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TAX PLANNING FOR COMPENSATION OF SERVICE PARTNERS

In exchange for services rendered, promoters of a business venture may receive an interest in a partnership formed by contributors of capital. Such promoters may be termed "service partners" in the partnership formed and may receive a share of future profits or a proprietary interest in the partnership.¹ Proprietary interests given these service partners may be in the form of percentages of profit, either outright or restricted, or in the form of inchoate interests which become absolute once certain preconditions are satisfied. None of these compensation techniques should be employed, however, without a thorough examination of tax consequences because significant differences exist among them.

The basic provision of the Internal Revenue Code that governs the tax ramifications of partnership formation is section 721² which provides for nonrecognition of gain or loss when "property" is contributed to a partnership in exchange for a partnership interest.³ Although analogous to section 351 which prescribes nonrecognition treatment for transfers of "property," defined so as not to include services, to controlled corporations,⁴ section 721 does not except

1. See Berger, *Real Estate Syndication: Property, Promotion, and the Need for Protection*, 69 YALE L.J. 725, 732 (1960).

2. Section 721 provides: "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." INT. REV. CODE OF 1954, § 721.

3. Section 721 applies to both the formation of partnership and to contribution to partnership capital in an ongoing partnership. See Treas. Reg. § 1.721-1(a) (1956). See also A. WILLIS, *PARTNERSHIP TAXATION* 79 (1971).

It is not entirely clear that section 721 was meant to deal with transfers of partial partnership interests, such as a right to receive only future profits. The language of the section stating that it applies where the transfer of property is for "an interest in the partnership" may mean only a true partnership interest in capital and profits. See also INT. REV. CODE OF 1954, § 741 (providing for capital gains treatment on the sale of "an interest in a partnership"); cf. Herman M. Hale, P-H Tax Ct. Mem. ¶ 65,274 (1965) (denied capital gains treatment to sale of an interest in future partnership profits). See notes 104-16 *infra* & accompanying text. Nevertheless, section 721 and the regulations promulgated thereunder have been considered applicable in profit-share situations, even if only to the extent that they do not purport to prescribe rules for such an interest. See, e.g., Sol Diamond, P-H Tax Ct. Rep. ¶ 56.42, at 56-378 (1971); Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX. L. REV. 161, 168-69 (1972).

4. Section 351(a) provides in part: "For purposes of this section, stock or securities issued

expressly transfers of services for partnership interests from the non-recognition rule.⁵ The regulations promulgated under section 721,⁶ however, deny service partners these benefits and reflect the same definition of "property" used in section 351(a). The Internal Revenue Service (IRS) and courts interpreting these sections also have opted for narrow interpretation of the word "property."⁷ With non-recognition of gain precluded for service partners, tax savings must be effected by other means. Following a review of the judicial treatment of section 721 property, this Comment will examine the tax consequences flowing from an election to use other techniques.

SERVICES AS PROPERTY

The leading case concerning nonrecognition treatment for contributions to partnership capital is *Frazell v. United States*,⁸ concerning a geologist who had entered into an agreement with two other individuals to purchase and develop oil and gas properties. According to the agreement the taxpayer was to use his skill and several valuable oil maps that he owned to locate desirable properties which could be purchased with money contributed by the other partners. He was to receive in return a monthly salary, reimbursement for all expenses, and a percentage interest in the partnership after profits from operations enabled the two capital contributors to recoup their expenses. His inchoate partnership interest was not assignable until he became entitled to it under the terms of the agreement, and any attempted disposal thereafter would be subject to a first option in the two co-venturers. When a total recovery of expenses appeared imminent, the venturers formed a corporation to acquire all the joint venture's property, with the two capital contributors receiving a major portion of the corporate stock plus debentures representing unrecovered expenses, while the taxpayer-geologist received 13 per-

for services shall not be considered as issued in return for property." INT. REV. CODE OF 1954, § 351(a).

5. The nonrecognition provision of section 721 also has no requirement comparable to the controlled corporation restriction in section 351(a). See *id.* § 368(c) ("control" means ownership of at least 80 percent of corporation's voting and nonvoting stock).

6. Treas. Reg. § 1.721-1(b)(1) (1956). See A. WILLIS, *supra* note 3, at 79. For the text of section 1.721-1(b)(1), see note 36 *infra*.

7. See notes 21-27 *infra* & accompanying text.

8. 213 F. Supp. 457 (W.D. La. 1963), *rev'd*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

cent of the stock in exchange for his inchoate partnership share. He sought to treat this receipt of stock as a tax-free exchange under section 351 by claiming that the relinquishment of his inchoate partnership interest constituted a transfer of property to the corporation in exchange for shares of its stock.⁹

The trial court accepted the taxpayer's arguments¹⁰ primarily because of a belief that the original venture should have been treated as a partnership for tax purposes. Premising its decision upon findings that the taxpayer had contributed his skill and efforts to the venture for only "nominal compensation,"¹¹ that he had contributed valuable oil maps to the venture, and that other incidents of a true partnership, rather than an employer-employee relationship, existed,¹² the court concluded that the taxpayer did possess "property," an interest in partnership assets subject to the terms of the original agreement, which could be transferred to the new corporation in a tax-free exchange.¹³

Finding that the trial court had given excessive attention to the incidents of partnership under state law, the Court of Appeals for the Fifth Circuit concluded that the partnership status of a joint venture did not determine the tax consequences of receiving an interest in such a venture and that the taxpayer's status as a joint venturer did not preclude deeming the interest he received to be ordinary income as compensation for services rendered.¹⁴ The court

9. *Id.* at 460.

10. *Id.* at 461.

11. *Id.* at 467.

12. For example, Frazell was found to have had some degree of management authority and some risk of loss in the venture. *Id.* at 467-68.

13. The trial court relied on several factors in its unarticulated holding that the taxpayer had transferred "property" to the original joint venture. These factors were related to its express holding that a true partnership existed despite language in the agreement strongly evidencing an employment contract. The agreement that the taxpayer contribute his skill, time, and labor, while the other co-venturers contributed capital, was a basis for finding a true joint venture. *Id.* at 466. Additionally, his contribution of his geological maps was deemed by both the trial court and the court of appeals also to be a true contribution of property. See note 17 *infra*. The taxpayer also was considered by the trial court to be a bearer of substantial risk of loss in the venture, 213 F. Supp. at 467, because if it failed to become profitable he would never recoup his investment in time and effort. Considering the taxpayer's salary "only nominal," the court apparently felt that the excess of the fair market value for his services over this nominal salary also was contributed property. Finally, the court found that the taxpayer also had some management authority, another indicium of true partnership or joint venture status and that his interest in the venture existed despite the fact that record title was maintained in the other co-venturers' names. *Id.* at 467-68.

