

INCOME REGULATION OF FUTURE INTERESTS IN PARTNERSHIPS PROFITS AND LOSSES—TAXATION—FEDERAL INCOME TAX —*Diamond v. Commissioner* (T.C. 1970)

It is well established that an interest in partnership capital received as compensation for personal services is taxable income to the recipient in the year in which the capital right is transferred.¹ It had been generally accepted that an interest in future partnership profits and losses was not taxable in the year of receipt.² The Tax Court in *Diamond v. Commissioner*,³ however, determined that income is realized upon receipt of an interest in future partnership profits and losses when such an interest is compensation for services already rendered.

Sol Diamond was a mortgage broker who obtained clients for the Marshall Savings and Loan Association of Illinois. In 1961 he was approached by Phillip Kargman who desired to procure a \$1.1 million full purchase price loan on a specific property in Chicago. Under the agreement between Diamond and Kargman, Diamond received a 60% interest in profits and losses for a term of 24 years as compensation for his aid in procuring this loan. Other pertinent provisions of the agreement termed the relationship a joint venture and provided that all capital was to be furnished by Kargman, who would have sole control over the management of the business and would be entitled to recoup his capital investment upon liquidation prior to the 60-40 distribution of the gain or loss.

1. Treas. Reg. § 1.721-1(b)(1) (1954); see *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *aff'd on rehearing*, 339 F.2d 885 (5th Cir. 1965), *cert. den.*, 380 U.S. 961 (1965).

2. See Bybee, *The Taxwise Ways of Oil and Gas Operations and Sales of Interests*, N.Y.U. 27th INST. ON FED. TAX. 931, 941 (1969); Nassau, *Tax Considerations in Writing Partnership Agreements: Suggested Clauses*, N.Y.U. 26th INST. ON FED. TAX. 125, 129 (1968); Nicholson, *Interests in Partnership Capital Received in Exchange for Services*, N.Y.U. 19th INST. ON FED. TAX. 227, 241 (1961); Weissman, *Problems in Transferring a Partnership Interest as Compensation for Services*, 25 J. TAX. 162 (1966); Whitman, *How a Partner Whose Primary Contribution is Services May Achieve Capital Gain*, N.Y.U. 22d INST. ON FED. TAX. 653 (1964); but see, 2 HOUST. L. REV. 411, 415 n.23, recognizing that there is no specific statutory exclusion from income of an interest in future profits and therefore this position may be without authority.

3. *Diamond v. Comm.*, Nos. 3260-65, 2989-66 (56 T.C. —, No. 42, June 21, 1971) [hereinafter cited as *Diamond*].

Diamond sold this interest three weeks after the execution of the contract and reported the sales price as a short-term capital gain.⁴ The Tax Court upheld the Commissioner's contention that the sales price was ordinary income and not capital gain. In denying capital gains treatment the Tax Court held that a future interest in partnership profits and losses was taxable to the extent of the fair market value immediately upon receipt of such interest.

The holding is objectionable on three grounds. First, the court's interpretation of section 1.721 of the Regulations is arguably not shared by either the Treasury or the Congress; second, the valuation of such an interest will create difficulties and inequities; and third, the holding was not necessary to reach the result the court desired. In addition, the effect of the 1969 Tax Reform Act must be considered to ascertain the current treatment of the interests discussed in *Diamond*.

Mr. Diamond contended that a taxpayer who receives a partnership interest as compensation for services is required to account for that interest as ordinary income only if he receives an interest in partnership capital, but not if he receives only the right to share in the partnership's future profits and losses. He relied primarily upon section 721⁵ as interpreted by 1.721-1(b)(1) of the Regulations.⁶

Section 721 provides that no gain or loss will be recognized to a partner when he contributes property in exchange for an interest in

4. The reclassification of this item as ordinary income resulted in a deficiency because it thereby became unavailable to absorb a reported short-term capital loss which was then required to be used as an off-set against a reported long-term capital gain.

Other issues not discussed in this article were Diamond's attempted deduction as business expenses of payments remitted to Marshall Savings and Loan.

5. INT. REV. CODE OF 1954 § 721 provides:

SEC. 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION

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.

All section references in the text are to the INT. REV. CODE OF 1954.

