RECOGNITION OF GAIN BY A P’SHPION ISSUING AN EQUITY INTEREST FOR SERVICES: THE PROPOSED REGULATIONS GET IT WRONG

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The Proposed Regulations

In May 2005 the Treasury Department and the IRS published proposed regulations dealing with the issuance of a partnership interest for services.¹ Those regulations attempt to provide definitive answers to a range of troubling issues surrounding the treatment of the partnership and the service-provider partner when a partnership interest is granted in exchange for services. Some issues have been clearly resolved for years. For example, no one seriously questions that the service provider who receives an interest in partnership capital must recognize ordinary income equal to the fair market value of the partnership interest.² Likewise, no one questions that the partnership is entitled to deduct (or capitalize as the cost of an asset) the fair market value of the partnership interest granted to the service provider.³

Not the least of the difficult issues, however, has been the treatment of receipt of a “profits-only” partnership interest. The extent to which receipt of a profits-only partnership interest triggered recognition of income has provoked numerous judicial opinions, from the famous Sol Diamond⁴ decision up to the equally well-known Campbell⁵ decision. Ultimately, by promulgating safe harbor revenue procedures, the IRS produced a reasonably workable answer by announcing that it would treat a partner who performs services “in a partner capacity” in exchange for a profits-only partnership interest as realizing income on receipt of the partnership interest only in the following three specific situations: (1) the partnership’s profits are derived from a substantially certain and predictable stream of income, such as from high-quality debt or a net lease; (2) the partner disposes of the


²Section 83(a); see, e.g., Hensel Phelps Construction Co. v. Commissioner, 74 T.C. 939 (1980), aff’d, 703 F.2d 485 (10th Cir. 1983). Section references are to the Internal Revenue Code of 1986, as amended, or the regulations promulgated thereunder, except as otherwise noted.

³Section 83(h); Treas. reg. section 1.83-6(a).

⁴Diamond v. Commissioner 492 F.2d 286 (7th Cir. 1974), aff’g 56 T.C. 530 (1971).

⁵Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991), rev’g T.C. Memo. 1990-162.
partnership interest within two years of its receipt; or (3) the interest is a limited partnership interest in a publicly traded limited partnership as defined in section 7704(b).4

Some of the other questions that arise when a partnership interest has been issued for services have been fairly easy to answer. For example, reverse section 704(c) allocation issues5 generally are the same regardless of whether a newly admitted partner receives his interest in exchange for services or for property. Until recently there was some question about whether it was permissible to book-up the partnership’s assets and capital accounts under the section 704(b) regulations on the entrance of a service partner to an existing partnership, but that issue has been answered in the affirmative by recently promulgated regulations.6

Other problems arose when the partnership interest was not vested and was subject to a substantial risk of forfeiture. As long as the service-provider partner had not made a section 83(b) election, the issues were fairly easy to resolve. Under the regulations, the service-provider partner was not a partner for tax purposes.9 Thus the service-provider partner had no distributive share; what would have been that partner’s distributive share would be taken into account by the other partners and distributions would be treated as compensation paid to a nonpartner. When the interest vested, there was a capital shift with the attendant tax consequences. It all involves multiple calculations, including two parallel but different sets of book capital accounts, but none of it is theoretically challenging or difficult to conceptualize for one versed in subchapter K.

Broadly speaking, the recently proposed regulations do not significantly change those fundamental results in most cases, but do clarify the authority for those results and deal with a wide variety of technical issues that heretofore have not been clearly addressed. The proposed regulations provide rules regarding valuation of the service-provider partner’s compensation income and the concomitant partnership deduction (or capitalized amount),10 as well as rules relating to capital account maintenance.11 Also, the recently proposed regulations provide a solution to the slightly murkier issues that surrounded allocations of distributive shares when the service-provider partner had made a section 83(b) election and subsequently forfeited the interest.12 Those proposed rules have generated criticism from the bar.13

More significantly, the proposed regulations would provide complete nonrecognition of gain or loss to the partnership issuing a partnership interest for services, while allowing a deduction (or capitalized amount) for the full fair market value of the partnership interest granted to the service partner.14 None of the commentators from the practicing bar have criticized that aspect of the proposed regulations. I do. The point of this special report is that the proposed regulations are wrong to the extent they allow the partnership a deduction (or capitalized amount) in an amount equal to the fair market value of the service-provider’s capital account without triggering the concomitant recognition of gain or loss on a pro rata portion of the partnership’s underlying assets.

The preamble to the proposed regulations explains the proposed rules as follows:

There is a dispute among commentators as to whether a partnership should recognize gain or loss on the transfer of a compensatory partnership interest. Some commentators believe that, on the transfer of such an interest, the partnership should be treated as satisfying its compensation obligation with a fractional interest in each asset of the partnership. Under this deemed sale of assets theory, the partnership would recognize gain or loss equal to the excess of the fair market value of each partial asset deemed transferred to the service provider over the partnership’s adjusted basis in that partial asset. Other commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest. They argue, among other things, that the transfer of such an interest is not properly treated as a realization event for the partnership because no property owned by the partnership has changed hands. They also argue that taxing a partnership on the transfer of such an interest would result in inappropriate gain acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently.