14. 335 F.2d at 489. Section 61 of the Internal Revenue Code defines gross income as "all

of appeals noted that under either of two theories, the termination of the original agreement and simultaneous formation of a corporation was a taxable event for the receipt of ordinary income by the taxpayer. If the transaction was a termination of the original agreement, the termination removed the preconditions to the taxpayer's acquisition of a partnership interest and allowed that interest to become possessory.¹⁵ Alternatively, if the stock was issued in substitution for the originally promised partnership interest, then the transaction resulted in an issuance of stock as compensation for services, a transaction taxable as ordinary income under section 351(a).¹⁶ Under either theory the fair market value of the stock would be taxed as ordinary income.¹⁷

Frazell is significant for at least two reasons: first, reliance by the court of appeals upon the regulations promulgated under section 721 to bolster the argument that ordinary income was realized by a service partner when his interest became possessory¹⁸ provided the foundation for the subsequent uncertainty surrounding transfers of various types of partnership interests;¹⁹ second, the court of appeals' reasoning implicitly rejected the taxpayer's attempt to treat services previously rendered as property that could be the subject of a tax-free contribution.²⁰

income from whatever source derived, including . . . [c]ompensation for services, including fees, commissions and similar items" INT. REV. CODE OF 1954, § 61(a)(1).

15. 335 F.2d at 490. Under this theory the receipt of a partnership interest was taxable to Frazell because it was compensation for services rendered. Treas. Reg. § 1.721-1(b)(1) (1956). Once received, this interest could be transferred to the new corporation in a nonrecognition exchange under section 351(a).

16. 335 F.2d at 490.

17. Because it was apparent that Frazell's geological maps were valuable and may have been contributed by him to the venture, they were considered section 721 "property," and he was allowed a credit for their value against the value of stock received. The case was remanded for factfinding on the questions of whether the maps actually were contributed and, if so, what their value was at that time. *Id.* at 491. See *Frazell v. United States*, 269 F. Supp. 885 (W.D. La. 1965) (on remand).

18. 335 F.2d at 490.

19. See notes 37-46 *infra* & accompanying text.

20. Whether the taxpayer in *Frazell* contended that the partnership interest, which he claimed was transferred to the corporation, had become his by any means other than as compensation for services rendered is unclear. The Commissioner argued that the original agreement was merely a contract of employment. 213 F. Supp. at 458. This argument was based on the realities of the transaction, which had most of the indicia of a partnership including title to the partnership's assets and management control in the capital-contributing partners. Additionally, the original agreement used language of employment when referring to Frazell. *Id.* at 463. See also *Diamond v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9306, at 83,651

Perhaps the clearest indication that services performed by a promoter will not be treated as "property" treated as a nonrecognizable contribution comes from the Tax Court's decision in *William A. James*.²¹ Although *James* involved section 351, rather than section 721, its rationale seems equally applicable to partnership organization.²² The taxpayer in *James* was a real estate developer

(7th Cir. 1974); Cowan, *supra* note 3, at 202-07 (discussion of partnership attributes).

Although the district court apparently believed this argument strong enough to merit specific consideration and rejection, 213 F. Supp. at 463, the court of appeals did not dwell on the taxpayer's status as an employee because of its finding that he had received taxable income as a service partner. 335 F.2d at 489-90. Adoption of the trial court's rationale would have allowed a taxpayer to escape entirely any taxation on the receipt of a partnership interest, a result wholly inconsistent with the principle that ordinary income is realized when compensation, in any form, is received for services. See INT. REV. CODE OF 1954, § 61(a)(1); note 14 *supra*.

Because the taxpayer was found to have acquired some interest in the venture by the time the original agreement was terminated and had paid no tax on the receipt of that interest, it follows that the trial court felt that the interest was received in a tax-free exchange under section 721. The taxpayer might have argued that the interest he owned at the later date had been transferred to him when the original agreement was executed, at a time when it had no value and therefore did not create any taxable income. Cf. Sol Diamond, P-H Tax Ct. Rep. ¶ 56.42, at 56-378 to -79 (1971); Vestal v. United States, 74-1 U.S. Tax Cas. 9407 (8th Cir. 1974); Cowan, *supra* note 3, at 192, 212.

Under proper analysis, however, the nature of the interest received by Frazell precludes that treatment. A true conveyance of property, if valueless when transferred, would give the taxpayer property that could be disposed of later as a capital asset transaction, or as attempted in *Frazell*, in a nonrecognition transfer under section 351(a), with no tax liability. See notes 37-43 *infra* & accompanying text. The interest given to Frazell, however, was not an absolute conveyance of property, but rather a promise to convey property at a later date upon the fulfillment of stated conditions. Therefore, the original agreement gave Frazell only a contract right to receive property later and not the property interest in a joint venture that he later claimed he could exchange for corporate stock. See also Cowan, *Receipt of a Partnership Interest for Services*, 32 N.Y.U. INST. ON FED. TAX. 1501, 1515-17 (1974) [hereinafter cited as *Partnership Interest*].

The court of appeals, by reasoning that the taxpayer had not received an interest in the partnership until the original agreement was terminated, in effect held that he had not yet received any compensation for services rendered. The trial court, however, apparently felt that a partnership interest already had been received. Because such an interest could not have been received in a nontaxable transaction unless the taxpayer had transferred "property" to the venture, the trial court must have believed that his services constituted the necessary property interest. A fundamental implication of the court of appeals' holding is that no such tax-free exchange had taken place. Therefore, the ultimate reversal of the trial court's decision in *Frazell* is not startling; the reversal is consistent with the realities of the situation, and it rejects the implicit argument that the taxpayer's services in some way constituted "property" under section 721.

21. P-H Tax Ct. Rep. ¶ 53.10 (1969).

22. In fact, the Tax Court in *James* cited the hybrid partnership-corporation *Frazell* case as one with "substantially similar" facts. *Id.* at 53-49.

and builder who, in return for promoting an apartment house project,²³ was to receive a 50 percent interest in the corporation formed to own the project. The minutes of a board of directors meeting stated that the taxpayer received his stock in exchange for various items, most notably mortgage loan commitments from a lender and the Federal Housing Administration, which were termed "property."²⁴ Finding that the promoter's services had not resulted in the development of a property interest, the Tax Court rejected the attempt to fit the transaction within section 351.²⁵ Holding that local law did not determine what constituted section 351 property,²⁶ the court declined to treat services as "property."²⁷

23. The taxpayer had responsibility for securing necessary planning, architectural, and legal services, for supervising construction, and for obtaining financing for the project. *Id.*

24. *Id.* at 53-47.

25. *Id.* at 53-49.

26. *Id.*

27. The Tax Court deemed the taxpayer's services distinguishable from patents and secret processes. *Id.* Moreover, because the mortgage loan commitments were commitments to the corporation that was to be organized to own the property when construction was completed, the court noted that they were never property belonging to the taxpayer; the FHA commitment, in fact, could not have been made to an individual under FHA regulations. *Id. Accord*, *Boles v. United States*, 72-2 U.S. Tax Cas. ¶ 9493 (S.D. Ohio 1972) (stock in corporation that had been organized by taxpayer and others to acquire a business held to have been issued for services and not for property under section 351); *Elihu B. Washburne*, P-H Tax Ct. Mem. ¶ 63,122 (1968).

