare much better. That case turned on the possibility that the taxpayer might otherwise be taxed prior to recovering her basis. In a profits share received for partner-capacity services, the service renderer typically has no basis in the intangible created by the services. More significantly, the fact that limited partners in many instances (prior to the passive activity loss rules) paid for a share of losses (and profits) helps establish value.

C. An Aggregate Approach: The Right Way

1. Aggregate concept: 'hypothetical proprietorship' standard. This article maintains that, as contrasted with a valuation approach, an aggregate approach better supports Rev. Proc. 93-27's general nontaxable event rule and all its exceptions, with certain modifications.

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![Commentary/Special Report](Image)
tions for sales within two years. The appellate Campbell’s “enigmatic” non-taxability under section 707 of receipt of a profits share for services *dictum* alludes to an aggregate analysis of the profits share for services issue. Indeed, the appellate court’s perception of the realization issue when a taxpayer performs partner-capacity services in return for a profits share subject to the risks of the venture is based on a reading of the 1984 legislative history similar to that taken above. 78

An aggregate approach to a particular subchapter K provision seeks to tax a partner in the same manner as a hypothetical individual entrepreneur or proprietor in similar circumstances would be taxed. 79 An aggregate approach is consistent with the long-held Treasury, and backfilling gaps in, subchapter K.

states transmitting services issue. Indeed, the appellate court’s perception approach is consistent with the long-held above. 78 Come to favor an aggregate approach in interpreting of the 1984 legislative history similar to that taken above. 75 The various bar reports, happily note 8; 1991 New York City Report, supra note 45 at III. Policy Considerations.

See note 156 infra for Treasury position in 1930s. For modern affirmation under subchapter K, see Department of the Treasury, the president’s 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals 118 (1978), reprinted in Message from the President of the United States Transmitting Proposals for Tax Reductions and Reform, H.D. 283, 95th Cong. 2d Sess. 277 (1978); Cunningham, supra note 44, and Castleberry, supra note 44.

See Appendix.


See note 156 infra for Treasury position in 1930s. For modern affirmation under subchapter K, see Department of the Treasury, the president’s 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals 118 (1978), reprinted in Message from the President of the United States Transmitting Proposals for Tax Reductions and Reform, H.D. 283, 95th Cong. 2d Sess. 277 (1978); Cunningham, supra note 44, and Castleberry, supra note 44.

See Appendix.


produces income or is disposed of in a taxable transaction, receipt of a profits interest for services is non-taxable so long as such services are rendered in a partner-like capacity and the partnership’s payment of the profit share is in effect subject to entrepreneurial risks. 84 As discussed above, the legislative history of the 1984 amendments to section 707 employs just such an analysis in distinguishing taxable sales of services or property between a partner and his partnership from tax-free contributions of such services or property with partnership payment in the form of any partnership distributions. 85

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2d Sess. 75 (Rep. Jere Cooper, D-Tenn.); 133 (Rep. Samuel Hill, D-Wash.); 139 (Chairman Bob Doughton, D-N.C.); 239 (Hill); 341 (Hill); 343-45 (Doughton); 476-71 (Doughton); and 643 (Colloquy between Chairman Doughton and a Treasury representative) (1936) ("1936 House Hearings"); see also Hearings on President's 1963 Tax Message before the House Committee on Ways and Means (Part I), 88th Cong., 1st Sess. 600-01 (1963) (Colloquy between Rep. Howard Baker, R-Tenn., and Secretary of the Treasury Dillon). The answer always was the small business could incorporate (and thus avoid the inside graduated corporate rates), which always was the small business could incorporate (and thus avoid the inside graduated corporate rates), which partially explains the over 1,000-percent growth in small corporations from the 1930s to the mid-1980s, while the population increased only 150 percent or so. The problem was present from the beginning. 1921 Confidential Senate Hearings, supra note 53, at 12, 14-5 (Colloquy between Dr. Adams and Sen. Farmdorf Simmons, D-N.C.) (complexities of which entity has tax advantage; Adams testified that equality would require that all small (10 owners or less) business entities be taxed the same. Amen.). The words of these men on the inequities of a lower inside corporate tax rate on (today's small annual amounts) of retained income as contrasted with every corporation, or every individual engaged in business, and the larger the capital is, the stronger the corporations from the entrepreneurial risk. Arguably, the same would be true of an interest in a publicly traded partnership (PTP)—just as a shareholder in a (publicly traded) corporation, a PTP partner is subject to investment, not entrepreneurial risk. More fundamentally, recognition upon receipt of such a profits share should result because a PTP partner does not materially participate in operations or management in his partner capacity, for most close corporations. The small C corporation regime with lower inside tax on annual accumulations of up to $100,000, no dividends, and a capital gains tax or step-up in basis at death and no tax outside on such accumulations, offset only somewhat by repeal of the codified General Utilities concept, produces less taxes than direct taxation of the owner as a proprietor. I believe that is the U.S. definition of capitalism—workers are taxed heavier than capitalists. True in the 1920s and true in the 1980s. The Clinton tax plan brought the capitalists (more the high-income professional two-income workers) more back in line with the other workers—taking into account payroll and other regressive taxes. See Lee, "Clinton's Capital Gains Provisions," supra note 71, at 1410; Lee, "Death and Taxes," supra note 70, at 1396, 1398.

Conversely, I wonder whether Judge Learned Hand's entity-tinged tax view of partnerships reflects a northerner's experiences with large investment partnerships that seem more like entities (certainly to populist eyes). More likely, such views represent an "entangle...[ment] in the jurisprudential aspects of so-called legal 'entities' to such extent as to cause it [the tribunal] to overlook the real meaning and purposes of these enactments." Commissioner v. Whitney, 169 F.2d 562 (2d Cir.), cert. denied, 335 U.S. 892 (1948).

1991 LA Bar Report, supra note 5 (tax service provider on receipt of profits share where capital is a material income producing factor and she has no material entrepreneurial risk); 1991 New York City Bar Report, supra note 45 (readily tradeable profits share should be currently taxed). The 1982 ALL Report, supra note 28 at 163-65, noted that under a private letter ruling reported in the Wall Street Journal a guaranteed payment to a manager of tax-exempt bond funds had passed through tax-exempt interest. See also 1991 New York City Bar Report, supra note 45 (section 707(a)(2) now addresses); addressed also in Rev. Rule. 81-301, 1981-2 C.B. 144, considered in GCM 38067 (Aug. 29, 1979).


A shareholder is not engaged in the trade or business of her corporation (even if closely held) under Whipple v. Commissioner, 373 U.S. 193 (1963), while a partner in contrast is engaged in the business of her partnership, Stanchfield v. Commissioner, 24 T.C.M. 1681 (1965); accord, Butler v. Commissioner, 36 T.C. 1097 (1961), acq. 1962-1 C.B. 3; GCM 39406 (Sept. 6, 1985); TAM 9310001 (November 4, 1992). On a policy basis, the latter rule should be limited to general partners, but the precedents go the other way. See GCM 39406, supra; GCM 36377 (Feb. 26, 1976), p. 38 (citing Lee, "Section 183, supra note 15").