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. . . . However, the Treasury Department

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4Rev. Proc. 93-27, 1993-2 C.B. 343, Doc 93-6562, 93 TNT 123-7, clarified by Rev. Proc. 2001-43, 2001-2 C.B. 191, Doc 2001-20855, 2001 TNT 150-11 (classification of a partnership interest received for services will be determined at the time the interest is granted, even if the interest is not vested; the service-provider partner is treated as the owner of the partnership interest from the date of its grant).

5Treas. reg. sections 1.704-3(a)(6)(i) and 1.704-1(b)(4)(i).


7Treas. reg. section 1.83-1(a). However, Rev. Proc. 2001-43 provides that a service-provider partner who receives a nonvested profits-only interest will be treated as a partner from the date the partnership interest is granted, even if no section 83(b) election is made, if the partnership and the service provider treat the service provider as a partner starting when the interest was granted and neither the partnership nor any of the partners deducts any amount for the grant of the interest and the conditions of Rev. Proc. 93-27 are satisfied.

8Prop. reg. section 1.83-3(e), (l)(1); section 1.83-6(b); see also Notice 2005-43, 2005-24 IRB 1221, Doc 2005-11236, 2005 TNT 98-37.


14Prop. reg. sections 1.83-6(b); 1.721-1(b).
and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 — to defer recognition of gain and loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations [prop. reg. sections 1.83-6(b) and 1.721-1(b)(2)] provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Under section 1.704-1(b)(4)(i) (reverse section 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership’s assets as those assets are sold, depreciated, or amortized.

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity, as defined in section 301.7701-3(a) of the Procedure and Administration Regulations, that becomes a partnership under section 301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest. See McDougal v. Commissioner, 62 T.C. 720 (1974) (holding that the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership). The position represents an official about-face for the IRS, which in GCM 36346 had concluded that the partnership recognized gain under the McDougal principles when it granted a capital interest to a service-provider partner.

The Analytical Models

As the preamble to the proposed regulations explains, many commentators have concluded that as a result of the transfer of an interest in partnership capital in exchange for services, the partnership is required to recognize gain or loss. Although the preamble does not cite the commentators who have taken this position, they are legion, and the position has been well articulated for over 40 years. Under that model, the partnership is treated as transferring an undivided portion of each of its assets to the service partner as payment for services, with gain and loss being recognized on the constructive transfer. The service partner then constructively retributes the property to the partnership, which takes a basis equal to the service partner’s “tax cost” basis, that is, fair market value, in the property under section 723. That analysis predominates in the scholarly literature. The commentators who have reached that conclusion have done so by applying well-established precedents.

McDougal v. Commissioner, cited in the preamble, is the most salient precedent. In that case, McDougal, who owned a racehorse named Iron Card, promised a trainer, McClanahan, that if the latter would train the horse, after McDougal had recovered the cost and expenses of acquisition, he would transfer a one-half interest in the horse to McClanahan. McClanahan would also receive a trainer’s fee. McClanahan trained Iron Card, who proved to be successful on the track, and nine months later, McDougal transferred a one-half interest in Iron Card to McClanahan. Thereafter, McDougal and McClanahan raced Iron Card and later, when he was retired due to injury, held him as a stud. Although the oral partnership was not finalized at the time of the transfer, the Tax Court held that for income tax purposes a partnership had been formed instanter at the time of the transfer:

[The aforesaid transfer constituted the formation of a joint venture to which the McDougal’s contributed capital in the form of the horse, Iron Card, and in which they granted McClanahan an interest equal to their own in capital and profits as compensation for his having trained Iron Card.]

The tax consequences to McDougal of the transfer of Iron Card to the partnership were then determined under a “deemed transaction” analysis:

When on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He and the obligee are deemed thereafter and in concert to have contributed those assets to the joint venture. The contributing obligor will recognize gain on the transaction to the extent that

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16GCM 36346 (July 25, 1977).


18See Treas. reg. section 1.83-6(b).

19See supra note 17.


21See supra note 17.
the value of the undivided interest which he is deemed to have transferred exceeds his basis therein.\textsuperscript{22}

Under established precedent, McDougal was properly required to recognize the gain\textsuperscript{23} and he properly claimed the deduction. What is important to note about the Tax Court’s analysis is that it concluded that the partnership arose \textit{instanter} at the time McDougal transferred an interest in Iron Card to McClanahan. Because the racing of Iron Card was a going business that was continued without interruption, there never was an instant of co-ownership outside of a partnership. Only for purposes of calculating McDougal’s gain did the court employ the legal fiction that there was a momentary transfer of a direct interest in Iron Card to McClanahan.