The taxpayer in *Washburne*, president and general manager of an accounts receivable factoring business, had been given permission by the owner to find a purchaser for the business who would be satisfactory to the taxpayer. After one unsuccessful attempt, a satisfactory buyer was found and the sale was consummated after extended negotiations. The taxpayer remained as manager of the business and received 10 percent of the stock of a corporation that had been formed to purchase the business. By characterizing the authorization received to find a purchaser for the business as an "option," the taxpayer attempted to structure the issuance of stock as a section 351 exchange. The Tax Court, however, rejected this claim by finding that the taxpayer was merely an agent of the former owner because the details of the transaction had not been worked out when the authority to locate a buyer was extended although in a true option such details would have been a part of the original agreement. *Id.* at 68-656. The court deemed a letter formalizing the former owner's offer to the taxpayer in terms of an option as a mere attempt to restructure the transaction to maximize the taxpayer's tax benefits after the sale had been finalized. *Id.* The issuance of stock was found to be compensation for taxpayer's services rendered, and to be rendered, to the new corporation, either because he had brought the opportunity to the attention of the new owners or in return for his agreement to continue to manage the business. *Id. Cf.* *Sol Diamond*, P-H Tax Ct. Rep. ¶ 56.42, at 56-377 (1972), *aff'd*, *Diamond v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9306 (7th Cir. 1974). *But see* *Sidney J. Ungar*, P-H Tax Ct. Mem. ¶ 63,159 (1963) (held to be transfer of property and not compensation for services under section 351 where taxpayer transferred to a corporation a valuable contract right to purchase, under favorable terms, an office building).

Frazell and *James* taken together create great difficulty for a service partner seeking to receive a partnership interest in a nonrecognition exchange within the ambit of section 721.²⁸ To the extent that the service partner also contributes money or other real or personal property to the venture, nonrecognition treatment would be available.²⁹ For example, if the service partner owned an option or contract to purchase real estate, this right also could be transferred to the partnership within section 721,³⁰ but such an option or contract right clearly must have been obtained by the partner in an independent transaction.³¹ Moreover, the courts will analyze carefully the motive underlying any transaction to determine whether in fact an option or contract right exists.³² Consequently, a promoter's efforts in obtaining property for a joint venture may reduce the likelihood that the contribution of that property would be protected by section 721.³³

Since the tax benefits of a section 721 transfer cannot be obtained for a mere service partner, attempts to minimize the federal income tax burden may be made in other ways. Immediate adverse tax effects might be avoided by spreading income over a period of years to avoid jumping the service partner into a higher bracket or by postponing recognition of income to future years when the service partner's income from other sources is reduced. Conversely, the taxpayer also might desire to realize his compensation income immediately whenever the value of property received as compensation will appreciate so as to create a greater subsequent tax liability. Proper tax planning also may enable the service partner to postpone the bulk of his tax liability until he disposes of the property received as compensation, at which time he can treat the amount realized as a capital gain. Attempts to arrange service-partner compensation to maximize these tax planning benefits may take one of two forms: rather than receiving an outright partnership interest, the service partner might receive either a restricted capital interest or an

28. Similarly, nonrecognition treatment would be precluded under section 351.

29. *Frazell v. United States*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965). If a corporate organization were involved, the 80-percent-control test of section 351(a) also would have to be satisfied. See note 5 *supra*.

30. Sidney J. Ungar, P-H Tax Ct. Mem. ¶ 63,159 (1963).

31. William A. James, P-H Tax Ct. Rep. ¶ 53.10 (1969).

32. Compare Elihu B. Washburne, P-H Tax Ct. Mem. ¶ 68,120 (1968), with Sidney J. Ungar, P-H Tax Ct. Mem. ¶ 63,159 (1963).

33. See generally Berger, *supra* note 1.

interest only in future profits of the partnership.³⁴

CAPITAL INTERESTS

Inasmuch as the *Frazell* opinion provides a leading case concerning use of capital interests to compensate service partners and a specific statute, section 83(a) of the Internal Revenue Code,³⁵ prescribes the treatment of capital interests, planning may be undertaken in this area with a high degree of certainty. The regulations promulgated under section 721³⁶ also address transfers of capital interests in a partnership to a service partner as compensation for services rendered.

A grant of this type of interest was attempted in *Frazell*,³⁷ al-

34. Arguably, section 721, rather than encompassing exchanges involving partial or restricted interests, only pertains to the exchange of property for an outright partnership interest. See note 3 *supra*. Because the regulations promulgated under section 721, however, speak of an "interest in capital," Treas. Reg. § 1.721-1(b)(1) (1956), they seemingly were intended to cover any capital interest in a partnership, whether restricted or unrestricted. Moreover, the regulations speak of "substantial restrictions or conditions" that may affect the time of realization of a capital interest. These regulations also have influenced judicial decisions concerning profit shares, and section 721 therefore is the primary statutory focal point for all forms of service partner compensation. See also Branscomb, *Taxation of the Service Partner for an Interest in Partnership Profits or Capital*, 22D ANN. TUL. TAX. INST. 90, 95-100 (1973).

35. INT. REV. CODE OF 1954, § 83(a). For the text of section 83(a), see note 52 *infra*. Proposed Treas. Reg. § 1.721-1(b)(1), 36 Fed. Reg. 10,799 (1971), makes section 83 applicable to restricted capital transfers under section 721. Even before enactment of section 83 in 1969, the transfer of a capital interest would have resulted in rather certain tax consequences. See A. WILLIS, *supra* note 3, §§ 8.02-.03, 9.02-.03.

36. The regulations provide:

Normally, under local law, each partner is entitled to be repaid his contribution of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest.

Treas. Reg. § 1.721-1(b)(1) (1956).

37. See notes 8-17 *supra* & accompanying text. The trial court stated in *Frazell* that the

though the attempt was ill conceived.³⁸ In particular, it is apparent that the transfer was not a present transfer of a property interest³⁹ at the time the agreement was executed, but a promise to make a future transfer of property once certain conditions were fulfilled.⁴⁰ Because the transfer of property thus was postponed, the taxpayer could not claim that he had received a property interest at the inception of the arrangement since that interest was of negligible value. Instead the termination of the agreement and subsequent formation of a corporation which issued stock to the taxpayer effectively conferred the promised property upon him, generating taxable compensation income at that time.⁴¹ An obvious tax planning guide to be derived from *Frazell* is that, whenever the property to be transferred as compensation will appreciate in value, the transfer should be made as quickly as possible to minimize the tax burden of receiving ordinary income. Early realization can be accomplished by drafting the partnership agreement⁴² to effect an immediate transfer of capital to the service partner.⁴³

If a present transfer of capital is undesirable for nontax reasons,

taxpayer was to receive an interest in the total profits of the venture, clearly an interest in partnership property. 213 F. Supp. at 459. In fact, when denying a petition for rehearing, the court of appeals specifically rejected an attempt to characterize the transfer as a profit share rather than a capital interest to show the inapplicability of section 721. *United States v. Frazell*, 339 F.2d 885, 886 (5th Cir. 1964) (per curiam). See A. ARONSOHN, *PARTNERSHIPS AND INCOME TAX* 60-61 (1970).

38. See A. WILLIS, *supra* note 3, at 72-73; *Partnership Interest*, *supra* note 20, at 1516-17.

39. A. WILLIS, *supra* note 3, at 70. Assuming the interest was valueless at the time, such an outright transfer would have given the taxpayer no recognizable ordinary income; a gain on subsequent sale of the interest would have generated capital gains income equal to the amount realized, because the basis would be zero.

40. See A. WILLIS, *supra* note 3, at § 8.05. The transfer was conditioned upon prior recovery of all costs incurred by the other partners. See note 9 *supra* & accompanying text.

41. See A. WILLIS, *supra* note 3, at 73. The tax consequences were the same under either of the appellate court's two alternative holdings in *Frazell*. See notes 15-17 *supra*.

