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SECTION 83 APPLIED TO PARTNERSHIP TRANSACTIONS: THE ROAD TO CERTAINTY IN PLANNING AND CONTROLLING THE TAX CONSEQUENCES OF EXCHANGES OF PARTNERSHIP INTERESTS FOR SERVICES

CHARLES R. GEHRKE

I. INTRODUCTION

Since the mid-1960's, the law of taxation regarding the receipt of a partnership interest in exchange for services has been an unsettled area, fraught with uncertainty, and filled with pitfalls for the unwary. In 1969, as part of the Tax Reform Act, Congress added to the confusion in the general state of the law through passage of section 83 with the apparent intent that it would apply to subchapter K of the Internal Revenue Code.[1] Nine years later, in 1978, the Treasury Department issued final regulations governing the tax treatment of property transferred in connection with services, with the caveat that "[s]pecial rules . . . concerning the treatment of transfers of partnership interests under section 721 of the Code are not adopted . . . and remain outstanding on notice."[2] This Comment examines the general development of tax law in partnership transactions and discusses the application of section 83 to partnership transactions.

One theme that has been consistently present through the years is the disparity of tax treatment given to the receipt of interests in partnership profits and the receipt of interests in partnership capital. The fundamental differences afforded these two distinct transactions are suggested in the current regulations under section 721.[3]

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1. Although the congressional committee reports do not specifically discuss the applicability of section 83 to partnership transactions, most commentators feel that the broad language of the section was meant to apply to all compensatory transfers of property. *See generally* W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS § 5.08 (1977) [hereinafter cited as MCKEE, NELSON & WHITMIRE]; A. WILLIS, J. PENNELL & P. POSTLEWAITE, PARTNERSHIP TAXATION §§ 26.01-.06 (3d ed. 1981) [hereinafter cited as WILLIS, PENNELL & POSTLEWAITE]; Banoff, *Conversions of Services Into Property Interests: Choice of Form of Business*, 61 TAXES 844, 849-50 (1983) (while Banoff agrees that § 83 applies to a receipt of partnership capital interest for services, he states that § 83 probably does not apply to the receipt of a partnership profits interest for services).

2. T.D. 7554, 1978-2 C.B. 71, 72. The proposal which remained outstanding was an amendment to Treas. Reg. § 1.721- 1(b)(1) (1960) containing an "explicit recognition" of a distinction between the receipt of capital interests and profits interests. WILLIS, PENNELL & POSTLEWAITE, *supra* note 1, § 26.04.

3. See Treas. Reg. § 1.721-1(b)(1), which states in part: "To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from

In view of this distinction, this Comment places particular emphasis on planning opportunities in the following four scenarios:

(1) Receipt of a partnership capital interest for past services and without a substanial risk of forfeiture;
(2) Receipt of a partnership capital interest for future services or subject to a substantial risk of forfeiture;
(3) Receipt of an interest in partnership profits for past services and without a substantial risk of forfeiture; and
(4) Receipt of an interest in partnership profits for future services or subject to a substantial risk of forfeiture.

II. Historical Perspective And General Background

As a starting point, it is important to develop an understanding of the distinctions drawn between a "profits interest" and a "capital interest" in partnerships. Most commentators are in agreement that a capital interest may be defined as "any interest which would entitle the holder to receive a share of partnership assets upon a hypothetical winding up and liquidation of the partnership immediately following acquisition of the interest."[4] A "profits interest" is a residual category which describes "any interest that does not entitle the holder to a share of the existing *value* of partnership assets."[5] These definitions are based in part on section 721 regulations which distinguish between transactions in which a partner "gives up any part of his right to be repaid his contributions" and those where he merely gives up "a share in partnership profits."[6] Further support for this distinction may be found in the family partnership provisions which define a capital interest as "an interest in the assets of the partnership, which is distributable to the owner . . . upon liquidation of the partnership." These provisions then go on to distinguish such an interest from the "mere right to participate in the earnings and profits of a partnership."[7]

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a share in partnership profits) in favor of another partner as compensation for services . . . section 721 does not apply."

4. McKee, Nelson & Whitmire, *supra* note 1, § 5.05[1]; *see also* American Law Institute, Federal Income Tax Project, Subchapter K, Proposals on the Taxation of Partners 143-164 (1984) [hereinafter cited ALI Proposals].

5. McKee, Nelson & Whitmire, *supra* note 1, § 5.05[1]; *see also* ALI Proposals, *supra* note 4, at 146.

6. Treas. Reg. § 1.721-1(b)(1). *See* McKee, Nelson & Whitmire, *supra* note 1, § 5.05[1].

7. Treas. Reg. § 1.704-1(e)(1)(v) (1960).

A. *Development of the Law Relating to the Transfer of a Capital Interest*

Although section 83 was not added to the Code until 1969, a complete discussion of the law relating to the exchange of an interest in partnership capital for services must begin with *United States v. Frazell*,[8] a 1964 Fifth Circuit case. William Frazell was a geologist who, in 1951, entered into a contract with two investors under which he agreed to contribute the use of certain oil maps and to supervise the exploration and development of various oil and gas properties. The investors, in turn, were to supply all the necessary venture capital for the project. In return for his services, Frazell was to receive a monthly salary, plus expenses, and specified interests in the property acquired.[9] However, the agreement specified that Frazell would not be entitled to, or be considered as owning, any interest in the properties until the investors had recovered their full costs and expenses relating to the acquisition and development of the properties.[10] In April 1955, after the venture proved successful, the 1951 contract was terminated, and the properties were transferred to W.W.F. Corporation. Frazell received from the corporation 13% of the W.W.F. stock, having a fair market value of $91,000. However, Frazell reported no taxable income on this transaction under the theory that the receipt of the W.W.F. stock was a tax-free exchange within the terms of section 351(a) of the Internal Revenue Code of 1954.[11] The court held that the value of the stock received in 1955 was taxable to Frazell under two alternative theories: (1) Frazell's partnership interest became possessory in 1955 upon the termination of the 1951 contract and was thus taxable to him under Treasury Regulation section 1.721(b)(1); or (2) Frazell received the stock in substitution for the originally contemplated partnership interest and thus received compensation for services which would be taxable under section 351(a).[12]

Though the subject of considerable debate, the better rationale appears to be the first one set out above. Viewed in this light, the *Frazell* rule may be succinctly stated as follows: "An individual who receives an unrestricted partnership capital interest for ser-

8. 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965).

9. *Id.* at 490.

10. *Id.*

11. *Id.* at 489.

12. *Id.* at 490. However, Frazell would not be taxed on stock he could prove was attributable to his contribution of maps to the venture. *Id.* at 491.

vices is taxable upon the fair market value of the interest at the time of receipt."[13]

In 1974, the Eighth Circuit faced the issue of how to treat the receipt of a partnership capital interest in exchange for services in the case of *Vestal v. United States*.[14] Although decided after the enactment of section 83, the case dealt with pre-1969 transactions, and thus section 83 was not applicable. Jack Vestal was a consulting engineer and geologist who, in 1962, received contractual rights to receive in the future a fractional share of a partnership in a Canadian oil and gas field development in return for services rendered to some of the limited partners in the development venture.[15] The contract stipulated that Vestal would receive his interest only after the limited partners had fully recovered their investment. The receipt of his interest was further conditioned upon his obtaining the consent of the general partners in the development partnership Olds, Ltd.[16] The oil and gas rights were subsequently sold, and Vestal received payments of almost $140,000 over a three-year period "in satisfaction of his contract rights to obtain a partnership share of the oil and gas field." Vestal sought to treat these sums as capital gains. The Commissioner of Internal Revenue denied the claims.[17] Noting that the contract called for future payments, which were conditional and rested in part upon speculative factors, and applying the general rule that "compensation is not deemed to be paid until the taxpayer actually or constructively receives the property,"[18] the court held that the $140,000 in payments should be taxed as ordinary income when received.[19] The court rejected Vestal's after-the-fact claim that he received income from, and a basis in, the contract rights obtained in 1962.[20] This rejection rested in large part on what the

13. McKee, Nelson & Whitmire, *supra* note 1, § 5.02[1]. For a thorough discussion, see Willis, Pennel & Postlewaite, *supra* note 1, § 26.03. The authors state that "the provisions [of the contract] make it abundantly clear that no property interest was transferred to Frazell in 1951." They go on to state that the property interest conditionally transferred in 1951 was compensation for services and that the court was correct in holding that the value of the stock received by Frazell in 1955 was compensation. In conclusion, they state that "[n]o § 351(a) exchange was involved as to Frazell because he did not transfer 'property' to the corporation." *Id.*

14. 498 F.2d 487 (8th Cir. 1974).