The preamble to the proposed regulations asserts that “[o]ther commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest.” Again the preamble does not cite the commentators. It is more difficult to find many theoretical or doctrinal articulations of that position in the literature, although many tax practitioners informally have advanced the argument. Two scholarly commentators have advanced an alternative theory — “cash-out-cash-in” — for dealing with the partnership’s side of the transaction that results in nonrecognition to the other partners.\textsuperscript{24} Under the cash-out-cash-in theory, the partnership — that is, the other partners — are treated as if the partnership paid cash to the service partner equal to the value of the partnership interest, following which the service partner immediately contributed the cash back to the partnership in a transaction subject to section 721. Under that model the partnership recognizes no gain and the basis of its assets remains unchanged. Although, if written on a blank slate, at first blush the cash-out-cash-in model might not be a wholly implausible alternative theory, the Internal Revenue Code is not a blank slate and the model finds no support in prior judicial decisions or administrative rulings. Furthermore, careful analysis reveals that the cash-out-cash-in model is fundamentally flawed from a tax policy perspective.

Prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) would produce results for the partnership issuing a partnership interest in exchange for service that is identical to the results under the cash-out-cash-in model, although the proposed regulations do not explicitly adopt the cash-out-cash-in model as the underlying theory for the result-oriented rules contained therein. As explained in the above excerpt from the preamble, while prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) would provide that a partnership does not recognize any gain or loss on the transfer of a partnership interest to a new partner in exchange for services to the partnership, the proposed regulations preserve the recognition result in \textit{McDougal} if the transfer of property in exchange for services creates a partnership out of a relationship that previously was not classified as a partnership.\textsuperscript{25} Notwithstanding the distinction in the preamble, there is no basis for distinguishing the two situations that justifies different treatment. In both cases, one party (or parties) transfers an interest in property to a party in exchange for services. As held in \textit{McDougal} and noted in the preamble to the proposed regulations, an exchange of an interest in property for services traditionally has been treated as a realization event.

As a practical matter, on admission of a partner, it generally is necessary to revalue the partnership’s property and adjust the partners’ capital accounts to reflect the revaluation. Treas. reg. section 1.704-1(b)(2)(iv)(f) specifically allows the partnership to revalue its property and adjust the existing partners’ capital accounts in connection with the grant of an interest in the partnership (other than a \textit{de minimis} interest) in consideration of services to the partnership by an existing partner acting in a partner capacity or by a new partner acting in a partner capacity or in anticipation of being a partner. Thus, for capital account purposes, the exchange of an interest in partnership capital is reflected as a realization event for the partnership and a transfer of partnership capital from the continuing partners to the service partner. Under an elective safe harbor rule in prop. reg. section 1.83-3(e)(1), the revalued capital account interest of the compensated partner, as reflected in capital accounts, measures the amount of income to be recognized by the service partner in lieu of the normal fair market value rule. That same amount is allowed as a deduction to the partnership, or capitalized, as is appropriate. The major revision of the proposed regulations is to treat the exchange of an interest in partnership property for services as a nonrecognition event and to defer recognition of gain or loss to disposition of partnership property.

\textbf{Putting the Models in Perspective}

Contrary to assertions in the preamble to the proposed regulations, the broader pattern of subchapter \textit{K} as a whole, which significantly incorporates the aggregate theory of partnership taxation, suggests that the \textit{McDougal} model is a more appropriate principle for determining the tax consequences to the other partners than the legal fiction employed in the cash-out-cash-in model. The position stated in the preamble that a transfer of interests

\textsuperscript{22}62 T.C. at 725-726 (emphasis added).
\textsuperscript{23}The court cited \textit{United States v. Davis}, 370 U.S. 65 (1962), and \textit{Kenan v. Commissioner}, 114 F.2d 217 (2d Cir. 1940), aff’g 40 B.T.A. 824 (1939). 62 T.C. at 726.

\textsuperscript{25}A similar result occurs in Rev. Rul. 99-5, 1999-1 C.B. 434, Doc 1999-2045, 1999 TNT 10-6, which requires that gain and loss be recognized by the member of a single-member LLC that sells an interest in the LLC to another person, thereby converting the disregarded entity to a partnership.
in partnership assets is not a realization event is directly contrary to the result in McDougal, which on careful reading is not really distinguishable on the grounds asserted in the preamble. The pervasive accepted doctrine, reflected in the cases cited in the McDougal opinion, is that the transfer of any interest in property in exchange for services results in recognition of gain or loss with respect to the transferred property, absent a nonrecognition rule. The only arguable exception to this principle is found in section 1032, regarding the issuance of corporate stock in exchange for services.

Section 1032, which provides for nonrecognition to a corporation on receipt of property in exchange for stock, is somewhat analogous to section 721, although not entirely so. The regulations under section 1032, Treas. reg. section 1.1032-1(a), apply that nonrecognition rule to the issuance of shares for services, but that regulatory provision is merely an extension of the rule in earlier regulations predating the enactment of section 1032, which provided that the issuance of shares by a corporation did not “give rise to taxable gain or deductible loss” unless the corporation was “dealing in its own shares as it might in the shares of another corporation,” that is, buying and selling on the market for speculative profit. In Hercules Powder Co. v. United States, the court interpreted that language in Treas. reg. 111, section 29.22(a)-15:

[The words “gives rise to neither taxable gain nor deductible loss” in the regulation concerning the original issue of shares did not create an exemption of income from taxation. That could not be accomplished by regulation. That language must mean that such an issue does not give rise to income, within the meaning of section 61].