42. See A. WILLIS, *supra* note 3, §§ 8.05, 8.07, 9.06, 9.12; cf. Cowan, *supra* note 3, at 192, 212 (suggests earlier transfer of profit share to minimize tax burden). Care must be taken when drafting the document to distinguish between a present transfer of property and a promise to transfer property in the future. See A. WILLIS, *supra* note 3, at 72. See also *Partnership Interest*, *supra* note 20, at 1530-31; Branscomb, *supra* note 34, at 103-09.

43. If, as in *Frazell*, the other partners desire to recover their costs before the service partner is to receive the benefits of his interest, a present transfer still can be arranged to minimize the service partner's tax burden. By contributing a minimal amount of money initially, and by loaning the rest of the necessary money to the venture, to be repaid out of the partnership profits, the capital contributors could transfer an outright interest to the service partner immediately. See A. WILLIS, *supra* note 3, at 94-95.

as was the situation in *Frazell*,⁴⁴ the service partner may be compensated by the transfer of a present interest subject to substantial restrictions.⁴⁵ This type of compensation is distinguishable from the promise of a future transfer in *Frazell* because the restricted transfer involves a present transfer of partnership capital.⁴⁶ Unlike an unconditional present transfer,⁴⁷ however, its use and enjoyment is limited by restrictions that may affect the value of the interest conveyed. Treasury regulations section 1.721-1(b)(1) clearly contemplates such transfers,⁴⁸ the amount of income being the fair market value of the interest conveyed⁴⁹ and the time of realization depending upon "all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest."⁵⁰ Great flexibility was accorded such transfers before July 1, 1969, because the taxpayer recipients were permitted to elect, under most circumstances after the restrictions had been removed, to be taxed upon the lesser of the value of the property when transferred or its value at the time the restrictions were removed.⁵¹ The taxpayer thus not only could postpone compensation, he also benefited from the advantage of hindsight when determining his tax liability.

Service partners receiving restricted property as remuneration after June 30, 1969, have lost the benefit of hindsight, however, because section 83⁵² of the Code now prescribes specific rules.⁵³ Al-

44. For example, the capital contributors might want to recover their costs before the service partner can enjoy the interest given to him, or they might want to condition such enjoyment on the successful management of the venture for a period of time.

45. See A. WILLIS, *supra* note 3, §§ 8.03-.04, 9.03.

46. A transfer of a partnership interest subject to restriction is treated similarly to a transfer of any property subject to restrictions as compensation for services. See *id.* § 9.03.

47. See notes 42-43 *supra* & accompanying text.

48. "The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest." Treas. Reg. § 1.721-1(b)(1) (1956). See A. WILLIS, *supra* note 3, § 9.03.

49. Treas. Reg. § 1.721-1(b)(1) (1956). The measurement of fair market value generally is at the time of transfer if the transfer is for past services, or when the services have been rendered if the transfer is conditioned upon completion of future services. *Id.*

50. Treas. Reg. § 1.721-1(b)(1) (1956).

51. See A. WILLIS, *supra* note 3, §§ 8.03, 9.03. The tax consequences of such a transfer therefore could be tailored to provide the same benefits as an outright immediate transfer. See *id.* § 8.03, at 71.

52. Section 83 was added to the Code by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 588, and provides, in part:

(a) General Rule.—If, in connection with the performance of services, prop-

though under section 83 receipt of restricted property need not generate ordinary income for the service partner until the restrictions expire,⁵⁴ the income realized from post-1969 transfers must be

erty is transferred to any person other than the person for whom such services are performed, the excess of—

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

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

(b) Election To Include in Gross Income in Year of Transfer.—

—(1) In general.—Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of—

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property. If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(c) Special Rules.—For purposes of this section—

(1) Substantial risk of forfeiture.—The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) Transferability of property.—The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

INT. REV. CODE OF 1954, § 83.

53. Section 83 does not provide expressly that it applies to transfers of partnership interests to service partners, but there is little doubt that such transactions were intended to be within its scope. A proposed regulation, Proposed Treas. Reg. § 1.721-1(b)(1), 36 Fed. Reg. 10,799 (1971), explicitly makes section 83 applicable to restricted transfers of partnership capital.

The restrictions mentioned in section 83 concern property that is not transferable or is subject to substantial risk of forfeiture. INT. REV. CODE OF 1954, § 83(a)(1). These restrictions, defined in section 83(c), seemingly would include the types of restrictions typically imposed in the transfer of a partnership interest to a service partner. See note 52 *supra*.

54. INT. REV. CODE OF 1954, § 83(a). See A. WILLIS, *supra* note 3, § 8.04.

measured by the fair market value of the property when the restrictions expire.⁵⁵ Nonetheless, some leeway still is permitted by section 83(b), which allows the taxpayer to elect to include the property in his gross income in the year of transfer.⁵⁶ Under this election, which must be made within 30 days of the transfer,⁵⁷ the property's value is its fair market value determined without regard to any restrictions that eventually will lapse.⁵⁸

A service partner anticipating a significant increase in the value of his partnership interest during the life of the restrictions therefore should make an immediate section 83(b) election to recognize ordinary income based on the interest's relatively low value at that time. This immediate recognition of ordinary income, combined with capital gains treatment of the increase in value upon a subsequent sale of the interest after the restrictions have expired, would result in a lower total tax than would postponement of recognition until the restrictions lapse when the entire value of the property would be treated as ordinary income. If the service partner foresees little appreciation in value, he should not elect to be taxed immediately because total declared income then would be the same regardless of when recognized and because the service partner could avail himself of the deferral provision of section 83(a).⁵⁹

Choosing among unrestricted present transfers of partnership capital, restricted transfers of partnership capital, and promises to transfer partnership capital in the future with a desire to minimize income tax liability requires the service partner to forecast into the future.⁶⁰ An unrestricted transfer, although frequently desirable for its tax advantages, may prove impractical from a business stand-

55. INT. REV. CODE OF 1954, § 83(a)(2). The consideration paid by the transferee, if any, is subtracted from the value of the property transferred to calculate the taxable income. *Id.* § 83(a).

56. *Id.* § 83(b)(1).

57. *Id.* § 83(b)(2). Such election is irrevocable without the consent of the Secretary or his delegate. *Id.*

58. *Id.* § 83(b)(1)(A).

59. Similarly, taxation should be deferred if the value of the restricted interest was expected to depreciate before the restrictions were removed. Deferred recognition also would be preferable where the restriction imposes a substantial risk of forfeiture, rather than a limitation on transferability, if the tax benefits of present recognition are not significant; such a taxpayer who makes a section 83(b) election may foreclose a deduction if the potential forfeiture actually should occur, *id.* § 83(b)(1)(B), the election of present taxation resulting in a tax on the value of compensation that the taxpayer never was able to enjoy.

60. For an excellent comparison of these three alternatives, see A. WILLIS, *supra* note 3, § 8.07. See also *Partnership Interest*, *supra* note 20, at 1530-36.

point. A restricted transfer, more in line with nontax realities when one member of a partnership is to contribute only services,⁶¹ often requires at the time of transfer a speculative judgment that can have troubling tax consequences. Finally, a promise to convey an interest in the future, although avoiding present recognition of income, can result in realization of a substantial amount of ordinary income at a later time when the interest actually is conveyed.⁶² Because the consequences of electing any one of these alternatives depend upon business fortuities, other methods have been sought for compensating a service partner in a manner that will minimize his federal income tax burden. The transfer of an interest solely in the future profits of the venture evolved as one popular method⁶³ to defer realization of income while removing to some degree the judgmental risks involved in the transfer of partnership capital.