15. *Id.* at 488.

16. *Id.* at 489.

17. *Id.* at 488.

18. *Id.* at 491.

19. *Id.* at 494.

20. *Id.*

court deemed "a very serious valuation problem . . . in attempting to value the contract rights in 1962."[21]

Taken together, the *Frazell* and *Vestal* holdings may be said to stand for the following propositions:

> (1) An individual who receives a partnership capital interest in exchange for services is taxable upon the fair market value of the interest at the time of receipt when there is no substantial risk of forfeiture involved.
>
> (2) An individual who receives a partnership capital interest in exchange for services is not taxable upon the fair market value of the interest at the time of receipt when there is a substantial risk of forfeiture involved; instead the transaction is "held open," and taxable income is recognized at the time the payments are actually received.

At first blush, such a scheme seems designed to protect the taxpayer, and in fact it does so in those cases where the venture ultimately fails. However, such treatment is a two-edged sword, and the "open transaction doctrine" may in some instances be utilized by the Commissioner to convert capital gains or other tax-favored income into ordinary income by characterizing it as compensation.[22]

B. Development of the Law Relating to the Transfer of an Interest in Profits

Prior to 1971, the consensus among commentators and practitioners was that the receipt of an interest in partnership profits as compensation for services was not a taxable event.[23] This consensus was based in part on the negative implication of the oft-quoted

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21. *Id.* at 493; *see also* WILLIS, PENNELL & POSTLEWAITE, *supra* note 1, § 26.03.

22. MCKEE, NELSON & WHITMIRE, *supra* note 1, § 5.06[3]. The authors further suggest that such an approach conflicts with requirements of § 702 that partnership income be characterized at the partnership level. *Id.* The "open transaction doctrine" refers to the Commissioner's position that when not enough has happened to complete the transfer of a partnership interest, the transaction should be held "open" so that the subsequent receipt of all monies may be characterized as compensation income rather than as capital gains or as distributions to a partner. For a thorough discussion of the doctrine, see Robinson, *infra* note 35, at 262.

23. *See, e.g.*, B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 85.3.4 (1981); MCKEE, NELSON & WHITMIRE, *supra* note 1, § 5.05[2]; WILLIS, PENNELL & POSTLEWAITE, *supra* note 1, §§ 27.01-.09.

Treasury Regulation section 1.721-1(b)(1) parenthetical[24] and in part on the practical problems associated with valuing and accounting for such an interest.[25] Then, in 1971, the Tax Court shocked both practitioners and commentators[26] with its decision in *Diamond v. Commissioner*,[27] which was later affirmed by the Seventh Circuit.[28]

Sol Diamond was a mortgage broker who helped Philip Kargman obtain financing for an office building in 1961. In exchange for these services, Diamond was to receive a 60% interest in all of the profits (or losses) of the joint venture.[29] Three weeks after the building was purchased, Diamond sold his interest for $40,000 and reported the receipt of these monies as a short-term capital gain resulting from the sale of a partnership interest. The Commissioner determined that the sales proceeds were compensation and thus taxable as ordinary income.[30] In a unanimous decision, the Tax Court rejected Diamond's argument that under Treasury Regulation section 1.721-1(b)(1) the receipt of a partnership profits interest was not a taxable event. In so doing, the court stated, "[T]he regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefor by giving him an interest in a partnership that came into being at a later date."[31] The court went on to say, "[W]e cannot believe that the regulations were ever intended to bring section 721 into play in a situation like the one before us."[32] While acknowledging certain practical problems in treating "the creation of profit-share as income," the Seventh Circuit chose to defer to the expertise of the Tax Court and to sustain its decision "that the receipt of a profit-share *with determinable market value* is income."[33]

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24. The referenced parenthetical is as follows: "(as distinguished from a share in partnership profits)." Treas. Reg. § 1.721-1(b)(1) (1960).

25. McKee, Nelson & Whitmire, *supra* note 1, § 5.05[2].

26. *See, e.g.*, Willis, Pennell & Postlewaite, *supra* note 1, §§ 27.01-.09; Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The* Diamond *Case*, 27 Tax L. Rev. 161 (1972).

27. 56 T.C. 530 (1971).

28. Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).

29. 56 T.C. at 536-37.

30. *Id.* at 539.

31. *Id.* at 546.

32. *Id.*

33. 492 F.2d at 291 (emphasis added); *see also* McKee, Nelson & Whitmire, *supra* note 1, § 5.05[3] (authors suggest that the Seventh Circuit decision might be viewed as limiting *Diamond* to situations where the profits interest has a readily ascertainable market value).

Struggling with the *Diamond* decision, commentators have suggested at one extreme that "bad fact situations generate bad case law"[34] and at the other that the decision is a taxpayer victory "which prevents application of the 'open transaction' doctrine."[35] Additionally, commentators have suggested that the decision should be limited to its unique facts[36] and that there are "indications that the IRS will not follow the case . . . [and that] the courts may disregard its existence."[37]

One of the strongest indications of the limited scope of the *Diamond* decision is in the case of *Wheeler v. Commissioner*,[38] decided four years after the Seventh Circuit affirmed the Tax Court's decision in *Diamond.* Richard Wheeler was a real estate developer who agreed to participate in a joint venture with Ainslie Perrault. Under this agreement, Perrault was to supply the necessary capital, and Wheeler the necessary expertise. The agreement stipulated that after Perrault had recovered his original investment plus 6% interest, Wheeler would be entitled to 25% of any remaining profits.[39] In 1968, some of the properties were sold, and Wheeler reported his share of the proceeds as long-term capital gain. In challenging this treatment, the Commissioner made no mention of *Diamond* but instead argued that Wheeler was a mere employee of Perrault and that no partnership existed.[40] The court, also making no mention of *Diamond*, held that Wheeler owned a property interest under the joint venture agreement and thus was entitled to capital gains treatment.[41]

Both the *Diamond* and the *Wheeler* cases, though decided after the passage of section 83, involved pre-1969 transactions and thus contain no discussion of the possible applicability of section 83. Superficially, at least, the results in these two cases appear to be at odds with one another. At a deeper level, however, the two cases may be reconciled and may be said to stand for the following

34. WILLIS, PENNELL & POSTLEWAITE, *supra* note 1, § 27.03.

35. Robinson, Diamond's *Legacy—A New Perspective on the* Sol Diamond *Decision*, 61 TAXES 259, 260 (1983).

36. Banoff, *supra* note 1, at 855. Commonly mentioned limiting factors include the following: (1) the services were performed over a short period of time and completed before the profits interest was transferred; (2) the interest had a readily ascertainable market value; and (3) the interest was sold quickly after acquisition for cash. *Id.*

37. *Id.* (footnotes omitted).

38. 37 T.C.M. (CCH) 883 (1978).

39. *Id.* at 884.

40. *Id.* at 886.

41. *Id.* at 891.

propositions:

> (1) In *Diamond*, the receipt of a partnership profits interest with a readily ascertainable value and without substantial restrictions on transfer, in exchange for past services, gives rise to taxable income at the time of receipt.[42]
> (2) In *Wheeler*, the receipt of a partnership profits interest in exchange for future services, or when valuation is difficult, may or may not create taxable income at the time of receipt, but such an arrangement does constitute a partnership and does create a property interest at the time of receipt.[43]

III. Section 83

A. *The Statute and Regulations*

In 1969, as part of the Tax Reform Act and in an effort to provide comprehensive guidelines for the treatment of transfers of property interests in exchange for services, Congress added section 83 to the Internal Revenue Code.[44] Section 83 prescribes the tax consequences for all "transfers" of "property" made "in connection with the performance of services."[45] In general, the statute provides that the excess of the fair market value over the amount paid for such property shall be included in the gross income of the person performing the services in the "first taxable year in which the rights . . . in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable."[46] The statute goes on to provide for an election, to be made within thirty days after the transfer, whereby the recipient of the property may include in gross income in the year of receipt an amount equal to the fair market value of the property less any amount paid for it, notwithstanding the fact that the property is not freely transfera-