Section 1032 was enacted merely to eliminate the recognition of gain or loss when a corporation dealt in its own shares as it might in the shares of another corporation. Its enactment effected no fundamental change in the treatment of the issuance of authorized but previously unissued shares in exchange for services. Thus, the apparent “extension” of section 1032 to stock issued for services in Treas. reg. section 1.1032-1(a) is illusory. Issuance of corporate shares in exchange for services does not give rise to gross income wholly apart from section 1032.

The result under section 1032 is theoretically correct; contributions to the capital of a corporation in any form should not be taxable to the corporation. Furthermore, even though the corporation realizes no gain on the issuance of its stock for services, the deduction is entirely proper. When it pays for services with stock, a corporation is “not selling an appreciated asset, but rather, taking on a burden or detriment that has a family resemblance to a corporate liability.” By issuing the stock, the fair market value of which represents the net present value of the future cash flow on the stock, the corporation has made a commitment to pay out that cash in the future. The deduction gives the corporation advance credit for nondeductible future payments (dividends), but it provides no tax advantage, because the amount of the deduction is limited to the discounted net present value of those future payments.

Transfers of partnership interests for services differ, however, from transfers of corporate stock. Where the corporation is committed to paying out future dividends from its after-tax income as a result of issuing the stock, when an interest in partnership capital is transferred the preexisting partners have shifted to the incoming partner the incidence of tax on the income thereafter to be received from the shifted capital. Regarding preexisting partners, allowing a deduction for the value of the partnership interest without requiring recognition of gain at the time of the transfer thus produces a double tax benefit — a future exclusion coupled with a current deduction for an amount equal to the net present value of the future income stream attributable to the transferred interest.

Further, from a statutory perspective, unlike situations involving the issuance of corporate shares, where the corporation’s tax consequences are determined under section 1032 and the shareholder’s tax consequences normally are determined under section 351, in the case of the admission of a partner to a partnership, the tax consequences to both the partner and the partnership normally are determined under section 721. While asymmetrical treatment of the corporation and the service provider is possible in the corporate situation, because different code sections provide the nonrecognition rules for the corporation and the shareholder, respectively,

26United States v. Davis, 370 U.S. 65 (1962) (husband who transferred appreciated stock to his wife in exchange for a release of his wife’s marital rights, in connection with their divorce, realized gain); International Frighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) (corporation that paid its executives bonuses in the form of stock of its parent corporation realized gain); United States v. General Shoe Corp, 282 F.2d 9 (6th Cir. 1960) (requiring recognition of gain by a corporation that contributed appreciated property to a qualified pension plan trust); Montana Power Co. v. United States, 171 F. Supp. 943 (Ct.Cl. 1959) (corporation that transferred property to obtain a release from a 10-year contract to supply oil to the transferee realized a loss).

27See, e.g., Treas. reg. 111, section 29.22(a)-15; Treas. reg. 118, section 39.22(a)-15.


32Id.

33By “income” here I am referring to the future yield, not to the unrealized appreciation at that time, which if not taxed at the time of the transfer, will be taxed to the preexisting partners under reverse section 704(c) allocations at some time in the future.

34The full double tax benefit would occur only if the partnership’s assets had a zero basis, but the principle applies regardless of the ratio of the basis to fair market value.
section 721 cannot be interpreted asymmetrically. The transaction is either a nonrecognition transaction under section 721 for both the party and the partnership, or it is a recognition transaction for both the partnership and the party. It cannot be a nonrecognition transaction for one and a recognition transaction for the other. And because there has been no prerequisite exchange of property, the admission of a partner with a capital interest in exchange for services cannot be a nonrecognition transaction for the partnership.

The history of the treatment of the partnership when a new partner is admitted for services stands in stark contrast to the treatment of a corporation that issues stock in exchange for services. Before enactment of section 721 in 1954, there was no specific code section governing the tax consequences of admitting a partner to a partnership, the contribution of property in exchange for a partnership interest was a nonrecognition event for both the partner and the partnership.\(^35\) In that regard, partnerships were accorded the same treatment as corporations. Although the pre-1954 case law had established that the receipt of a capital interest by a service-provider partner triggered immediate recognition of ordinary income,\(^36\) it does not appear that any consideration ever had been given to the proper tax treatment of the other partners when a partner was admitted and obtained an interest in capital in exchange for services.\(^37\) There was at least some thought, however, that capital shifts on the admission of a new partner could result in recognition of gain or loss to the existing partners, although the analysis directly addressed only capital shifts in connection with the admission of a partner who contributed capital, not services, and focused on changes in the value of capital accounts and the concept of sales of interests in the partnership by the existing partners.\(^38\) In that regard, the pre-1954 treatment of partnerships was distinctly different from the treatment of corporations. That difference is significant regarding the validity of the proposed regulations, because the committee reports accompanying the 1954 code state that section 721 codifies but does not change preexisting law.\(^39\) Indeed, Arthur Willis, one of the leading commentators on partnership taxation in the last half of the 20th century, concluded in his treatise published shortly after adoption of the 1954 code that a capital shift in favor of a service-provider partner triggered recognition to the other partners.\(^40\)