6. Treas. Reg. § 1.721-1(b)(1) (1954)
REGULATIONS SEC. 1.721-1

(b)(1) Normally under local law, each partner is entitled to be repaid his contributions 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 the 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 partnership so transferred to a partner as compensation for services constitutes income to the partner under section 61 . . .

the partnership. Section 1.721-1(b)(1) of the Regulations states that section 721 does not apply "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*."⁷

In examining the parenthetical phrase in the Regulations, the court commented:

[A]lthough the meaning of the phrase was obscure, it at most excludes that type of situation from the rule which the regulations affirmatively set forth in respect of readjustments of capital interests; but [section 721] does not deal one way or another with situations described in the parenthetical phrase.⁸

In effect, the Tax Court is stating that the interest in future profits and losses given *as compensation for services rendered* were never intended to fall within section 721 and that the parenthetical phrase does not bar the immediate recognition of ordinary income. Thus, consistency necessitates the inclusion in income of both capital and future profit and loss interests when given for services rendered.

However, it can be argued that the parenthetical phrase indicates that the Treasury sees a distinction between these two types of interests sufficient to require a different treatment; namely, that an interest in future profits and losses need not be recognized immediately as ordinary income. The court, in fact, intimates that there may be some kind "of equitable justification for giving the parenthetical clause some limited form of affirmative operative scope, as perhaps where there is a readjustment of partner's shares to reflect 'current' services being performed by one of the partners."⁹

Since it appears the Treasury may make such a distinction, it is necessary to determine if Congress intended capital interests and future profit and loss interests to be treated differently. Section 721 was primarily a codification of pre-existing case law.¹⁰ No specific indication of legislative intent can be drawn from the committee reports during the formation of this section. However, an indication of intent for section 721 may be inferred from pro-

7. *Id.*

8. *Diamond*, *supra* note 3.

9. *Id.*

10. H.R. REP. No. 1337, 83rd Cong., 2d Sess. 1 (1954); S. REP. No. 1622, 83rd Cong., 2d Sess. 1 (1954).

posed section 770 covering the same subject matter.¹¹ Section 770 was introduced in 1960 and passed by the House of Representa-

11. H.R. 9662, 86th Cong., 2d Sess. (1960). Proposed sec. 770, INT. REV. CODE states:

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.*—

(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 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.

tives,¹² but the bill was tabled by the Senate for reasons apparently unrelated to the bill or to this specific provision.¹³

Proposed section 770 dealt with the transfer of partnership *capital* as compensation for services rendered. In addition to treating the interest in capital as ordinary income, the section provided the method for handling the partnership deduction of such a transfer. It valued the capital interest at the lower of the fair market value or the value subject to restrictions upon transferability.¹⁴

This section was also intended (as was 721) to provide a clear statutory basis for existing case law.¹⁵ This time, however, an indication of congressional understanding of the existing case law is found in the committee reports concerning the proposed legislation.

The Senate committee report on 770 showed that the section is to apply to capital interests only. If "such a service partner had acquired only an interest in the appreciation of assets occurring subsequent to his admission and in profits of the partnership earned after such time, the rule of 770 would have no application."¹⁶ A congressional intent to differentiate between interests in future profits and losses and interests in capital is therefore evident.

Since these interests were to be treated differently under 770, the difference had to be in recognition of income to the recipient. If also excluded from the non-recognition provisions of 721, the value of the interests would then be immediately included in gross income under section 61.¹⁷

The Supreme Court has broadly construed section 61. It has held that gross income even for a cash basis taxpayer was not limited to cash, but included the fair market value of other items received.¹⁸

12. CONG. REC.: H. RES. 436, 86th Cong., 2d Sess., 106 CONG. REC. 2112 (1960).

13. Nicholson, *Interest in Partnership Capital Received in Exchange for Services*, N.Y.U. 19th INST. ON FED. TAX. 235, 239 (1961).

14. See note 11, *supra*.

15. H.R. REP. NO. 1231, 86th Cong., 2d Sess. 1 (1960); S. REP. NO. 1622, 86th Cong., 2d Sess. 1 (1960).

16. *Id.*

17. INT. REV. CODE OF 1954, § 61.

18. *Helvering v. Bruun*, 309 U.S. 461 (1939); See also, *LoBue v. United States*, 351 U.S. 243 (1956).

The test for recognition by the cash basis taxpayer has been expanded to a factual question of "equivalency to cash," with the item included as ordinary income to the extent of its fair market value.¹⁹ If applied to interests in future profits and losses, such an interpretation would accord essentially the same treatment as is currently accorded capital interest under 1.721-1(b)(1) of the Regulations. But such treatment would be opposed to presumed congressional intent to treat these interests differently evidenced by section 770 and to the intent of the Treasury evidenced by the Regulations.