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42. *See supra* notes 30-33 and accompanying text.
43. *See supra* notes 38-41 and accompanying text. Insofar as the Commissioner chose not to raise "receipt of a partnership interest as compensation" as an issue, the *Wheeler* decision makes no mention of whether such a transaction gives rise to taxable income at the time of receipt or at some point in the future when valuation difficulties have disappeared.
44. Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a), 83 Stat. 487, 588-90 (codified at I.R.C. § 83 (1982)); *see supra* note 1 and accompanying text.
45. I.R.C. § 83(a) (1982).
46. *Id.*

ble or remains subject to a substantial risk of forfeiture.[47] The statute further states that the rights in the property are subject to a substantial risk of forfeiture if the rights are "conditioned upon the future performance of substantial services by any individual"[48] and that the rights are transferable only if they are not subject to a substantial risk of forfeiture in the hands of the transferee.[49] The statute also contains a list of transactions to which section 83 does not apply.[50] Conspicuously absent from these provisions is any mention of subchapter K transactions, lending further credence to the generally accepted view that section 83 was indeed intended to apply to partnership transactions. Finally, the statute provides that the person for whom services were performed is entitled to "a deduction under section 162" in an amount equal to the amount included in the gross income of the person who performed such services.[51]

In 1978, the Treasury Department adopted final regulations relating to section 83.[52] Of particular importance to this discussion are various definitions which clarify when and how the statute will apply. First, the regulations state that "a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction . . .)."[53] The regulations further define the term "property" to include "real and personal property other than money or an unfunded and unsecured promise to pay money in the future."[54] Property is transferred in connection with services if done "in recognition of the performance of, or the refraining from performance of, services," and this transfer "is subject to Section 83 whether such transfer is in respect of past, present, or future services."[55] Deductions by the transferor are available "only to the extent such amount meets the require-

47. *Id.* § 83(b) (1982). While this election affords significant planning opportunities by allowing the taxpayer to time his recognition of income and to perhaps minimize the amount of gross income realized through early recognition, taking the election is not without risk. The section further stipulates that, in the event such an election is made and the property is subsequently forfeited, "no deduction shall be allowed in respect of such forfeiture." *Id.* § 83(b)(1).

48. *Id.* § 83(c)(1).

49. *Id.* § 83(c)(2).

50. *Id.* § 83(e).

51. *Id.* § 83(h).

52. *See supra* note 2 and accompanying text.

53. Treas. Reg. § 1.83-3(a)(1) (1978).

54. *Id.* § 1.83-3(e).

55. *Id.* § 1.83-3(f).

ments of sections 162 or 212."[56] No deduction is allowed "to the extent that the transfer of property constitutes a capital expenditure."[57] Finally, the regulations state: "Except as provided in section 1032, . . . the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property."[58]

This Comment has focused on these areas of the statute and the accompanying regulations because most of the controversy surrounding taxation of the receipt of a partnership interest entails whether a "property interest" has been received and whether (or when) a "transfer" has actually occurred.[59] Of critical importance is the issue of whether the property was received in connection with services or whether it was exchanged for other property, thus bringing the transaction within the scope of section 721.[60] In light of the unique nature of partnerships[61] and the great flexibility as-

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56. *Id.* § 1.83-6(a)(1).

57. *Id.* § 1.83-6(a)(4).

58. *Id.* § 1.83-6(b).

59. In addition to being of critical importance in determining the impact of § 83 on partnership transactions, these same issues were important to courts in cases decided before the enactment of § 83. See, e.g., Vestal v. United States, 498 F.2d 487 (8th Cir. 1974), and United States v. Frazell, 335 F.2d 487 (5th Cir. 1964) where much of the discussion centered on *when* the property interest was actually transferred; see also Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978), where much of the discussion focused on whether the agreement conferred in Wheeler an actual property interest.

60. Section 721 provides in general that the receipt of a partnership interest in exchange for property is a non-taxable event. This may afford some relief from strict application of the § 83 recognition rules where an individual is successful in converting his "services" to a "property interest". *See, e.g.*, Stafford v. United States, 435 F. Supp. 1036 (M.D. Ga. 1977), *rev'd*, 611 F.2d 990 (5th Cir. 1980), *on remand*, 552 F. Supp. 311 (M.D. Ga. 1982), *rev'd*, 727 F.2d 1043 (11th Cir. 1984). In *Stafford*, the taxpayer argued that his services ripened into a property interest in the form of a favorable lease and loan arrangement that was then assigned to the partnership. The district court granted summary judgment in Stafford's favor. 435 F. Supp. at 1039. The Fifth Circuit reversed, holding only that the presence of unresolved issues of material fact made summary judgment inappropriate. 611 F.2d at 995. On remand, the district court granted summary judgment for the Commissioner because there was no exchange of property within the meaning of § 721(a). 552 F. Supp. at 314. On the second appeal, the newly created Eleventh Circuit again reversed the summary judgment and remanded for determination of whether Stafford's receipt of a partnership interest was in exchange for property, for services, or both. The Eleventh Circuit did conclude that "Stafford's transfer of the letter of intent to the partnership met both the 'exchange' and 'property' requirements of § 721." 727 F.2d at 1054.

61. Unlike corporations, partnerships do not fall within the protective purview of § 1032, which allows a corporation to recognize no gain on the issuance of its stock. Therefore, the transfer of a partnership capital interest, and presumably that of a profits interest as well, results in gain to the partnership (or to the partners). For a thorough discussion of these collateral consequences, see McKee, Nelson & Whitmire, *supra* note 1, § 5.07.

sociated with special allocations,[62] the employer's deductions allowed under section 83(h) are worthy of special comment.

B. Post-Enactment Legal Developments

Little case law with respect to partnerships has developed since section 83 was adopted in 1969. In part, this slow development may have resulted from the Treasury Department's nine-year delay in promulgating final regulations relating to the statute.[63] However, the Commissioner as well as tax practitioners and commentators have been reluctant to push for a resolution of the issues regarding the application of section 83 to partnership transactions.[64]

In *Hensel Phelps Construction Co. v. Commissioner*,[65] one of the few partnership cases dealing directly with section 83, the Tax Court held that the receipt of a partnership capital interest in exchange for services did constitute compensation income to the recipient.[66] Hensel Phelps Construction Co. was a general contracting firm that agreed to construct an office building for no profit in exchange for an interest in partnership capital. Much of the court's attention centered upon when Hensel Phelps received its interest. The taxpayer argued that the interest was received before May 31, 1973, while the Commissioner argued that it was received in the fiscal year ending May 31, 1974.[67] While holding that the partnership was formed in August of 1973, the court noted that even if the interest was received earlier, the operation of section 83 would nonetheless cause recognition to occur in the year ending May 31, 1974. This timing of recognition was based on the court's interpretation that any interest received was nontransferable within the meaning of section 83(c)(2) because the taxpayer's rights were subject to a substantial risk of forfeiture until such

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62. Partnerships, unlike corporations (excepting subchapter S of the I.R.C.), pass through profits and losses to the partners. Partnership taxation therefore has been somewhat schizophrenic in nature, depending on whether the courts have applied "aggregate or entity theories" in reaching their decisions. However, as a result of this pass through, great flexibility has been achieved through the use of special allocations which, within certain constraints, allow the partners to divide profits, losses, and cash flows as they wish. For a thorough discussion of special allocations, see Weidner, *Partnership Allocations and Capital Accounts Analysis*, 42 OHIO ST. L.J. 467 (1981).

63. *See supra* note 2 and accompanying text.

64. *See* Robinson, *supra* note 35, at 260 n.5.

65. 74 T.C. 939 (1980).

66. *Id.*

67. *Id.* at 947.

time as the partnership agreement was executed on August 1, 1973.[68] In valuing the capital interest, the court applied the presumed equivalency doctrine, holding that the value of the partnership interest "equaled the value of petitioner's construction services in addition to the value placed upon petitioner's loans to the partnership." Thus, Hensel Phelps was taxable upon the excess of the fair market value of its partnership interest over the amount paid for it by Hensel Phelps.[69]

In *Jensen v. Commissioner*,[70] the Tax Court was faced with a joint venture arrangement in which the taxpayer received in exchange for his services an interest which was "virtually identical to that received by Diamond."[71] Jensen was a developer who entered into an agreement with Westlear Company whereby he was to share in profits from the project after Westlear had been paid back all of its invested capital plus a 35% return on the average capital invested. The agreement further stipulated that Jensen " 'did not, and shall not, have any legal or beneficial interest in the Property.' "[72] Later, Westlear repurchased Jensen's joint venture interest and Jensen reported the receipts as a "capital gain from the sale of an interest in land." The Commissioner, relying principally upon the open transaction doctrine, sought to recharacterize the receipts as compensation income.[73] Interestingly, no mention was made of section 83, and the Commissioner did not attempt to press his "victory" in *Diamond*. In holding for the taxpayer, the court concluded that based on all the facts, Jensen received a partnership interest and that the subsequent liquidation of his interest resulted in capital gains rather than ordinary income.[74]

In *Kessler v. Commissioner*,[75] the Tax Court again faced the issue of how to treat the receipt of a "profits interest" in exchange

68. *Id.* at 953.