PROFIT SHARES

Prior to 1972 compensation by means of a profits-only interest in a partnership provided rather predictable tax consequences⁶⁴ to a service partner, particularly where the future profitability of the venture could be foretold accurately. Virtually all authorities agreed that the transfer of an interest in future profits to compensate a service partner did not create any present taxable income.⁶⁵ Largely as a consequence of the language of section 1.721-1(b)(1) of the regulations⁶⁶ and the difficulties inherent in any alternative treatment,⁶⁷ it was assumed that a service partner receiving a profit share

61. For example, the capital-contributing partners undoubtedly would want to restrict the service partner's right to dissolve the partnership and claim his proportionate share of partnership capital. Thus, conditions might be placed upon the service partner's right to a share of that capital, and the transfer no longer would be unrestricted. See A. WILLIS, *supra* note 3, § 9.03.

62. See *id.* § 8.07. Willis concludes that the restricted transfer usually is preferable. *Id.* at 76, 84.

63. See Cowan, *supra* note 3.

64. The consequences of a profit-share transfer were subject to an accepted interpretation of the treasury regulations that was a "consensus . . . shared by the entire tax bar." *Id.* at 183. See also *Partnership Interest*, *supra* note 20, at 1522-23.

65. See, e.g., Herman M. Hale, P-H Tax Ct. Mem. ¶ 65,274, at 65-1646 n.3 (1965); A. ARONSOHN, *supra* note 37, at 57-58; Cowan, *supra* note 3, at 161.

66. See note 36 *supra*. See also Cowan, *supra* note 3, at 168-69.

67. Willis has noted:

However obliquely the proposition is stated in the regulations, it is clear that a partner who receives only an interest in future profits of the partnership as a compensation for services is not required to report the receipt of his partnership

would be taxed only on his distributive portion when the partnership realized income. This approach prevented the double taxation that would have occurred if the service partner had been taxed upon receipt of the interest and again on his subsequent share of distributed income. The only alternative for avoiding double taxation would have been to allow the service partner to offset against subsequent partnership income the value of the profit interest upon which taxes had been paid.⁶⁸ This latter alternative would have been difficult for the IRS to administer.⁶⁹

A fear that deferred taxation would enable service partners to sell for a lump sum their rights to receive future profits and treat gain on that sale as capital gain led the Tax Court to hold in 1972 that the receipt of a profit share as compensation for services was a taxable event in some circumstances.⁷⁰ This decision, affirmed by the Court of Appeals for the Seventh Circuit in *Diamond v. Commissioner*,⁷¹ sharply reversed rather well settled tax doctrine. The resultant uncertainty undoubtedly will curtail the use of profit shares to compensate service partners.

The facts in *Diamond* illustrate not only the fears that led to the court's holding, the result of which admittedly is sound, but also an alternative rationale under assignment of future income principles that would not discourage the use of this compensation technique. The taxpayer in *Diamond* was a builder and mortgage broker who agreed to obtain financing for the acquisition of an office building by a partnership in return for a 60-percent interest in the venture's

interest as taxable income. The rationale is twofold. In the first place, the present value of a right to participate in future profits is usually too conjectural to be subject to valuation. In the second place, the service partner is taxable on his distributive share of partnership income as it is realized by the partnership. If he were taxed on the present value of the right to receive his share of future partnership income, either he would be taxed twice, or the value of his right to participate in partnership income must be amortized over some period of time.

A. WILLIS, *supra* note 3, at 84-85. See also A. ARONSOHN, *supra* note 37, at 57-58. These difficulties were recognized by the court of appeals in the case that nevertheless ended the previous unanimity of interpretation. *Diamond v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9306, at 83,654 (7th Cir. 1974). See note 71 *infra* & accompanying text.

68. See A. WILLIS, *supra* note 3, at 85.

69. This unmanageability was exacerbated by the absence of any established method by which such interest could be amortized. See *Diamond v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9306, at 83,654 (7th Cir. 1974). See note 102 *infra* & accompanying text.

70. See *Sol Diamond*, P-H Tax Ct. Rep. ¶ 56.42 (1971).

71. 74-1 U.S. Tax Cas. ¶ 9306 (7th Cir. 1974).

future profits.⁷² Within three weeks after the original purchase the taxpayer indirectly sold his profit share to a third party for \$40,000.⁷³ Instead of reporting this sum as gross income for that year, the taxpayer claimed a short-term capital gain of \$40,000 from the sale of a partnership interest.⁷⁴ That the amount received was compensation for services apparently was undisputed, and no attempt was made to characterize the original transaction as a tax-free exchange under section 721.⁷⁵ Instead, the taxpayer relied upon the then prevailing interpretation of regulations section 1.721-1(b)(1) that no taxable event occurred upon the transfer of a profits-only, as distinguished from a capital, partnership interest.⁷⁶ Rejecting this argument and finding that the taxpayer's interest had a value at the date of transfer because of its high sales price less than three weeks later,⁷⁷ the Tax Court determined that section 721 did not protect the transfer.⁷⁸

72. P-H Tax Ct. Rep. ¶ 56.42, at 56-372. The taxpayer was to receive the agreed percentage from profits generated by the operation of the building and bear a proportionate share of any losses. He also would receive the same percentage of the gain realized on a subsequent sale of the property, but only after the other partner had been reimbursed for expenses incurred in the original acquisition.

73. The taxpayer sold his 60-percent interest back to the other partner, who then sold a 50-percent interest to the third party purchaser.

74. *Id.*

75. In fact, the original agreement stated that the interest conveyed was "compensation . . . for the services to be rendered" by the taxpayer. P-H Tax Ct. Rep. ¶ 56.42, at 56-372.

76. *Id.* at 56-378.

77. *Id.*

78. *Id.* The Tax Court apparently misconstrued the taxpayer's argument when it held that section 721 did not apply to prevent the realization of gain upon the initial transfer. The court stated: "Certainly, unless section 721 of the Code grants the relief which petitioners seek, they are left subject to section 61." *Id.* See note 14 *supra*. The taxpayer, however, probably had not claimed that section 721 protected him; rather, he undoubtedly based his argument on the regulations promulgated thereunder, which had formed the foundation for the prior consensus that Code section 721 and section 1.721-1(b)(1) of the regulations did not purport to deal with profit shares but only controlled the tax treatment of transfers of an interest in partnership capital. *Cf.* Cowan, *supra* note 3, at 190. The Tax Court neglected to refute or even mention the prior interpretation of section 1.721-1(b)(1), and therefore seemingly missed the point of the taxpayer's contention. Of course, even the previously accepted understanding of the taxation of a profit share would not support the taxpayer's attempt to treat the proceeds of a sale of his profit share as capital gains income; it only would prevent the taxation of the value of such an interest when initially received.