It is true that many of the more recent commentators who have maintained that the McDougal principle applied to all instances of a partnership interest being granted for services also have referred to current Treas. reg. section 1.721-1(b), which provides in part as follows: "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..." If that provision were the sole reason for triggering recognition of gain or loss to the other partners, Treasury and the IRS arguably have the power to change the rule. On the other hand, that provision has been in the regulations for nearly 50 years, its interpretation by the commentators has been well known, the case law establishing that a transferor of an interest in property who receives services in return has been well established for over 50 years, and Congress has repeatedly revisited subchapter K, enacting many technical provisions to fine-tune its operation. Thus, the better interpretation is that section 721 does not provide nonrecognition to the partnership when the partnership issues a partnership interest in exchange for services. The gain recognition rule has, in effect, been codified.\(^41\) Furthermore, even if the reenactment argument is not accepted, the commentators generally have not relied on current Treas. reg. section 1.721-1(b) as the linchpin of their arguments. Their arguments turn primarily on the application of core tax principles to the statutory language of section 721. Current Treas. reg. section 1.721-1(b) merely confirms the result — that services are not property and therefore section 721 applies to neither the partnership nor the partner when a partnership interest is granted in exchange for services.

37See Paul Little, Federal Income Taxation of Partnerships (Little, Brown & Co. 1952); Jacob Rabkin and Mark H. Johnson, "The Partnership Under the Federal Tax Laws," 55 Harv. L. Rev. 909 (1942); see also Lloyd v. Commissioner, 15 B.T.A. 82 (1929) ("salaries" paid to partners that exceeded the sum of the partnership’s taxable income and the payee partner’s share of partnership capital was gross income; other partners were entitled to deductions for the amount by which their shares of partnership capital were reduced).
39H.R. Rep. No. 83-1337, 83rd Cong. 2d Sess. 68, A227 (1954) ("Contributions to a partnership will have the same effect under (Footnote continued in next column.)

the proposed provisions as under present practice... This section, which codifies existing case law makes clear that no gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property to the partnership in exchange for a partnership interest."
41See Cottage Savings Association v. Commissioner, 499 U.S. 554, 562 (1991) ("because Congress has left undisturbed through subsequent reenactments of the Code the principles of realization established in these cases [involving corporate reorganizations before the enactment of the corporate reorganization rules], we may presume that Congress intended to codify these [realization] principles").
The case for adopting the cash-out-cash-in model, or any other theory on which to ground the nonrecognition rule in prop. reg. sections 1.83-6(b) and 1.721-1(b), is further weakened by the consideration and failure of Congress to enact proposed section 770(b) in 1960. Proposed section 770 would have dealt comprehensively with the treatment of the issuance of a partnership interest in a partnership capital to a service-provider partner with a capital account, but would have limited the partnership’s deduction (or capitalized amount) to the lesser of the fair market value of the transferred capital account or the partnership’s basis attributable to the transferred capital account. The absence of a nonrecognition rule, in the face of Congress’s failure to enact such a rule after considering it, even though the provision was only a small part of a much larger bill that Congress failed to enact, indicates that it is not part of the current statutory pattern.

Nothing in the accompanying committee reports indicates that the nonrecognition rule in proposed section 770 would have been merely a codification of prior law. Contemporaneous commentary, including commentary by Arthur Willis, the chair of the advisory group that recommended the enactment of a provision on which proposed section 770 was based, indicates that the prevailing interpretation of the rules at that time was that such recognition was required. Thus, the nonrecognition rule in proposed section 770 would have been a new rule, replacing what the drafters apparently considered to be the then-existing rule — and because proposed section 770 was never enacted, the still-existing rules require recognition to the partnership on the transfer of an interest for services and proposed section 770(b) specifically would have provided that the partnership did not recognize any gain or loss on the admission of a service-provider partner with a capital account, but would have limited the partnership’s deduction (or capitalized amount) to the lesser of the fair market value of the transferred capital account or the partnership’s basis attributable to the transferred capital account. The absence of a nonrecognition rule, in the face of Congress’s failure to enact such a rule after considering it, even though the provision was only a small part of a much larger bill that Congress failed to enact, indicates that it is not part of the current statutory pattern.

That proposed section 770 would have changed the law is further supported by the committee hearing leading up to the introduction of the bill in which it was contained. Proposed section 770 was based on proposed section 724 in Advisory Group on Subchapter K of the Internal Revenue Code of 1954, “Revised Report on Partners and Partnerships Transmitted to the Committee on Ways and Means,” with some modifications. Although the report itself does not articulate a view of the then-current state of the law, the testimony of Willis, the chair of the advisory group, does reveal the advisory group’s view that “[i]f there should be appreciation in the value of the [partnership’s] property, it also would be necessary to recognize a gain on the capital that was transferred to the service partner, because in theory there would be a disposition of that property” with the result that “we would have (1) taxable income to the service partner, (2) a deduction to the other partners, who were giving up some of their capital interest, and (3) sort of an artificial creation of taxable gain to the partners giving up some of their capital interest.” Notwithstanding that it was the correct answer, to avoid complexity the advisory group recommended a statutory enactment providing for nonrecognition to the partnership coupled with limiting the partnership’s deduction to the portion of the basis of the partnership’s assets attributable to the capital interest shifted to the service-provider partner.