69. *Id.* at 954. The petitioner argued that the value of the interest received was only $300, despite the fact that the land had been purchased for $731,160 in 1972. *Id.* at 953-54. Had he been more reasonable in valuing the interest, the court may have been inclined to accept the fair value of the interest transferred as the measurement of income recognized rather than resorting to the presumed equivalency rule.

70. 40 T.C.M. (CCH) 1058 (1980).

71. Robinson, *supra* note 35, at 263.

72. 40 T.C.M. (CCH) at 1059 (quoting the joint venture agreement).

73. *Id.* at 1060. The Commissioner's principal argument was that Jensen was a "key employee" of Westlear Co. and that the amounts received were "in settlement of his employment contract." The Commissioner did not argue for recognition of income when the interest was received. *Id.* at 1060 n.2.

74. *Id.* at 1062.

75. 44 T.C.M. (CCH) 624 (1982).

for services. Once again, conspicuously absent from the discussion was any mention of section 83 or the *Diamond* decision. Instead, the Commissioner again chose to pursue the open transaction doctrine, claiming that the relationship was one of employment rather than a partnership. The Commissioner claimed that receipts from the sale of certain partnership property characterized as capital gains at the partnership level were taxable as ordinary income in the form of compensation for services.[76] Noting the "absence of proper intent" and stressing that there was no "interest in capital" involved, the court held there was no "join[ing] together" to form a partnership.[77] The court concluded that these "profits" were in fact compensation for services and were thus taxable as ordinary income.[78]

C. *The American Law Institute Proposals*

While in the case law the battlelines are drawn around "the open transaction" doctrine without regard to whether the interest received is one of partnership capital or partnership profits,[79] practitioners continue to focus on the differences between the two. The proposals in The American Law Institute's *Federal Income Tax Project, Subchapter K,* are exemplary. In particular, part H deals with the receipt of a partnership interest for services. The proposals begin by making distinctions between capital and profits interests which are virtually identical to those discussed earlier in this Comment.[80] They conclude that under the general principles of

76. *Id.* at 627.

77. *Id.* at 629.

78. *Id.* at 630. Applying the open transaction doctrine, the court held, "The profits interest received by the investment partnership in exchange for services had no ascertainable value on the date of receipt. The investment partnership was therefore entitled to hold recognition of income attributable to the profits interest in abeyance until the occurrence of a subsequent recognition-triggering event." *Id.* What is particularly alarming in the *Kessler* decision is the court's acceptance of the Commissioner's argument that the petitioner "received the profits interest in exchange for services and thus . . . had ordinary income when he received his share of the profits." *Id.* at 627. Implicit in the court's decision is an acknowledgement that the transfer of a profits interest may not result in partnership treatment for tax purposes.

79. The open transaction doctrine seems to have been applied successfully both to capital and to profits interests. *See* Robinson, *supra* note 35, at 262-63.

80.

> 1. Capital Interest in a Partnership
>
> A partner will be considered to have received a capital interest in a partnership in exchange for services to the extent that he would be entitled to share in the proceeds of a sale of the partnership's assets at fair market value at the time he obtains his partnership interest.

section 61 and section 721,[81] and subject to rules of section 83, the receipt of "an interest in partnership capital in exchange for services will be taxed on the value of the interest when received."[82] The proposals note three particular problem areas in taxing the receipt of a partnership profits interest exchanged for services: (1) the value of the profits interest in many instances will reflect the capitalized value of future services to be rendered by the recipient; (2) varying profit shares make such interests difficult to value; and (3) the large variety of partnership agreements causes further difficulties with valuation.[83]

In discussing the general applicability of section 83 to partnership transactions, the proposals state that "the approach taken by the [section] 83 regulations can result in the service partner not being treated as a partner until receipt of the interest results in tax under [section] 83."[84] Although noting suggestions that the service partner in this circumstance should nonetheless be a partner for the purpose of determining distributive shares under subchapter K, the proposals conclude that "requiring the transferee to treat his entire distributive share as compensation is more consistent with the general approach of [section] 83." However, "[n]o recommendations have been made relating to the [section] 83 regulations."[85]

The proposals continue to recognize the distinction between capital and profits interests received for services.[86] Within limited ex-

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2. Profits Interest in a Partnership

A partnership interest shall be considered to be an interest in partnership profits for purposes of this section if it is not an interest in partnership capital.

ALI PROPOSALS, *supra* note 4, at 159; *see also supra* notes 4-7 and accompanying text.

81. ALI PROPOSALS, *supra* note 4, at 143-44.

82. *Id.* at 145.

83. *Id.* at 153-54.

84. *Id.* at 157.

85. *Id.* at 158.

86.

Proposal HI—Interest for Services

A. Receipt of an Interest in Partnership Capital

The fair market value of a capital interest in a partnership received in exchange for the performance of services for such a partnership shall constitute income to the recipient.

B. Receipt of an Interest in Partnership Profits

1. In General

Except as provided in Paragraph (B2) below, the fair market value of a interest in partnership profits received in exchange for performing services for such partnership shall not be included in the recipient's income. . . .

2. Profits Interest Received for Unrelated Services

If a profits interest in a partnership is received in exchange for services that are

ceptions, the proposal on receipt of a profits interest would reverse the two *Diamond* decisions, which stated that "the recipient of a profits interest in a partnership may be taxed on the value of that interest."[87] The comments state that the receipt of a partnership profits interest should be taxed only when the following four factors are present:

> (i) the partnership is one in which capital is a material income-producing factor;
>
> (ii) the partner [receiving a profits interest] has not contributed capital to the partnership (or assumed liability for indebtedness) in proportion to his interest;
>
> (iii) the partner receiving a profits interest has less than a [10%] interest in the partnership; and
>
> (iv) less than [50%] in interest of the partnership is owned by service partners described in (iii).[88]

Under the proposals, partnership capital interests received in exchange for services create taxable income to the recipient equal to the fair market value of the interest received.[89] The comments suggest that the value is affected by a number of factors, including marketability of the interest, restrictions on transfers, and the amount a partner would receive if he withdrew from the partnership.[90]

D. *Analysis*

At present, the law relating to the receipt of a partnership interest in exchange for services suffers from the confusion and uncertainty which is often associated with areas where the outcome of a case is dependent upon the intent of the parties as divined from all the facts and circumstances.[91] Under the present scheme, the tax-

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> not performed, either for the partnership or in connection with property contributed to the partnership, the fair market value of such interest shall be included in the recipient's income.

Id. at 159.

87. *Id.* at 161.

88. *Id.* at 162-63.

89. *Id.* at 159.

90. *Id.* at 161.

91. Most of the cases in this area have revolved around the factual findings of the court. If the court finds that based on all the facts and circumstances, a property interest was

payer has little chance of either planning or controlling the tax consequences of transactions into which he enters. At one end of the spectrum, the Commissioner has ample precedent to hold the transaction open and thus achieve the conversion of what is arguably capital gains into ordinary income in the form of compensation.[92] This applies with equal force to the receipt of both capital and profits interests.[93] At the other end of the spectrum there is also ample precedent for the Commissioner to force recognition of income immediately upon receipt of the interest;[94] again, this applies with equal force to both capital and profits interests.[95] The courts are left to determine on an *ad hoc* basis when or whether a transfer occurred; whether a property interest was transferred; and whether a partnership was created, depending on the particular facts and circumstances surrounding the case. Furthermore, there is little statutory guidance in the area, so the courts are usually forced into a factual comparison with previous cases.

Partly because of the lack of meaningful statutory guidelines, the law relating to the transfers of partnership interests has become unnecessarily complicated. For example, in a distillation of existing case law, one commentator has identified at least ten distinct scenarios involving the transfer of a partnership interest, with most of them at least potentially resulting in different tax consequences.[96]

The ALI project represents a laudable attempt to bring much-

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transferred and a partnership did exist, the transaction is closed as to future receipts without regard to whether any amount was initially recognized upon receipt. *See, e.g.*, Jensen v. Commissioner, 40 T.C.M. (CCH) 1058 (1980); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978). Alternatively, if the court finds that no partnership was intended, the transaction remains open, and future receipts are taxable as compensation income. *See, e.g.*, Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Kessler v. Commissioner, 44 T.C.M. (CCH) 624 (1982); Burglass v. Commissioner, 38 T.C.M. (CCH) 979 (1979) (portion of the profits received from sale of real estate was compensation for services rendered and taxable as ordinary income).

92. *See, e.g.*, Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Pounds v. United States, 372 F.2d 342 (5th Cir. 1967) (portion of the profits recieved from sale of real estate was compensation for services rendered and taxable as ordinary income); Kessler v. Commissioner, 44 T.C.M. (CCH) 624 (1982); Burglass v. Commissioner, 38 T.C.M. (CCH) 979 (1979).