The second objection to the Tax Court's holding in *Diamond* is the problem of valuation. In *Pounds v. U.S.*,²⁰ the taxpayer, a real estate agent, received a percentage of the future profit upon resale of the property in lieu of commission. The Court of Appeals held that ordinary income could not be converted into capital gains by measuring the value of compensation in terms of possible profits from the future sale of land. The court also acknowledges the recognition problem, holding that the taxpayer was not required to recognize the value of the right received until the property was resold. It noted:

[A] serious valuation problem would accrue in determining the present value of a right to receive future profits on real estate under the control of a third person and that under-evaluation *would* allow income clearly taxable at ordinary rate to be treated improperly as capital appreciation [upon sale of the interest].²¹

Other courts faced with a valuation problem have postponed income recognition until the taxpayer recovers his basis.²² The effect of such a view would be to treat the income from future profit and loss interests as ordinary income when the profit or loss for each taxable year was recognized. This provides a treatment different from that of a capital interest, the value of which is recognized when the interest itself (as opposed to the income from that interest) is received. This treatment would be in accord with the congressional and Treasury intent discussed above.

However, the Tax Court's position (that the fair market value of an interest in future profit and losses must be recognized as ordinary income when received) can be supported for the following reasons. First, section 721 requires a contribution of *property* to the partnership in exchange for an interest in the partnership. In the

19. *Cowden v. Comm.*, 289 F.2d 20, 24 (5th Cir. 1961).

20. 372 F.2d 342 (5th Cir. 1967).

21. *Id.* at 347-8.

22. See *Burnett v. Logan*, 283 U.S. 404 (1931) (sale of stock for per ton iron royalty); *Comm. v. Kann's Estate*, 174 F.2d 357 (3rd Cir. 1949) (sale of stock for private annuity); *Comm. v. Carter*, 170 F.2d 911 (2d Cir. 1948).

tax sense, property has generally been held not to include the right to be compensated for personal services.²³

Secondly, as previously mentioned, section 61 is to be read broadly and that in the absence of an express provision excluding it, that income shall be recognized. Here, the taxpayer had received something of value (a right to future profits) and in some way should be required to recognize this income when received.²⁴

Third, the valuation problem would be alleviated by using the value of the services rendered, thus assessing the future right by indirect but otherwise acceptable means.²⁵ The trend in the courts, moreover, has been towards requiring immediate recognition even in questions concerning difficult valuation problems.²⁶

Finally, the immediate recognition would follow generally accepted accounting principles by more closely matching revenue with the period in which it was earned.

The third objection to the holding in *Diamond* is that the court considered an unnecessary issue, when it decided whether the partnership interest had to be reported as ordinary income when received. The pertinent issue was really whether the proceeds received on the sale of the interest was ordinary income or capital gain. Even if *Diamond's* interest was not recognized under section 721 when received, he should not have been accorded capital gains treatment upon the ultimate sale.

The Tax Court disregarded the well-settled rationale available to them, as exemplified by *Hort v. Commissioner* and subsequent cases which dealt solely with the question of capital gains treatment versus ordinary income. This approach is better suited to the fact question involved.

23. See WILLIS, PARTNERSHIP TAXATION 55 (1957); INT. REV. CODE OF 1954 § 351; *Diamond*, *supra* note 3 at n.14.

24. See note 18, *supra*.

25. *United States v. Davis*, 370 U.S. 65 (1962) (valuing marital status by amount of divorce settlement).

26. *Kleberg v. Comm.*, 43 B.T.A. 277 (1941), enunciated the old rule that there must be a note, bond, or other evidence of indebtedness, but *Cowden v. Comm.*, 289 F.2d 20 (5th Cir. 1961) expanded the test to a factual question of "equivalency to cash". See also *United States v. Davis*, 370 U.S. 65 (1962); and INT. REV. CODE OF 1954 § 83, note 34 *infra*. But see *Robinson v. Comm.*, 44 T.C. 20 (1965); *Edelman v. United States*, 329 F.2d 950 (Ct. Cl. 1962).

In *Hort v. Commissioner*, the Court held that a lump sum payment received as compensation for a release from future rent payments was ordinary income and not capital gain.²⁷ A similar position was adopted in *Jamison v. U.S.*, where the District Court held:

. . . Amounts received by a taxpayer in exchange for a contractual right to receive future payments constitutes ordinary income, and must be treated as ordinary income, even though as stated in *Hort* the contractual right could be treated as property for some purposes.²⁸

*Pounds v. U.S.*²⁹ extended this principle directly to rights to future profits and losses received as compensation for services. *Wilkinson v. U.S.* enunciated the general principle, stating broadly that "future income can't be converted into capital gains."³⁰

Even in *U.S. v. Frazell*,³¹ relied on by the Tax Court in *Diamond*,³² the Fifth Circuit had no difficulty holding that the recipient of a partnership interest could not claim capital gains treatment since the interest was given for services rendered in an oil exploration venture. The court reached their decision without reference to the interest in future profits and losses inherent in the interest received. In fact, the court specifically omitted (by use of ellipses) that portion of 1.721-1(b) (1) dealing with future profit and loss interests.³³

When received for services after 1969, the treatment of these interests is further complicated by the addition of section 83.³⁴ This section covers property received in connection with the performance of services. It provides that the fair market value of property transferred in exchange for the services shall be included in the gross income of the recipient in the taxable year in which the transfer is complete.