In light of the legislative history and statutory structure, section 721 simply cannot be read to provide nonrecognition to a partnership that admits a service-provider partner with a capital account that is transferred in exchange for services. Under the current statutes, the transaction must be a recognition event.
The Tax Arbitrage Grift

The tax policy problem here is one of tax arbitrage. The proposed regulations, in effect, allow a partnership to purchase services in exchange for an interest in appreciated property while obtaining a deduction (or capitalized amount, which might be depreciable or amortizable) without the concomitant recognition of gain. That is exactly the result rejected in McDougal and a result that is clearly unobtainable outside subchapter K. The result permitted under the proposed regulations is exactly the type of tax arbitrage sought by taxpayers in cases like *McDougal* and *International Freighting Corporation Inc. v. Commissioner*, and which the courts, at the behest of the IRS, have consistently refused to permit.

From a tax policy perspective it is critically important to an income tax system to prevent that tax arbitrage. As explained 15 years ago by Prof. Mark Gergen:

An exchange of a partnership interest for services is really an investment in the services (or in the asset the services produce), and, to the extent we allow the original partners to make that investment with appreciated assets without recognizing gain, we have allowed them to make the investment with untaxed wealth, which is equivalent to exempting from tax the returns from that part of the investment. Thus, taxing the original partners on an exchange of a partnership interest for services is essential to preserving the integrity of the income tax.

To allow a deduction for the value of the partnership interest without requiring recognition of gain at the time of the transfer thus produces a double tax benefit — a future exclusion coupled with a current deduction for an amount equal to the net present value of the future income stream attributable to the transferred interest. That is the tax arbitrage grift in the proposed regulations.

The best measure of the existence of tax arbitrage profits is the existence of an after-tax rate of return to an investment that exceeds the before-tax rate of return multiplied by (1 - tax rate). Assuming a tax rate of 40 percent, if an investment produced a before-tax rate of return of 10 percent, the fully taxed after-tax rate of return would be 6 percent. Any rule respecting the timing of a deduction that results in an after-tax rate of return in excess of 6 percent is a signal of tax arbitrage. Application of that analysis to the proposed regulations readily reveals the tax arbitrage grift.

Assume, for example, that the AB partnership has a self-created asset with a fair market value of $120 and a basis of zero, and $120 of cash. Both assets yield 10 percent per annum, or a total of $24, and the partnership has no expenses, so its annual net cash flow is $24. The before-tax rate of return to the partnership’s already taxed investment — the $120 of cash — is 20 percent. The partners pay taxes of $9.60, leaving $14.40 after tax. The after-tax rate of return is 12 percent, exactly 60 percent of the before-tax rate of return. Now assume that C performs services for the partnership that give rise to a deduction in exchange for a one-quarter partnership interest with a capital account of $60. The partnership’s annual net cash flow remains $24.

Section 721 simply cannot be read to provide nonrecognition to a partnership that admits a service-provider partner with a capital account that is transferred in exchange for services.

If the *McDougal* recognition rule is followed, A and B must recognize gain of $30 on the transfer to C of a one-quarter underlying interest in the asset, but A and B are entitled to a $60 deduction ($30 attributable to a one-quarter interest in the asset and $30 attributable to a one-quarter interest in the cash). Thereafter, A and B share $18 of the partnership’s $24 net cash. Their share of the partnership’s already-taxed investment is now only $90 ($120 original basis + $30 gain - $60 deduction). An $18 return on $90 is a 20 percent pretax return. After paying taxes, A and B’s aggregate share of the after-tax cash flow is $10.80, which is a 12 percent rate of return on $90. The after-tax rate of return is the expected 60 percent of the pretax rate of return.

If, however, A and B are allowed a deduction of $60 without recognizing any gain, their share of the partnership’s already-taxed investment is now only $60 ($120 original basis - $60 deduction). A and B’s aggregate after-tax cash flow remains $10.80, but that amount now represents an after-tax rate of return of 18 percent on their $60 share of already-taxed investment. An after-tax rate of return of 18 percent is 90 percent of the 20 percent pretax rate of return. Thus, A and B have an effective tax rate of only 10 percent, not the statutory 40 percent. That analysis clearly reveals that the proposed nonrecognition rule in prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) is incompatible with the proper taxation of capital income realized by the partnership after the admission of the service-provider partner.