93. The *Pounds* and *Vestal* cases involved receipts of capital interests, while the *Burglass* and *Kessler* cases involved profits interests.

94. *See, e.g.*, Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974); United States v. Frazell, 335 F.2d 487 (5th Cir. 1964); Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939 (1980).

95. The *Frazell* and *Hensell Phelps* cases involved capital interests while the *Diamond* case clearly involved a profits interest.

96. *See* Banoff, *supra* note 1, at 853-57.

needed order and consistency to the law governing transfers of partnership interests. It proposes to treat the receipt of a capital interest as a taxable event, subject to the general provisions of section 83.[97] As to the receipt of a profits interest, it proposes a return to the pre-*Diamond* days when such a transfer resulted in no immediate tax consequences to the recipient but nonetheless conferred in him the ownership of a capital asset, thus presumably preventing an application of the "open transaction" doctrine.[98] In acknowledgment of the *Diamond* decision, those proposals carve out a narrow set of situations in which the *Diamond* rule is followed and receipt of a partnership profits interest accordingly results in immediate taxation. The proposals then set forth definite guidelines to aid both practitioners and the courts in determining when such a situation exists.[99] Admittedly, these proposals would do much to resolve the current uncertainty, and they do so in a manner which is most favorable to the taxpayer. However, in light of the Commissioner's continued emphasis on the open transaction doctrine[100] and his obvious reluctance to press his "victory" in *Diamond*,[101] it seems unlikely that he will acquiesce and endorse the proposals. Nor is there any evidence that the courts, on a uniform basis, are willing to adopt the guidelines set forth in the proposals.[102]

Planning and controlling the tax consequences of a transaction are critical. Often, a "good deal" may be a "bad deal," depending upon the tax consequences. In the area of partnerships in particular, tax considerations are often a major factor in planning and consummating the deal.[103] Section 83 was intended to provide a

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97. *See supra* note 81 and accompanying text.

98. ALI PROPOSALS, *supra* note 4, at 149.

99. *See supra* note 88 and accompanying text.

100. Repeatedly, even in the face of periodic defeat, the Commissioner has continued to attack these arrangements through application of an open transaction doctrine as opposed to an application of § 83. *See, e.g.*, Jensen v. Commissioner, 40 T.C.M. (CCH) 1058 (1980); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978).

101. Interestingly, the *Wheeler*, *Jensen*, and *Kessler* cases, each involving profits interests in some ways similar to the interest received in *Diamond*, contain no mention of that decision.

102. Invariably, the courts have relied upon internal criteria, usually revolving around the intent of the parties based on all the facts and circumstances. *See, e.g.*, *Kessler*, 44 T.C.M. (CCH) at 628; *Jensen*, 40 T.C.M. (CCH) at 1060; *Wheeler* 37 T.C.M. (CCH) at 889-90. The case law contains no reference to the external criteria supplied by the ALI proposals. *See supra* note 88 and accompanying text.

103. In general, the flexibility afforded by the unique nature of a partnership and by the special allocation rules makes the partnership an attractive vehicle for tax shelters. This attractiveness is even more enhanced in the area of limited partnerships. For a more thor-

comprehensive set of guidelines regarding the receipt of property in exchange for services. The statute and regulations contain specific rules dealing with the *transfer* of property, with the *definition* of property, and with the transfer of property for future services or property subject to a substantial risk of forfeiture.[104] In fact, the statute and regulations, promulgated by Congress and the Treasury Department, provide a comprehensive set of guidelines which are applicable to most, if not all, of the fact patterns found in the case law or in actual situations.[105] While section 83 does not offer as favorable a treatment to the taxpayer as do the ALI proposals,[106] section 83 does introduce certainty and provide valuable aid in planning and controlling the tax consequences of a great variety of transactions. In most instances, the statute and the regulations have the virtue of being consistent with, and aiding in the reconciliation of, case law. The application of section 83 to partnership transactions may provide a number of planning opportunities which would help ensure continued flexibility in partnership planning. Because of these tax planning advantages associated with section 83, particularly as applied to tax shelters, it is not surprising that the Commissioner has been reluctant to press either his "victory" in *Diamond* or the potential application of section 83 to partnership transactions.[107] For the same reasons, commentators and practitioners alike should wholeheartedly endorse the application of section 83 to the transfer of both partnership capital and profits interests in exchange for services.

IV. Section 83 Applied

In general, as applied to partnership transactions, section 83 provides a natural distinction between those interests which are received for past services and which are not subject to a substantial risk of forfeiture and those interests which are received for future services or which are subject to a substantial risk of forfeiture.[108]

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ough discussion of the flexibility and the tax planning advantages offered by the partnership form, see Weidner, *Partnership Allocations and Tax Reform*, 5 Fla. St. U.L. Rev. 1 (1977).

104. *See supra* notes 44-62 and accompanying text.

105. *See infra* notes 110-120 and accompanying text.

106. Apparently, the ALI proposals would result in the "best of both worlds" insofar as they characterize a profits interest as a capital asset but in most cases would not require any recognition of income upon its receipt. Implicit in the application of § 83 to profits interests is a recognition of their nature as capital assets; however, § 83 requires at least some recognition of income upon receipt.

107. Robinson, *supra* note 35, at 260 n.5.

108. In general, § 83(a) requires income recognition during the first taxable year in

To the extent that actual and theoretical differences exist between a capital interest and a profits interest, partnership transactions may be further divided into the four categories discussed in this Comment. Within the overall framework discussed herein, a fifth category emerges which involves those agreements having no "transfer" of "property" within the meaning of section 83.[109] These five categories adequately cover all the fact patterns presently found in the case law and provide clear and rational guidelines for planning and controlling the tax consequences of most, if not all, transactions encountered in actual practice.

Section 83 provides a general rule that the fair market value of property received in exchange for services shall be includable in the gross income of the recipient at the time the interest becomes freely transferable or not subject to a substantial risk of forfeiture.[110] When conditioned on future services, an interest is subject to a substantial risk of forfeiture and is not freely transferable.[111] The application of section 83 to the receipt of a partnership capital interest thus seems consistent with the *Frazell* case.[112] In at least one commentator's view, Frazell received in 1951 a partnership interest which was clearly subject to a substantial risk of forfeiture.[113] The recognition event, then, occurred in 1955 when services

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which the rights in the property are freely transferable or not subject to substantial risk of forfeiture. Section 83(c) states that property is subject to a substantial risk of forfeiture if it is conditioned upon future services and that property is not freely transferable if it remains subject to a substantial risk of forfeiture in the hands of the transferee. Section 83(c) creates two primary categories: (1) if property is received for future services or is otherwise subject to substantial risk of forfeiture, it is not taxed at the time of receipt; and (2) if property is received for past services and with no substantial risk of forfeiture, it is taxable at the time of receipt.

109. Section 83 is applicable only if both a "transfer" and a "property interest" are involved. For a more thorough discussion of what this involves, see *supra* notes 53-54 and accompanying text.

110. I.R.C. § 83(a) (1982).

111. *Id.* § 83(c). Technically, § 83(c) stipulates that property is not transferable if it remains subject to a substantial risk of forfeiture in the hands of the transferee. As a practical matter, in most but not necessarily all cases, § 83(c) operates to make property subject to a substantial risk of forfeiture not freely transferable. This distinction is designed to handle those instances where an interest may be subject to a substantial risk of forfeiture but is nonetheless transferable. In the author's view, the distinction in cases such as *Frazell* which involve future services is relatively unimportant because, unless waived, the condition of future employment operates to cause a forfeiture whether the asset is in the hands of the transferor or a transferee.

112. 335 F.2d 487 (5th Cir. 1964). The joint venture in *Frazell* was first begun in 1951. Much of the court's decision involved a finding that Frazell's rights to ownership in the property did not vest until sometime in 1955.