27. 313 U.S. 28 (1941).

28. 297 F. Supp. 221, 225 (N.D. Cal. 1968).

29. See note 20, *supra*.

30. 304 F.2d 469, 474 (Ct. Cl. 1962).

31. See note 1, *supra*.

32. *Diamond*, *supra* note 3.

33. *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964). See note 1 and 31, *supra*.

34. INT. REV. CODE OF 1954, § 83 states:

SEC. 83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) General rule.—If, in connection with the performance of services, property 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 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, . . .

(e) Applicability of section.—This section shall not apply to—

(1) a transaction to which section 421 applies.

For the purposes of this section, property is defined to include both realty and personalty other than money and an unfunded or unsecured promise to pay deferred compensation.³⁵ The section makes no distinction between capital interests and profit and loss interests. If each is considered property, then the receipt of either one should produce taxable income.

Several arguments can be made against the applicability of section 83 to one or both types of interests. In the first place, without any specific reference to partnership interests in section 83 committee reports, section 770 congressional intent, previously discussed, should control to treat profit and loss interests differently.³⁶ This result is not possible if both interests are included within section 83.

Moreover, despite the broad definition of property under section 83, the promise to pay future profits could be considered an unsecured or unfunded promise to pay deferred compensation and therefore excluded. The exclusion of these interests as unfunded or unsecured should be controlled by the facts of the transaction. Rights to future profits are generally not funded in any way prior to distribution by the partnership.

And finally, unlike corporate stock, the right to future partnership profits may exist *independently* of an interest in partnership capital and therefore be much more difficult to value. Section 83 does take note of some valuation problems by excluding from immediate recognition the value of stock options (funded or unfunded) where the market value is not readily ascertainable.³⁷ However, it makes no such provision for other types of property. In the absence

(2) a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2).

(3) the transfer of an option without a readily ascertainable fair market value, or

(4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant.

35. Proposed Treas. Reg. § 1.83-3(e), 36 Fed. Reg. 10788 (1971) states:

(e) *Property*. For purposes of section 83 and the regulations thereunder, the term "property" includes both realty and personalty other than money and other than an unfunded and unsecured promise to pay deferred compensation.

36. H.R. REP. No. 552, 91st Cong., 1st Sess. 1 (1969); S. REP. No. 413, 91st Cong., 1st Sess. 1 (1969).

37. Proposed Treas. Reg. § 1.83, see note 35, *supra*.

of a clear legislative intent to the contrary, it can be argued that the exception should be extended to include profit and loss interests.

The current treatment of future profit and loss interests is dependent upon the applicability of section 83. If this section is applicable to these interests, *Diamond* has no value as precedent to cases arising subsequent to 1969. The income from these interests would be recognized upon receipt of the interest itself.

Even if section 83 is found to be inapplicable, the holding in *Diamond* is of questionable value. Although the Tax Court was justified in rejecting the generally accepted interpretation that future profit and loss interests were included under the non-recognition provisions of section 721,³⁸ it went too far in its holding. For the reasons previously discussed it does not necessarily follow that the exclusion from section 721 requires the interests to be immediately recognized as ordinary income. In fact, it is quite possible that the rationale of the general acceptance of section 721 applicability³⁹ was based upon these reasons and not upon a thorough study of the statutory basis, since the effect of either theory is deferral of recognition.

The value of *Diamond* as precedent is further minimized by the nature of the case itself. Mr. Diamond's frequent trips to the Tax Court⁴⁰ and the Commissioner's contention that Diamond's dealings with Marshall Savings and Loan "constituted a criminal violation under section 1006 Title 16 of the U.S. Code"⁴¹ may have influenced the Tax Court's decision.

The holding in *Diamond* should not be considered as conclusive and that immediate inclusion of the fair market value of future partnership profit and loss interests should be challenged.

S. F. POUCHER

38. See note 2, *supra*.

39. *Id.*

40. *Diamond v. Comm.*, 22 T.C.M. 229 (1963).

41. *Diamond*, *supra* note 3 at n.11.