The tax arbitrage created under the proposed regulations is not significantly different from the arbitrage to which Congress responded with section 265(a)(1), disallowing deductions for expenses to produce tax-exempt income. It is true that the arbitrage permitted by the

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50 See Gergen, *supra* note 17, at 1488-1490.
51355 F.2d 310 (2d Cir. 1943) (corporation that paid its employee’s bonuses in the form of parent stock purchased on the market recognized gain on the transfer).
52 See *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960) (requiring recognition of gain by a corporation that contributed appreciated property to a qualified pension plan trust).
54 Note that the 10 percent before-tax financial return to value is doubled to 20 percent when expressed as a return of already-taxed investment. That doubling occurs because of the tax advantage effected by the realization requirement in lieu of a mark-to-market regime.
proposed regulations is deferral of gain coupled with a current deduction, rather than exemption coupled with a deduction. But taxes deferred are taxes forgiven, and Congress has recognized that. The deferral of arbitrage is exactly the type of arbitrage that section 163(d) addressed in the years from 1987 through 1991, when capital gains were taxed at the same rate as both interest and dividends. In those years, when investment interest was deductible against all of recognized capital gains, interest, and dividends, the sole function of section 163 was to preclude a current deduction when recognition of gain was deferred. That well illustrates congressional disapproval of the type of arbitrage that would be permitted under the proposed regulations. There is no policy reason or statutory support for allowing such a result through the use of subchapter K.

Yet another analogy is the situation to which section 707 is addressed insofar as disguised payments for services are concerned. If a partnership can pay for services, the cost of which otherwise would be capitalized through special allocations and distributions, the capitalization requirement is sidestepped. That result is inconsistent with the principles of an income tax system. The result of avoiding capitalization of an amount that properly should have been capitalized is to effectively exempt from taxation the yield to the invested capital. That is the result produced under the nonrecognition rule in the proposed regulations.

That analysis applies regardless of whether the partnership is acquiring services or an asset. If the service provider is creating a partnership asset in exchange for the partnership interest, to the extent that the other partners are permitted to capitalize an amount in excess of the sum of their share of the portion of the basis of the partnership’s underlying property proportionate to the transferred interest, plus gain recognized on the transaction, the yield from the partnership’s underlying assets will be taxed at effective rates below the statutory rate. That theory is reflected in the long-standing doctrinal law regarding the “cost” basis of property acquired in an exchange that is not accorded statutory nonrecognition treatment. The raison d’être for assigning a fair market value basis to the property received in such an exchange is that the taxpayer recognized gain on the exchange of the surrendered property. Indeed, that fundamental rule is incorporated into the current regulations under section 83.

The deviation from proper tax principles embodied in prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) inevitably will be exploited by aggressive tax planners, as was recognized by former House Ways and Means Committee Chair Wilbur Mills when questioning Arthur Willis regarding the treatment of the issuance of a partnership interest for services during the 1959 hearings before the House Ways and Means Committee on the advisory group recommendations on subchapters C, J, and K:

I just know that when we treat something differently for tax purposes from what it is in reality we run the risk of getting into difficulty because I have seen these provisions become used far beyond any person’s concept at the time of their enactment. Whenever we tax less than the value involved, as we would under this recommendation, I would think we would be opening the door to the use of partnership arrangements for purposes of reducing taxable income.

Now, while we are still in the midst of the Second Great Tax Shelter War, Wilbur Mills’s advice should be heeded more than ever.

An Old New Alternative?

The tax policy objections to the nonrecognition allowed by the proposed regulations could be avoided by limiting the partnership’s deduction (or capitalized amount) to a pro rata portion of the partnership’s aggregate basis for its assets. That would have been the rule under proposed section 770(c)(3) in the Trust and Partnership Income Tax Revision Act of 1960, which was never enacted. For example, if a service-provider partner is admitted to a partnership that has assets with an aggregate basis of $20 and a fair market value of $200, and is given a capital account of $50, the partnership should be allowed a deduction (or capitalized amount) of only $5 ($20 x $50 / $200). The obvious rationale for the limitation of the deduction to a proportionate share of the partnership’s basis for its assets in proposed section 770(c)(3) was that proposed section 770(b) accorded nonrecognition of gain (or loss) to the partnership on the transfer. That treatment eliminates the tax arbitrage while avoiding current recognition.

While at first blush the nonrecognition/deduction limited to basis model looks to be more administrable,
the administrability advantage actually exists only if the partnership does not revalue the partnership’s property and adjust the partners’ capital accounts to reflect the revaluation under Treas. reg. section 1.704-1(b)(2)(iv)(f). If it does so, all of the calculations necessary to apply the constructive transfer and reclamation model (that is, McDougal) will have been made. Additional complexity might arise with respect to assets subject to section 704(C) or reverse section 704(c) allocations. In those cases, the partnership’s deduction should be allocated among the partners to reflect the net deduction that would have to be allocated to each partner if the constructive transfer and reclamation model had been followed, with gain allocated under section 704(c) to the extent required. Thus, this alternative might not be significantly more administrable in practice.

The proposed regulations are grounded in a wholly spurious analogy to the application of section 1032. The comparison is of apples with oranges.