113. McKee, Nelson & Whitmire, *supra* note 1, § 5.02[1]; *see supra* text accompanying notes 12-13.

had been fully performed and the risk of forfeiture was removed. The amount includable in gross income was the fair market value of the interest at the time when the risk of forfeiture was removed rather than at the time the interest was originally received. Furthermore, the section 83 regulations stipulate that when property is not freely transferable or is subject to a substantial risk of forfeiture, the transferor is considered the owner and any income from the interest received by the transferee prior to the removal of the restrictions shall constitute compensation income to the transferee.[114] The application of section 83 to partnership transactions is also consistent with the *Vestal* case.[115] Like Frazell, Vestal received an interest conditioned on future services and subject to a substantial risk of forfeiture. However, unlike Frazell's, Vestal's interest was liquidated prior to the lifting of the restrictions,[116] and the "profits" he received were treated as compensation income.[117]

The *Vestal* case is often cited as involving a "profits" rather than a "capital" interest.[118] To the extent that this analysis is correct, it lends further support to the view that the application of section 83 to the receipt of a partnership profits interest is in fact consistent with prior case law. The application of section 83 to a profits interest for past services is also consistent with the *Diamond* decision.[119] The application of section 83 to a profits interest may also be partially reconciled with *Wheeler*, at least to the extent that *Wheeler* stands for the proposition that a profits interest exchanged for future services is a property interest and in light of

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114. Treas. Reg. § 1.83-1(a)(1)(ii) (1978).

115. 498 F.2d 487 (8th Cir. 1974). In *Vestal* the basis of the court's decision seemed to be a finding that the contract called for payments which were conditional. *Id.* at 490. Stated another way, Vestal's rights in the property had not vested, and thus any income he received was compensation.

116. *Id.* at 489-90.

117. *Id.* at 494. The better rationale for the result reached by the court in *Frazell* is that the geologist received an unrestricted partnership interest in 1955 which was subsequently transferred to a corporation in exchange for stock. In any event, Frazell retained an interest in the ongoing operations. 335 F.2d at 489. In *Vestal*, the facts are significantly different insofar as the monies received were in complete liquidation of whatever interest Vestal had. 498 F.2d at 489-90.

118. Despite the treatment of *Vestal* as a capital interest by the authors in WILLIS, PENNELL & POSTLEWAITE, *supra* note 1, § 26.03, who admonished that "no contention was made that the taxpayer received a profits interest in a partnership," most commentators now discuss *Vestal* as involving a partnership profits interest. *See, e.g.*, Banoff, *supra* note 1, at 857; ALI PROPOSALS, *supra* note 4, at 149 n.11.

119. In *Diamond*, the court held that the receipt of a profits interest which was freely transferable gave rise to taxable income at the time of receipt. 56 T.C. at 544, 546. Implicit in this decision is a finding that a property interest was involved.

the fact that the court did not specifically address the issue of possible tax consequences at the time of receipt.[120]

The section 83 regulations clearly state the collateral tax consequences relating to the transfer of property in exchange for services. The transfer represents an "expenditure" on the part of the transferor which will result either in a current deduction to the extent allowable under sections 162 or 212[121] or in an increase in the basis of a capital asset, the cost of which may be recovered over time.[122] The amount of this expenditure is equal to the amount of compensation income recognized by the recipient and is deemed to occur in the same tax year in which the compensation income is recognized.[123] The regulations also require that gain must be recognized by the transferor to the extent that the amount of this deduction (plus any other amounts realized) exceeds the transferor's basis in the property.[124] Although affording less favorable treatment than that enjoyed by corporations,[125] the application of section 83 to partnership transactions is, nonetheless, consistent with existing case law.[126]

In summation, the straightforward application of section 83 to partnership transactions results in tax consequences to the transferor and the transferee which are, in large part, consistent with the results that have developed in the case law. However, there is one important difference. In the case law, the timing of any income recognition and the point at which the taxpayer makes the conversion from "employee" to "capitalist" have been dependent upon all the facts and circumstances, to be determined, usually after the

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120. In *Wheeler*, the Commissioner did not argue, and therefore the court did not address, the issue of whether the initial receipt of a profits interest gave rise to taxable income. The court did decide that Wheeler had a property interest in the form of a capital asset and thus future payments were capital gains rather than compensation for services. 37 T.C.M. (CCH) at 891.

121. Treas. Reg. § 1.83-6(a)(1) (1978).

122. *Id.* § 1.83-6(a)(4).

123. *Id.* § 1.83-6(a)(1).

124. *Id.* § 1.83-6(b). Apparently, the only exception to this rule is the issuance of corporate stock in a § 1032 transaction. *Id.*

125. The more favorable treatment afforded to corporations results from the fact that under § 1032 a corporation, unlike a partnership, recognizes no gain when issuing stock in exchange for property or services. However, as with a partnership, a corporation receives a deduction under § 83(h) in such a transaction.

126. *See, e.g.*, McDougal v. Commissioner, 62 T.C. 720 (1974) (the court held that because the fair market value of the appreciated property transferred as compensation for services exceeded the transferor's basis, the transaction resulted in a recognition of capital gains to the transferor and gave rise to a current deduction equal to the fair market value of the interest transferred).

fact, by a court. Section 83(b), in providing for an election,[127] places the control of these critical factors directly in the hands of the taxpayer. The flexibility afforded by this control, coupled with the certainty provided by the general framework of section 83, far outweighs any detriments associated with its application to partnership transactions. The remainder of this Comment discusses the planning opportunities and highly predictable tax consequences that would flow from the application of section 83 to a variety of partnership transactions.

A. *The Receipt of a Partnership Capital Interest in Exchange for Past Services and Not Subject to a Substantial Risk of Forfeiture*

The application of section 83 to this type of transaction is relatively straightforward, and the results are almost identical to those which have developed in the case law.[128] Under section 83 the recipient recognizes, in the year of receipt, compensation income equal to the fair market value of the interest received less the value of any property given for it. In turn, the transferor receives either a current deduction or basis in a capital asset equal to the amount of compensation recognized by the recipient. The transferor also recognizes a gain to the extent that the deduction (and the fair market value of any property received) exceeds his basis in the interest transferred.

The law in this area is rather sterile with respect to planning opportunities. Both under case law and under the application of section 83, the results described above are almost automatic. Most of the opportunities revolve around timing the recognition event in such a way as to obtain the maximum advantage to both the service partner and the partnership; in framing the agreement in such a manner as to create a current deduction for the partnership; and in minimizing the value assigned to such a transfer. Timing, of course, is a matter of matching the tax years in which a service partner has low to moderate taxable income with the tax years in which prospective capital partners are in need of tax deductions.

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127. Section 83(b) allows the transferee, within 30 days of the receipt of the interest, to elect to recognize income even though the interest remains subject to a substantial risk of forfeiture. The benefits of this election lie in closing the transaction as to future payments received and perhaps in timing the recognition event to avoid having future appreciation taxed as compensation income. The drawback to making such an election lies in the fact that the recipient of the interest may not later claim a loss if in fact the interest is forfeited.

128. *See supra* notes 110-14 and accompanying text.

Furthermore, the transaction is best suited to those situations involving the transfer of capital assets which are held for more than six months,[129] are depreciable, and have appreciated in value. Framing the agreement is a matter of ensuring that the nature of the services rendered are such that the "expenditures" give rise to a current deduction as allowed under sections 162 or 212.[130] With respect to valuation of the interest, there appear to be two avenues of approach: (1) the value of the interest received is presumed to be equivalent to the value of the services rendered;[131] or (2) the value of the interest received is used, particularly when the capital interest has a readily ascertainable market value. From a reporting viewpoint, the best strategy is probably to take an aggressive posture in selecting the method of valuation which is most favorable to the taxpayer. Additionally, section 83(d) provides that in certain cases of restrictions which will never lapse, the property price determined by a given formula shall be deemed to be the fair market value of the property received and that the burden of proof to the contrary shall be upon the Secretary of the Treasury.[132]

While not significantly altering the results obtained under case law or adding much in the way of flexibility, the application of section 83 to the receipt of a partnership capital interest is, nonetheless, highly beneficial in providing clear guidelines around which the partnership agreement may be drafted in order to ensure that the transaction is closed with respect to future payments.[133] In this sense, the application of section 83 adds a high degree of certainty

129. The holding period requirement for long-term capital gains is six months. I.R.C. § 1222(3) (West Supp. 1985). Only 40% of net capital gain is included in gross income. I.R.C. § 1202(a) (1982).

130. In general, these items are the "ordinary and necessary" expenses associated with operating a business, I.R.C. § 162 (1982), or managing investments, *Id.* § 212.

131. See Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939, 954 (1980), for an application of the presumed equivalency doctrine. This doctrine should apply only when there is no means of valuing the interest received. Under the general rules of § 83(a), the fair market value of property transferred is the appropriate measuring stick, and the taxpayer should not be taxed on an amount greater than that value.

132. I.R.C. § 83(d) (1982). Generally, these agreements take the form of binding buy-sell agreements entitling the transferors to repurchase the interest at a price determined by a formula. For further discussion, see Treas. Reg. § 1.83(5)(a) (1978).

