Regulations proposed on May 24, 2005, would except capital partnership interests from the requirement that an employer (the partnership) recognize gain or loss on property it transfers to a service provider as compensation.1 Treasury’s explanation of the shift is not very convincing. What were they thinking?

To make a long story relatively short, the proposal would change the state of the law generally from (1) employee recognition of partnership capital interest as compensation and nonrecognition of partnership profits interest as compensation, plus (2) partnership deduction for the amount the employee recognizes, plus (3) partnership recognition of gain or loss on the capital interest paid to the employer; to (1) and (2) the same, but (3) without partnership recognition of gain or loss on the capital interest paid to the employee.

Thus, the big change would be the nonrecognition to the partnership when it transfers property in the form of a capital interest to the employee, the employee recognizes income, and the partnership claims a deduction. The Treasury preamble to the proposal explained the change this way:

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.

Section 721

Section 721 says that neither the partner nor the partnership recognizes gain or loss on the transfer of property to the partnership in exchange for a partnership interest. It is difficult to see how Treasury derived from those words the underlying policy on which it claims to rely.

One could as easily say that section 351 implies that policy, but without section 1032 it is unlikely that the corporation would avoid recognition of gain or loss on the stock it issues to the employee. One could almost as easily extend that policy to deferral of the employee/partner’s recognition of the compensation income.

The General Rule

The proposed approach is, of course, in stark contrast to the general rule of section 83 and its regulations — when an employer transfers property to an employee, not only does the employee recognize compensation income but the employer both deducts the value paid and recognizes any gain or loss on the property transferred.

In the partnership area the big argument always has been whether a partnership profits interest is “property” for that purpose. If it were and the partnership were then liquidated, the new partner presumably would get nothing. The proposal resolves that dispute on the employee side by saying that all partnership interests are taxable property but then allows the partnership to value the interest at current liquidation value, which sort of winds up at the same place as current law: Profits interests have no current liquidating value, and capital interests do or can.

The proposed change to reg. section 1.83-6(b) would add to the sole current exception to the gain recognition rule (for section 1032) the new nonrecognition rule to be provided in proposed reg. section 1.721-1(b). It would state that the partnership will not recognize gain or loss on the transfer of a “compensatory partnership interest.” The proposal applies to both profits and capital interests, but capital interests are the ones for which there actually is a shifting of interests in partnership property that could produce gain recognition to the partnership.

Possibilities

Maybe the proposal is not just the good policy consistency move it claims to be, but rather a practical effort to ease administrability for both the IRS and taxpayers. For example, it would prevent a trap for the unwary partnership that issues the small capital interest for services and has no idea it is supposed to deem that a sale of a fraction of the partnership assets.

Conversely, Treasury might have figured that (1) partnerships are not likely to issue capital interests anyway, but if they do (2) they probably are not going to report the gain on the deemed asset sale, whether accidentally or on purpose, so (3) there is not much to be gained by sticking to a recognition rule.2

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2See “NYSBA Tax Section Comments on Proposed Regs on Exchanges of Partnership Interests for Services,” Doc 2005-22612, 2005 TNT 214-19 (Nov. 7, 2005) (also stating that currently mostly profits interests are issued for services and the authors are not aware of abuses).
Treasury might even view the proposal as removing an unfair impediment to the issuance of capital interests by wary partnerships. Of course the greatest impediment to that issuance is that the service partner will not want to pay tax on receipt of the interest, and that will likely continue to inhibit the use of capital interests (unless and to the extent the service partner’s tax would be low, based on low property valuation).

Another impediment to the use of capital interests is that in theory it necessitates the creation of a capital account for the new partner. Some have complained that the capital account would have to exceed the amount taxed to the partner to make the capital interest economically worth the taxed value. Any such problem could have been solved if Treasury had imputed a cash payment to the service provider, followed by an imputed purchase of the capital interest with the cash.3

But Treasury did not impute a circular flow of cash, and it was wise not to do so. Sometimes a circular flow of cash is posited for purposes of ascertaining an amount realized on a property transfer and also for establishing the amount of basis and deduction — but sometimes an actual circular flow of cash is disregarded under the step transaction doctrine.4 Therefore, the government must be very careful in espousing a circular flow of cash theory. Such a theory — which is, in effect, the rule of the Philadelphia Park case5 — is merely descriptive and not policy-based. Therefore, it might be inappropriate for real life consequences, like capital account consequences, as contrasted with tax consequences, to flow from the construct.