Subjecting the \$40,000 to taxation as ordinary income seems proper on the facts present in *Diamond* since the tax law disfavors every attempt to transform ordinary income into capital gains. See authorities cited at P-H Tax Ct. Rep. ¶ 56.42, at 56-379 n.16. By preventing this conversion, however, the Tax Court arguably used an unnecessary path which reversed authoritative interpretations of an admittedly obscure regulation to reach an objective with apparently minimal revenue effects. See Cowan, *supra* note 3, at 211. Because compensation

The Court of Appeals for the Seventh Circuit concluded, as did the Tax Court, that no provision in the Code or regulations expressly prescribed the tax treatment for receipt of a profit share in a partnership.⁷⁹ After noting that affirmation of the Tax Court decision would break with past interpretations,⁸⁰ the court also acknowledged that the Tax Court's holding would necessitate a valuation of the profit share transferred and a determination of whether a transfer is within the scope of the ruling.⁸¹ Following the ruling also would raise the possibility of double taxation because of the lack of a recognized setoff procedure.⁸² Although the court limited the expansive Tax Court holding by providing for immediate taxation only when the market value of a profit share is readily determinable,⁸³ a situation apparently believed to be exceptional, it affirmed, deferring to the expertise of the Commissioner and the Tax Court.⁸⁴ This deference to expertise, however, appears unwarranted in *Diamond*; by affirming, the court compounded the uncertainties of a radical departure from existing law by accepting opinions which failed to refute the arguments supporting the previous consensus. Moreover, in its desire to prevent the revenue drain that would result if the taxpayer were able to obtain capital gains treatment of his partnership share, the court approved an approach which creates more problems than it solves.⁸⁵

Problems inherent in the *Diamond* approach surfaced in *Vestal v. United States*,⁸⁶ a case in litigation while *Diamond* was pending

to the service partner is deductible by a partnership, partnerships previously had allocated part or all of that deduction to the service partner to offset some or all of his taxable income from the compensation for services. See *Partnership Interest*, *supra* note 20, at 1533-34; Branscomb, *supra* note 34, at 109-10.

79. 74-1 U.S. Tax Cas. ¶ 9306, at 83,652.

80. *Id.* The court of appeals recognized that the taxpayer's contention, that the profit share was not taxable upon receipt, was supported by commentators, Tax Court dictum, legislative history, and administrative interpretation. *Id.* at 83,652-53.

81. *Id.* at 83,652-53.

82. *Id.*

83. *Id.*

84. *Id.* at 83,653.

85. One commentator has suggested that extension of *Diamond* "to its logical limits" would make taxable such events as the elevation of a law firm associate to partner status or the increase of a partner's percentage share of future profits. *Partnership Interest*, *supra* note 20, at 1526. Accord, Branscomb, *supra* note 34, at 102. This unexpected effect could be negated, however, by allocating the partner some or all of the partnership deduction. See note 78 *supra*.

86. 73-1 U.S. Tax Cas. ¶ 9260 (W.D. Ark. 1973), *rev'd*, 74-1 U.S. Tax Cas. ¶ 9407 (8th Cir. 1974).

on appeal. As compensation for bringing the investment to their attention, investors in certain Canadian oil and gas fields agreed individually to give the geologist-taxpayer in *Vestal* a right to receive, after recovery of all costs, an interest in the partnership formed to develop the fields. The partnership sold its oil and gas properties before any interest was conveyed to the taxpayer, and after deducting their expenses from the sale proceeds, each investor paid the promised fractional share out of the residual balance. In response to the taxpayer's attempt to report these payments as long-term capital gains in the year they were paid, the Government argued that since he had received nothing of ascertainable value when the original contracts were executed, the sale of the interests in a later year resulted in a realization of ordinary income as compensation for prior services.⁸⁷

Accepting the taxpayer's claim that the interest had a determinable value when received, the trial court found that it constituted ordinary income to the taxpayer at that time.⁸⁸ Additionally, the court implicitly found that the taxpayer had received at the earlier date an interest in the partnership, even if not fully vested.⁸⁹ This finding enabled the court to hold that the taxpayer realized long-term capital gain upon the sale of his interest after more than six months.⁹⁰

The Court of Appeals for the Eighth Circuit rejected the trial court's ruling on the grounds that it allowed the taxpayer to pay tax at capital gains rates on his share of the sale proceeds⁹¹ and that it was based upon the self-serving concession that receipt of the interest had constituted income, taxation of which was barred by the statute of limitations.⁹² Reversing the lower court's decision, the court of appeals found that the taxpayer had received neither in-

87. 74-1 U.S. Tax Cas. ¶ 9407, at 84,005-06.

88. 73-1 U.S. Tax Cas. ¶ 9260, at 80,506-07. As the court of appeals noted, however, the tax owed under the trial court's holding, that income was reportable when the contracts initially were executed, would have been uncollectable because of the running of the statute of limitations. 74-1 U.S. Tax Cas. ¶ 9407, at 84,008.

89. 73-1 U.S. Tax Cas. ¶ 9260, at 80,507-09.

90. *Id.* at 80,509.

91. Not only was the income treated as capital gains income, but the taxpayer also was allowed to deduct from the proceeds of the sale his basis in the interest supposedly transferred to him initially, although he had paid no taxes on the receipt of that interest. 74-1 U.S. Tax Cas. ¶ 9407, at 84,005.

92. *Id.* at 84,008. The court of appeals indicated its contempt for the taxpayer's claim: "In this respect, taxpayer cannot at the same time 'have his cake and eat it too.'" *Id.*

come nor any outright partnership interest upon the execution of the original contracts⁹³ and that the payment from each investor represented compensation for services rendered which was taxable as ordinary income upon receipt.⁹⁴ Significantly, the court rejected the trial court's finding that the fair market value of the interest conveyed to the taxpayer had been established,⁹⁵ finding that the value was too conjectural and dependent upon "speculative factors."⁹⁶ The court apparently deemed that section 721 and the regulations thereunder had no bearing on the issue before it, although it found support for its conclusion in *Frazell*.⁹⁷ Although neither of the *Diamond* opinions was considered, the court of appeals later, when denying a petition for rehearing, explicitly stated that *Diamond* was inapposite and not inconsistent with the original decision in *Vestal*.⁹⁸ Indeed, *Vestal* and *Diamond* involved different types of partnership interests: *Diamond* was concerned with an absolute transfer of an interest in future profits, while *Vestal* involved a contract to convey a complete partnership interest in the future similar to the interest granted in *Frazell*.⁹⁹

Nonetheless, a comparison of the facts in *Diamond* and *Vestal* will illustrate some of the difficulties inherent in the *Diamond* approach. Two different business ventures were attempted in these cases. The purchase of an existing office building in *Diamond* represented a rather stable investment facilitating valuation of a member's interest. Conversely, the fact that the oil and gas undertaking in *Vestal* was more speculative strongly influenced the court of appeals to reject the trial court's finding that the taxpayer's interest had a determinable market value long before operations had commenced. In light of this fundamental difference the two cases are reconcilable, since under the "readily determinable market value" test utilized in *Diamond*, the speculative nature of even an interest in the future profits of, rather than a conditional promise of a future capital interest in, the unproven fields would prevent immediate taxation of the service partner.

93. *Id.* at 84,009.

94. *Id.*

95. *Id.* at 84,008. See 73-1 U.S. Tax Cas. ¶ 9260, at 80,507.

96. 74-1 U.S. Tax Cas. ¶ 9407, at 84,008.

97. *Id.* at 84,007.