133. Unlike the case law, I.R.C. § 83 leaves no doubt as to when the transaction is closed or remains open. The transaction is open until such time as the interest is freely transferrable or not subject to a substantial risk of forfeiture, *id.* § 83(a), or until such time as an election is made under § 83(b). Upon the happening of any of these events, income is recognized, and the transaction is closed. Given these guidelines, it is a relatively easy matter to draft an agreement which controls these events and ensures a timing which is favorable to the taxpayer.

to the transaction and should provide a valuable aid to practitioners in planning and controlling the tax consequences of these types of transactions.

B. *The Receipt of a Partnership Profits Interest in Exchange for Past Services and Not Subject to a Substantial Risk of Forfeiture*

The application of section 83 to this type of transaction is again relatively straightforward, and the results are consistent with *Diamond*[134]and to a lesser extent with subsequent case law. The tax consequences to the recipient of the profits interest and to the transferor are virtually identical to those discussed above for receipt of a capital interest. Because a profits interest is viewed as property,[135] the transaction will result in the recognition of capital gains by the transferor in an amount equal to the fair market value of the profits interest[136] and, at the same time, result in an expenditure subject to the same rules discussed above for capital interests.[137] The recipient, of course, recognizes compensation equal to the fair market value of the interest received and consequently has a basis in his partnership interest which includes this amount.[138] However, unlike the capital interest, a partnership profits interest does not confer in the holder a tangible interest in the underlying partnership assets. In this sense, the profits interest is an intangible asset which arguably may be amortized by the partnership over time.[139] If the profits interest is not amortized (with the amortiza-

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134. *See supra* note 119.

135. For a discussion of a profits interest as property, see ALI PROPOSALS, *supra* note 4, at 146-149; *see also* Robinson, *supra* note 35, at 264-65.

136. Because a profits interest does not involve an interest in the underlying assets of the partnership, the better view is that the transferor has no basis in the interest transferred. For a thorough discussion of the consequences relating to a transfer of profits interest, see McKEE, NELSON & WHITMIRE, *supra* note 1, § 5.07.

137. *See supra* notes 121-22 & 130 and accompanying text.

138. The law in this area is clear with respect to "capital interests." Treas. Reg. § 1.722-1 (1960) states, "If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest." The regulation goes on to refer to the distinction drawn in the § 721 regulations between a capital and a profits interest. *See supra* note 3 and accompanying text. Implicit in treating receipt of a "profits interest" as giving rise to compensation is the fact that it would result in similar treatment of such a transaction under the § 722 regulations. For a more thorough discussion of these concepts, see McKEE, NELSON & WHITMIRE, *supra* note 1, §§ 5.02[7], .03[1](c), .07[2].

139. McKEE, NELSON & WHITMIRE, *supra* note 1, § 5.07[2]. In large part, this intangible asset arises from the two-step process associated with a transfer of a partnership interest in exchange for services. Basically, the transaction is viewed first as a transfer from the part-

tion specially allocated to the recipient partner), it will remain a part of the recipient's partnership basis and presumably operate to reduce later gains recognized upon the sale or liquidation of the interest.[140]

The planning opportunities associated with this type of transaction are similar to those relating to the receipt of a capital interest. Efforts should be directed toward matching the differing needs of the service partner and the capital partners and framing the agreement in such a way as to create a current deduction. However, the nature of the capital assets involved is largely irrelevant in this type of transaction. Instead, much of the planning strategy will involve valuation of the interest. The transaction seems most suited to those situations where the potential profits are moderately speculative in nature and are not likely to be realized in the immediate future. Because no interest in underlying partnership assets is involved, a profits interest is most appropriately viewed as a right to the receipt of cash at some future point. The value of this right is subject to an appropriate discount rate to reflect net present value and to an additional discount to properly account for the speculative nature of the project.[141] In many instances, this valuation process will result in the recognition of only a nominal amount of income upon the receipt of the interest.[142] Recognition of income is a small price to pay for "closing" the transaction, which is a result that the application of section 83 will ensure.

C. *The Receipt of a Partnership Capital Interest in Exchange for Future Services or Subject to a Substantial Risk of Forfeiture*

Case law governing this area of the law is fairly well-settled. The courts have ruled that the transaction is held open and that future payments received are to be treated as compensation based on the

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nership to the partner of the underlying "property interest" as a § 707(c) transaction, followed by a recontribution of the underlying "property interest" from the transferee to the partnership. Under the § 722 regulations, the transferee receives a basis equal to compensation recognized, and this basis then carries over to the partnership under Treas. Reg. § 1.723-1 (1960) when the property is "recontributed." For a thorough discussion of these concepts as applied to "profits interests," see McKEE, NELSON & WHITMIRE, *supra* note 1, § 5.07.

140. *Id.* Presumably, just as in the case of a transfer of corporate stock, the taxpayer receives a "cost basis" in the asset received equal to the amount of compensation income recognized. I.R.C. § 1012 (1982). *See also supra* note 138.

141. *See* WILLIS, PENNEL & POSTLEWAITE, *supra* note 1, § 27.01 n.3.

142. *See infra* notes 158-66 and accompanying text.

nature of their origin, which is often characterized as an employer-employee relationship.[143] In a general sense, the application of section 83 continues this treatment.[144] However, section 83(b) offers the recipient the opportunity to opt out of this treatment by making a timely election within thirty days. Such an election will result in essentially the same tax consequences as if the receipt of the partnership capital interest were in exchange for past services and not subject to a substantial risk of forfeiture. Unfortunately, the statute and regulations seem to apply an "open transaction doctrine" when this election is not made, at least to the extent that the "profits" are actually received by the transferee.[145] The recipient should not be viewed as a partner for tax purposes until such time as the forfeiture restrictions are removed.[146] However, in defining when the recognition event occurs, the statute and regulations also provide the means by which the taxpayers involved may control the consequences of the transaction. Flexibility is the name of the game in partnerships, and partnership agreements may be amended at will by the partners. Thus, in addition to the one-time election available to the transferee (at least to the extent that the interest is not contingent upon future services), the partnership may exercise continued control over the consequences of the transaction simply by amending the agreement to remove the risks of forfeiture, thus triggering the recognition event and closing the transaction at whatever point in the life of the partnership deemed most advantageous to all parties concerned. Additionally, and particularly with respect to interests received for future services, the application of section 83 will provide an interesting opportunity for income-splitting through a type of "step-vesting." It would be a simple matter under section 83 to provide that a portion of the interest transferred is "earned" each year as services are ren-

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143. *See, e.g.*, Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Pounds v. United States, 372 F.2d 342 (5th Cir. 1967). One interpretation of United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), suggests that the 1951 transaction was held open because no property interest was received, and thus the amounts received in 1955 were taxable as ordinary income. *See* WILLIS, PENNEL & POSTLEWAITE, *supra* note 1, § 26.03.

144. As long as the interest remains subject to a substantial risk of forfeiture and is not transferable, the regulations clearly provide that any income received by the transferee will be taxed as compensation income. Treas. Reg. § 1.83-1(a)(1) (1978).

145. The regulations are specific in stating that compensation results when income from the nontransferable property is *received* by the taxpayer. If one adopts an entity approach, then, arguably, profits which are held by the partnership rather than distributed may fall outside the parameters of this rule. Of course, the Commissioner may attempt to apply the constructive receipt doctrine to avoid this result.

146. *See* MCKEE, NELSON & WHITMIRE, *supra* note 1, § 5.08(3)(a).

dered.[147] In the proper setting, this approach would provide a steady stream of deductions to the partnership and would spread the recipient's recognition of income over a number of years, thus allowing him to minimize the tax consequences.[148] These planning opportunities and the control which is imparted to the taxpayer make the application of section 83 to partnership transactions an exciting planning tool for the tax practitioner.

D. *The Receipt of a Partnership Profits Interest in Exchange for Future Services or Subject to a Substantial Risk of Forfeiture*

Unlike those areas previously discussed, the law in this area is not well-settled. In one line of cases, the courts have ruled that this type of transaction is held open and that any future payments received are treated as compensation income.[149] In another line of cases, the courts have held either that the receipt of such an interest results in a closed transaction and thus future payments retain their character as determined at the partnership level or have held that the subsequent sale of such an interest results in capital gains.[150] The issue left unresolved is whether the transferee recognizes income immediately upon the receipt of the interest.[151] In general, section 83 follows the first line of cases in providing that the transferee recognizes no income upon the receipt of the interest but that future payments received or proceeds from the sale of the interest prior to its vesting will constitute compensation income. However, as in the case involving a capital interest, section 83 places the timing of recognition and the control of related tax consequences directly in the hands of the taxpayer.[152]

147. *See* Treas. Reg. § 1.83-1 (1978).