Was Treasury thinking about some other policy? Were they thinking they would extend section 1032 to partnerships (even though they do not mention section 1032 in the proposal’s preamble)? Perhaps the proposal implies some parallelism between sections 721 and 1032, but there is none.

Section 1032

Section 1032 states that a corporation will not recognize gain or loss on the issuance of its stock; that applies even if the corporation is allowed a deduction for the value of stock issued for services. Thus, under the proposal the treatment of a corporation and of a partnership issuing their capital interests for services looks like this:

<table>
<thead>
<tr>
<th>Employer</th>
<th>Compensation Income</th>
<th>Deduction</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Partnership</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>

What a nice parallelism. And perhaps Treasury thinks the lack of gain recognition is even more appropriate in the partnership case because partnerships are even more favored than corporations as easy-to-get-into and easy-to-get-out-of business entities. That approach would fit with what the regulation’s preamble said about the policy of section 721.

The Theory of Section 1032

But wait — the theory that allows the combination of deduction and nonrecognition in section 1032 does not fit at all with section 721.

The ability of a corporation to obtain a deduction for paying compensation with its stock, while at the same time not recognizing gain on that stock, has always seemed a surprising result. We are schooled in the theory that underlies section 83, that the price of deduction from a property transfer is either that the employer has basis in the property to start with, or recognizes gain in it to the extent it does not have basis. Thus, the employer’s basis/gain “pays for” (provides a tax theory justification for) the deduction. Somehow, somewhere in the system, there must always be basis or gain recognition to “pay for” a deduction.6

What pays for the deduction in the section 1032 case? There can be only one answer, because there is only one other source of basis or gain in the system: The income recognized by the employee/shareholder pays for the corporation’s deduction. That reflects a sort of cloning of the attribute of the new shareholders into the corporation, which is entirely consistent with all the other ways that the shareholder and the corporation can clone each other’s tax attributes, all of which flow from the general doubling of tax characteristics “in the world” that always attends incorporation (and does not attend creation of partnerships).7

Conversely, the better reading of current law, such as it is, is that the partnership gets its deduction the old-fashioned way — from its basis in its assets and the gain or loss it recognizes on transferring a piece of them to the employee.8 Unlike the corporation, there is no cloning of a new taxpayer when a partnership is formed. Rather, the partnership is the partners (the aggregate theory) for most purposes.

Prof. McMahon’s View

Prof. McMahon dislikes the proposed partnership nonrecognition rule, just as I do, and believes it shares no common ground with section 1032, but for a different reason.9 He espouses the “present value theory” of

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3See id.
6For a complete analysis of this approach, see Cummings, supra note 5.
7Id.
8Id. at 142.
section 1032 and cites for it an article by Prof. Johnson, as if the theory were received wisdom accepted by all.\textsuperscript{10} It is not.

The Johnson idea is that the value of stock given to an employee is the present value of the future dividend stream from that stock; the corporation will not get a deduction for paying dividends, so it should get a deduction for giving the stock, because it "has a family relationship to a corporate liability."

There are any number of reasons why that theory makes no sense: (1) no one really thinks that the market price of stock is based on the discounted present value of its future dividends (for example, Berkshire Hathaway stock pays no dividends, and neither did Microsoft stock until recently); (2) the corporation is not obligated to pay dividends, which is a critical distinction from debt; (3) this theory in effect allows a deduction for dividends paid; and (4) it present-values deductions, which is generally foreign to the tax law.

All Johnson has really said is that by allowing a deduction for stock paid to employees, and assuming the value of the stock did reflect future dividends, it looks as if the corporation is deducting future dividends. But appearances do not a cogent theory make.

Conclusion

It is entirely consistent with traditional tax policy and theory to require the partnership to recognize gain or loss on partnership property when it transfers a capital interest in the property as pay for services and claims a deduction for the value. That view has not been enough of an impediment to the creation of partnerships and the compensation of service partners to justify suggesting that there is some penumbral policy around section 721 that should preclude that gain recognition.

If Treasury was thinking that it wanted to waive the "right" result for reasons of administrability, it should say so, rather than suggesting new theories about tax policy that can produce unintended results the next time a taxpayer wants to argue the policy of section 721.


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