98. *Vestal v. United States*, 74-2 U.S. Tax Cas. ¶ 9501 (8th Cir. 1974).

99. See generally A. WILLIS, *supra* note 3, § 9.06-.07; *Partnership Interest*, *supra* note 20, at 1536-39.

The weakness of the test advanced in *Diamond*, however, is the necessity of ascertaining when the transferred profit share is susceptible to valuation. Although the facts presented in neither *Diamond* nor *Vestal* seem troubling under this test,¹⁰⁰ other transferred interests might fall somewhere in between these extremes, making value determinations much more difficult. Moreover, the fact that the determination must be made at the inception of the venture compounds its difficulty. If a service partner concludes that the market value of the interest is readily determinable, reports it as current ordinary income, and later decides to sell the interest after it has appreciated in value, he assumes the risk that capital gains treatment of the sale will be denied because of a finding that the value in fact was not readily ascertainable upon receipt. In such a case, the Commissioner might repeat the claim successfully made in *Vestal* that the original income was reported erroneously and that the entire proceeds of the later sale constitute ordinary income received as compensation for services rendered.¹⁰¹ Conversely, if the

100. The court in *Diamond* also was blessed with a ready-made valuation because the interest had been sold within a short time after it was created. Thus, the court not only was dealing with a real estate project, arguably one of the more stable types of business ventures, but it also was aided by the availability of perhaps the most accurate method of valuation, a timely sale of the property in question between a willing seller and buyer. In contrast, the valuation accepted by the trial court in *Vestal* was based upon testimony of one of the partners in the venture given several years after the fact when the taxpayer was attempting to restructure the transaction to minimize his tax liability. An example of the difficulties of valuation when the interest is in a speculative business can be seen in *Mailoux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963) (Tax Court determination of fair market value reversed where it had not given proper consideration to impairment of the value of uranium mining corporation stock resulting from restrictions on resale and the highly speculative nature of the stock).

101. One commentator has noted that the *Diamond* rule at least will enable service partners to be taxed immediately on a profits-only interest with little value, while being able to sell the interest later in a capital gains transaction. See Cowan, *supra* note 3, at 212. This observation was made, however, after the Tax Court's absolute holding which no longer seems correct in light of the court of appeals' narrower "readily determinable market value" test. Because the tax treatment depends upon susceptibility of the profit share to valuation in each case, such tax planning would be practical only in the most clear-cut cases. Indeed, the suggestion that even in *Diamond* the taxpayer could have avoided recognition of extensive ordinary income by having the profit share transferred to him at an early date when it had little value would seem precluded by the rule in *Diamond*. If, in fact, the interest when transferred has a negligible market value, but is transferred in anticipation that its value will appreciate in later years, it would not have a readily determinable market value; the early transfer itself would indicate that value of the profit share is not readily determinable and is being transferred early to prevent greater taxation on the anticipated future value.

If the taxpayer were to establish a value for his interest and report that value as income, the Service possibly would be estopped from later attempts to restructure the transaction as

service partner determines that the market value is not readily determinable, he will not report income upon receipt. Such action, however, would leave his tax liability subject to a possible subsequent determination that his interest was susceptible to valuation and that he had failed to report income that was realized in the year of transfer.¹⁰²

one in which the profit share did not have a readily determinable market value. If several years had passed since the initial return and if, as in *Vestal*, the statute of limitations had run on the first return, this estoppel argument might be even stronger. Perhaps the taxpayer's reliance also would be sufficient to support a laches defense to later restructuring by the Service. Indeed, to deny the estoppel defense in such a situation would be to allow the Service to effectuate the same type of after-the-fact restructuring that the court of appeals found so distasteful in *Vestal* when attempted by the taxpayer. See notes 91-92 *supra* & accompanying text. But if, for example, the initial receipt and subsequent sale were in the same tax year, the IRS would seem free to rearrange the tax treatment of a profit-share transfer irrespective of the taxpayer's expectations. Moreover, if the reviewing court was as unsympathetic to the taxpayer's dilemma as were the *Diamond* courts, there is little hope that any reliance by the taxpayer would be sufficient to overcome the deference to the Commissioner's expertise.

102. In addition to the uncertainty of valuation, which itself might be sufficient to discourage the use of profit shares as a means of service partner compensation, there is also the problem of the absence of an established method of amortization by which the taxpayer, if presently taxed on the "readily determined" market value of his profit share, can offset future income derived from the profit share. See notes 67-69 *supra* & accompanying text. Without some amortization, double taxation will result. This problem, like the uncertainty of business planning resulting from the *Diamond* rule, was recognized by the court of appeals in *Diamond*, but was not deemed a sufficient reason to reject the Commissioner's and Tax Court's determinations. See 74-1 U.S. Tax Cas. ¶ 9306, at 83,654. This problem is significant not only because it presents increased difficulties in the use of profit shares, but also because it compounds the unrealistic effects of a premature determination of the market value of a profit share.

The taxpayer, if taxed on the value of the profit share when received, should be allowed to deduct that amount from later income derived from the partnership profits interest over a period of years. As with other methods of amortization and depreciation, however, the period of years for which deductions are to be allowed might be determined in a rather arbitrary manner. Unlike standard depreciation, the profit-share amortization would not rely on a basis that had been determined in a market transaction; rather, it would be the product of a subjective determination, presumably established by expert opinion or other less reliable methods. If the interest were sold before the allowable amortization period expired, it is not clear whether further deductions would be precluded. If the income received from the profit share eventually was greater than the undiscounted value originally anticipated, it also would be difficult to tax the unanticipated income.

These problems, of course, are not incapable of resolution, but adequate handling of the related issues conceivably would require provisions as intricate as those dealing with depreciation of income-producing property. This complexity indicates that the *Diamond* rule is indeed arbitrary, based on the same conjecture, albeit much more limited, that was so disliked by the court in *Vestal*. See also *Partnership Interest*, *supra* note 20, at 1535. Even the court of appeals in *Diamond* recognized the desirability of precise regulation in this nebulous area. See 74-1 U.S. Tax Cas. ¶ 9306, at 83,654.

When considering the facts presented in *Diamond*, both courts deemed the ascertainable-value approach to be the necessary means by which to reach a result they deemed appropriate. Several alternative approaches existed, however, by which those courts could have held that the sale of the taxpayer's interest gave rise to realized ordinary income instead of capital gains.¹⁰³ One well-established theory, the taxation of present income as ordinary income because it represents an assignment of future ordinary income, could have been employed without disturbing preexisting interpretations of the regulations.