Nevertheless, even this solution would appear to constitute an attempt to amend the code by regulation. Thus, it suffers from doctrinal legal process defects similar to the proposed regulations. But at least it is not objectionable from a tax policy perspective. Further, taxpayers seeking the safe harbor of nonrecognition under such a regulatory scheme could not be reasonably heard by a court to complain about the concomitant limitation of the deduction (or capitalized amount) to basis.

Conclusion

The proposed regulations providing for nonrecognition to a partnership that issues a partnership interest in exchange for services find no support in statutory construction, the history of the tax treatment of partnerships, or tax policy. The case against the nonrecognition rule in prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) is incontrovertible. Nonrecognition to the other partners when there is a capital shift in favor of an incoming service-provider partner never has been the law. The cash-out-cash-in model has no support in law, theory, or policy. Thus, nonrecognition cannot be justified under the cash-out-cash-in model. Nor can nonrecognition be justified by analogy to section 1032. The proposed regulations are grounded in a wholly spurious analogy to the application of section 1032. The comparison is of apples with oranges. The nonrecognition rule proposed in prop. reg. sections 1.83-6(b) and 1.721-1(b)(2) should be abandoned.

The proposed regulations should not be finalized, but should be revised to eliminate the egregious tax arbitrage they will produce. The final regulations should either require recognition of gain and loss or limit the partnership’s deduction or capitalized amount to a pro rata share of the partnership’s aggregate basis in its assets. The latter alternative has little more support in prior law than the unjustifiable nonrecognition approach in the proposed regulations, but at least it eliminates the tax arbitrage benefits that are conferred on partnerships by the proposed regulations. Finally, if Treasury doesn’t see fit to remedy its own error in the proposed regulations, Congress should step in and resolve the problem by enacting a statutory provision substantially similar to proposed section 770(c) from the Trust and Partnership Income Tax Revision Act of 1960, limiting the partnership’s deduction or capitalized amount to an allocable portion of the partnership’s basis.

Appendix


SEC. 770. INTEREST IN PARTNERSHIP CAPITAL EXchanged for services

(a) Treatment of person performing services. — If a person receives an interest in the capital of a partnership in exchange for the performance of services for the partnership:

(1) the amount determined under subsection (c) shall be included in such person’s gross income, and

(2) an amount equal to such amount shall be deemed to be a contribution by such person to the partnership.

(b) Treatment of Partnership and of Partner Relinquishing Interest. — If any partner relinquishes an interest in the capital of a partnership in exchange for the performance of services for such partnership, no gain or loss shall be recognized to such partner on the relinquishment and, with respect to the amount determined under subsection (c):

(1) the partnership shall be allowed a deduction, to the extent such amount constitutes a trade or business expense (described in section 162(a)) to the partnership, and

(2) the adjusted basis of the partnership properties shall be increased (in accordance with the services performed with respect to each), to the extent such amount constitutes an amount properly chargeable to capital account under section 1016(a)(1).

Any deduction allowable under paragraph (1) shall be allocated among the relinquishing partners (or their successors in interest) on the basis of that portion of such deduction which is attributable to each such partner.

(c) Amount to be taken into account; time when taken into account. —

63Sec., e.g., Boyd v. Commissioner, 122 T.C. 305, Doc 2004-8978, 2004 TNT 82-13 (2004) (taxpayer who did not comply with all of the conditions of a safe harbor revenue procedure could not claim the benefit of the advantageous provisions); Namyst v. Commissioner, T.C. Memo. 2004-263, Doc 2004-22136, 2004 TNT 223-9 (2004) (employee who was not required to return excess expense reimbursement to employer, which is a condition of claiming above-the-line deduction of employee business expenses under Treas. reg. section 1.62-2(f), could not net expenses and reimbursement even though the reimbursement plan was otherwise an accountable plan).
(1) In General—Except as provided in paragraphs (2) and (3), for purposes of subsections (a) and (b) the amount determined under this subsection:

(A) if the interest, at the time of the exchange, is not subject to substantial restrictions or limitations as to its transferability, shall be taken into account at the time of the exchange, and shall be the fair market value of the interest at such time, or

(B) if the interest, at the time of the exchange, is subject to substantial restrictions or limitations as to its transferability, shall be taken into account at the time such restrictions or limitations cease to be substantial or the interest is disposed of (other than by death, where the substantial restrictions or limitations continue), whichever first occurs, and shall be the lesser of

(i) the fair market value of the services, or

(ii) the fair market value the interest would have had at the time of the exchange had there been no such restrictions or limitations.

(2) Reduction of Amount for Unrealized Appreciation in Section 751 Assets.— The amount required to be taken into account under paragraph (1) of this subsection for purposes of subsections (a) and (b) shall be reduced to the extent the fair market value of the interest exchanged is attributable to an excess in the fair market value of section 751 assets over their adjusted basis to the partnership.

(3) Limitation on Deduction Under Subsection (b) (1).—The amount of the deduction under subsection (b) (1) shall not exceed the aggregate amount determined by taking into account, with respect to each relinquishing partner, whichever of the following is the lesser:

(A) his adjusted basis (as of the time of the exchange) in the relinquished interest, or

(B) that portion of the amount determined under paragraph (1) which is attributable to his relinquishment.