In *Herman M. Hale*,¹⁰⁴ cited by the court of appeals in *Diamond* as authority for the pre-*Diamond* interpretation of the regulations,¹⁰⁵ the Tax Court held that the sale of a partnership profit share generated ordinary income rather than capital gains for the seller.¹⁰⁶ The taxpayer in *Hale* had received a future interest in partnership profits as compensation for services yet to be rendered to a partnership organized to develop a tract of land and sell homes constructed thereon.¹⁰⁷ Before the partnership earned profits, the taxpayer elected to sell his profit share and report the net proceeds as capital gains income. Despite the lack of profits prior to sale, the Tax Court found that, at the sale date, future profits reasonably could be estimated.¹⁰⁸ Relying on cases that had denied capital gains treat-

103. For example, the court might have held that the taxpayer was an employee rather than a partner, thus avoiding any question of acquisition of a partnership interest. See 74-1 U.S. Tax Cas. ¶ 3506, at 83,651; Cowan, *supra* note 3, at 202-07. It also might have been claimed that the taxpayer was granted an undervalued interest in profits that derived its true value from the already appreciated value of partnership property, thus in effect constituting a transfer of capital taxable under section 1.721-1(b)(1) of the treasury regulations. See 74-1 U.S. Tax Cas. ¶ 9306, at 83,654; Cowan, *supra* note 3, at 192. Conceivably, the transfer of a profit share might be covered by section 83, although this section could not have been applied to the pre-1969 transfers involved in *Diamond*. Proposed amendments to the regulations under section 721 imply, however, that section 83 applies only to capital interests and not to profit shares. See note 35 *supra*. See also Cowan, *supra* note 3, at 186-87.

Although these alternatives may have been proper, their applicability in *Diamond* was aided by the precise facts of that case. Arguably, the alternatives would not apply to a broad range of profit-share situations. Cf. notes 104-17 *infra* & accompanying text.

104. P-H Tax Ct. Mem. ¶ 65,274 (1965).

105. 74-1 U.S. Tax Cas. ¶ 9306, at 83,653.

106. P-H Tax Ct. Mem. ¶ 65,274, at 65-1646.

107. Possibly, because the partnership in *Hale* was to terminate after all the planned houses were sold, while in *Diamond* the anticipated real estate venture was to be an ongoing concern, the two cases are distinguishable. Any such distinction, however, seems inconsequential when considering the taxation of a service partner in a bona fide joint venture that is not a mere attempt to shield compensation income as a proprietary interest.

108. P-H Tax Ct. Mem. ¶ 65,274, at 65-1646. This finding indicates that the court, if asked

ment upon the sale of a capital asset if the sale was in effect an anticipation of future income,¹⁰⁹ the court found that the sale of a partnership profit share was not entitled to preferred tax treatment despite the characterization of the share as a capital asset.¹¹⁰ Ordinary income was deemed to have been received on the sale because the lump sum consideration constituted the present value of the assignment of future income that the taxpayer would have received but for the sale.¹¹¹

Underlying the *Hale* decision was the policy of restricting the availability of preferential tax treatment pursuant to the Code's capital gains provisions.¹¹² Although generally unarticulated,¹¹³ this same desire undeniably has induced the courts to formulate various reasons for rejecting attempts by service partner-taxpayers to manipulate the wording of section 721 to their tax advantage. A frank expression of this rationale would have alleviated the uncertainties of the *Diamond* approach. The court of appeals could have achieved the same tax result in *Diamond* merely by characterizing the sale of the taxpayer's profit share as an assignment of income that he otherwise would realize in the future. Moreover, this rationale would

to do so, might have found that the profit share had a readily determinable market value when first conveyed, thus necessitating immediate taxation under the test later developed in *Diamond*. The court in *Hale*, however, stated specifically that no income was realized on the receipt of a profit share. *Id.* at 65-1646 n.3, cited in *Diamond v. Commissioner*, 74-1 U.S. Tax Cas. ¶ 9306, at 83,653 (7th Cir. 1974).

109. *Commissioner v. P.G. Lake*, 356 U.S. 260 (1958); *Hort v. Commissioner*, 313 U.S. 28 (1941). "The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." 356 U.S. at 265.

110. P-H Tax Ct. Mem. ¶ 65,274, at 65-1646.

111. *Id.*

112. The Tax Court noted in *Sol Diamond*:

Even if one of petitioners' . . . arguments had prevailed, it would still not be altogether clear that the \$40,000 petitioner received on the sale of his interest in the land trust would qualify as a short-term capital gain. Although section 741 [INT. REV. CODE OF 1954, § 741], provides for capital gain treatment on the sale of an interest in a partnership, it is not at all clear that it contemplates the sale of a right to receive income in the future in return for a lump sum payment which would enable a taxpayer to convert what would otherwise be taxable as ordinary income into capital gain . . . In view of our disposition of this case, however, we need not reach this question.

P-H Tax Ct. Rep. ¶ 56.42, at 56-379 n.16.

113. Apparently, only the court of appeals in *Vestal* has relied explicitly upon this principle in service partner cases, noting that "[c]apital gains treatment was intended [only] to relieve the taxpayer from the excessive tax burden on gain resulting from a conversion to capital investment." 74-1 U.S. Tax Cas. ¶ 9407, at 84,008, quoting *Pounds v. United States*, 372 F.2d 342, 346 (5th Cir. 1967).

seem more proper in *Diamond* than in *Hale*, where the court faced a claim that the profit-share interest was a capital asset.¹¹⁴ The profit share in *Hale* had been held for a considerable period of time and appeared to have been acquired for investment purposes,¹¹⁵ while in *Diamond* the relatively short holding period might raise an inference that no investment purpose had motivated its transfer to the taxpayer.¹¹⁶ If the *Hale* rationale had been used in *Diamond*, there would have been no reason to create the unmanageable "readily determinable market value" test; prior interpretations of section 721 could have continued unimpaired, and no income would have been realized immediately upon the transfer of the profit share to the service partner. Under a *Hale* approach, income later realized by the profit-share recipient from his distributive portion of partnership profits would be taxed as ordinary income. If, however, the service partner later assigned or sold the profit share, the proceeds from the assignment or sale also would be treated as ordinary income since they would represent the realization of the present value of anticipated future ordinary income. Utilization of this approach would make unnecessary a speculative determination by the taxpayer of the market value of his profit share and would alleviate the need to develop a workable amortization or setoff procedure that could prevent double taxation on the service partner's profit share.

CONCLUSION

Granting service partners a partnership interest is a desirable compensation technique because it gives added incentive to promote the venture, to increase its profitability, and to enhance the value of partnership assets. Such interests also provide a flexible method of compensation by which the service partner's tax burden may be minimized if properly planned. The receipt of a capital interest by the service partner perhaps provides the most flexibility. An outright grant, at a time when the interest has little value, can minimize taxation by generating ordinary income only to the extent of that small present value and by deferring taxation on the appreciated value of the interest until it is sold, at which time it will

114. P-H Tax Ct. Mem. ¶ 65,274, at 65-1646. See INT. REV. CODE OF 1954, § 741 (capital gains treatment provided for the sale of an interest in a partnership).

115. This fact alone would not justify treatment of the sale of the interest as a capital gains transaction, however, since the interest had been received as compensation for services.

116. See Cowan, *supra* note 3, at 195.

create capital gains. If restrictions on the enjoyment of a capital interest are necessary for nontax reasons, similar planning also can provide desirable tax treatment for the lower present value at the transfer date.

Tax deferral benefits also can be achieved by granting the service partner an interest in future profits. Although long believed to create no present tax liability, profit shares recently have been held taxable upon receipt if they have a readily determinable market value. The present taxation of a profit share may benefit the service partner in some circumstances since the taxation upon receipt as ordinary compensation income would permit later capital gains treatment of the sale of an interest that had appreciated in value.¹¹⁷ Use of this compensation device, however, undoubtedly will be curtailed because it imposes upon the service partner serious consequences for any mistake in determining whether his share has a readily determinable value and because it raises the specter of double taxation.

117. *See id.* at 201.