148. Because of the progressive structure of our tax system and because each tax year is viewed independently of others, spreading the recognition of income over several years is an important and often employed technique for minimizing taxes.

149. *See, e.g.*, Vestal v. United States, 498 F.2d 487 (8th Cir. 1974); Kessler v. Commissioner, 44 T.C.M. (CCH) 624 (1982); Burglass v. Commissioner, 38 T.C.M. (CCH) 979 (1979).

150. *See, e.g.*, Jensen v. Commissioner, 40 T.C.M. (CCH) 1058 (1980); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978).

151. In Diamond v. Commissioner, 56 T.C. 530 (1971), the receipt of such an interest resulted in taxable income. In the *Jensen* and *Wheeler* cases, that issue was not before the court.

152. As applied to profits interests, the election under § 83 and the general guidelines set forth by the statute and regulations provide the same opportunities for timing the recognition event as those discussed with respect to capital interests. *See supra* notes 143-48 and accompanying text.

While not as favorable as those cases where the taxpayer has successfully closed the transaction and also avoided the recognition of any income arising from the initial receipt of the interest,[153] the ability of the taxpayer to close the transaction at will and with certainty is an important planning tool. Because of the unique nature of a profits interest and the methods by which it should be valued,[154] the price for this certainty and control will in most cases be minimal. Indeed, in many instances the value of a profits interest, particularly one of a highly speculative nature, may be very small at the front end of a deal. In some cases, the service partner may wish to opt into the "capitalist" status by making a section 83(b) election and thus recognize a very small amount of compensation; the service partner must realize, however, that he is "gambling" on the success of the venture. The service partner may in fact later find that he "purchased" an asset through income recognition and is not entitled to an offsetting deduction if the venture fails or if his interest is forfeited.[155] In other cases, a "wait and see" attitude may seem more appropriate; the partnership agreement can be amended at an appropriate time to remove the risks of forfeiture and thus close the transaction. To the extent that the profits outlook for the partnership has improved over time, this approach will result in recognition of a greater amount of compensation income to the recipient of the interest. However, this approach still allows the partners to time recognition and, more importantly, to close the transaction and thus ensure the characterization of future payments either as distributive shares governed by the provisions of section 704 or as capital gains resulting from the sale or other disposition of property. Additionally, the recognition of compensation income will give rise to a basis in a capital asset in the hands of the transferee, and this basis in cases not involving a section 83(b) election will give rise to a capital loss deduction if the venture ultimately fails.[156] In summary, the application of section 83 to this type of transaction affords all of the planning opportunities discussed with respect to capital interests.

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153. In *Jensen* and *Wheeler*, the taxpayers got the "best of both worlds" because no income was recognized upon receipt of the interests, and the transactions were deemed to be closed as to future receipts. In part, this outcome was the result of the Commissioner's reluctance to pursue his *Diamond* victory.

154. *See supra* note 140; *infra* notes 158-66 and accompanying text.

155. *See supra* note 127.

156. The prohibition contained in § 83(b) against future loss deductions applies only to those cases where the election is made.

Because of the valuation feature, section 83 offers unique opportunities to minimize income recognition, thus making this category the most fertile ground for planning and controlling the tax consequences of the transfer of a partnership interest in exchange for services.

E. The Receipt of an Interest Outside the Partnership Context

Although the application of section 83 to the previous four transactions would seem to provide all the flexibility necessary to ensure favorable and controlled tax consequences, situations may still arise in which the principals involved simply do not wish to "draft into" the intricacies of subchapter K. Again, section 83 provides clear guidelines on how this may be accomplished. By casting the agreement in terms of "an unfunded and unsecured promise to make payments in the future," the transaction can be placed outside the scope of section 83 and outside of the scope of the general partnership provisions of the Code.[157] Casting the transaction in this manner almost certainly will result in no immediate recognition of income and in an application of the open transaction doctrine as to any future payments received. The motives for taking such an approach will no doubt be business related rather than tax related.

F. Illustrations

The examples which follow are based on factual patterns similar to those found in case law. Primary emphasis is placed on the wide variety of results which may be obtained under the application of section 83 and on the planning opportunities and flexibility associated with such an application.

1. Example One

Investors, with the help of a geologist, acquire various land holdings which are potentially oil and gas bearing. The investors decide to exchange a 10% interest in the properties for the geologist's services. The properties presently have a basis of $900,000 and a fair market value of $1,000,000.

If the exchange is characterized as a capital interest in payment

157. Section 83 applies only to the transfer of property. The regulations state that property does not include "an unfunded and unsecured promise to pay money in the future." Treas. Reg. § 1.83-3(e) (1978).

for past services and not subject to a substantial risk of forfeiture, the tax consequences are as follows: (1) the service partner (the geologist) recognizes compensation income of $100,000, and (2) the investors recognize a capital gain of $10,000 and receive a current deduction of $100,000. Depending on the relative tax brackets of the individuals involved, this characterization could result in overall tax savings of more than $11,000.[158]

If the exchange is characterized as a capital interest in payment for future services and the interest is to vest in increments of one-third in each of the next three years, and assuming there is no substantial increase in the value of the properties, the outcome is the same as above except that income recognition and deductions are spread over a three-year period. To the extent that the geologist remains in the lower tax bracket and the investors are in the 50% bracket, the resulting overall tax savings may exceed $22,000.[159]

If the exchange is characterized as a profits interest in payment for past or future services, the outcome is quite different than with a capital interest. The key to this difference is in the valuation process. For purposes of this illustration, it is assumed that any profits will be realized in five years and that the geologist's 10% profits interest applies to those amounts received in excess of the original investment of $900,000 plus a 10% annual return to the investors on their investment. It is further assumed that the following probabilities for success of the venture exist:

> (1) There is a 75% chance that the investors will simply recoup their money, resulting in no profit to the geologist.[160]

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158. This savings, of course, is possible only in those cases where the service partner is in a considerably lower tax bracket than the other partners. For example, if exclusive of the transaction the service partner has taxable income of $11,900, then recognition of the $100,000 additional compensation income results in additional taxes of $36,770 (applying 1984 rates and assuming that the taxpayer was married and filed a joint return). At the same time, assuming that the other partners are in the 50% marginal bracket, the transaction results in tax savings of $48,000 because the partners receive a $100,000 current deduction while recognizing only $10,000 in long-term capital gains.

159. The larger savings in this instance result from the service partner's spreading out income recognition and thus taking advantage of the progressive tax structure. Assuming the service partner has other taxable income of $11,900, this transaction results in additional taxes of $8,500 in each of the three years. The other partners save $16,000 each year, resulting in total savings over the three-year period of $22,500.

160. For example, applying a simple 10% return for five years on the initial investment of $900,000, the property must sell for more than $1,350,000 before the service partner (geologist) will share in any of the profits.

(2) There is a 20% chance that the properties can be sold for $1.5 million, resulting in a profit to the geologist of $15,000.[161]

(3) There is a 5% chance that the properties can be sold for $2.5 million, resulting in a profit to the geologist of $115,000.[162]

The value of the profits interest five years in the future may be calculated by multiplying the sum of the probabilities by their respective profits: ([.75 × $0] + [.20 × $15,000] + [.05 × $15,000]). The profits interest thus has a value of $8,750 five years in the future. Applying an annual discount rate of 10%, the profits interest has a present value of approximately $5,430.

The remaining tax consequences are virtually identical to those of capital interests, with the exception that the investors recognize capital gains equal to the entire $5,430 and the partnership presumably has an intangible asset with a basis of $5,430 to be amortized over time. Of course, the figures will be much smaller and the tax consequences even further minimized if the interest vests over a longer period of time.

2. *Example Two*

An investor owns an apartment complex with a fair market value of $1,000,000 and liabilities of $800,000. The investor's basis in the property is $900,000. He transfers a 25% interest in the complex in exchange for services provided by a rental property manager (the service partner). If the exchange is characterized as a capital interest in payment for past services and not subject to a substantial risk of forfeiture, the tax consequences are as follows: (1) the service partner recognizes compensation income of $50,000,[163] and (2) the investor recognizes a capital gain of $25,000[164] and receives a current deduction of $50,000 for compensation paid to the manager. Assuming an optimal match of tax brackets, this transaction

161. If the property is sold for $1,500,000, the amount over the original $900,000 investment and over the $90,000 per year for five years (10% of the original investment) is $150,000. The geologist's 10% interest results in total profits of $15,000 for him.

162. If the property is sold for $2,500,000, the service partner (geologist) shares in the $1,150,000 of "profits." The geologist's 10% interest results in total profits of $115,000 for him.

163. The $50,000 in compensation income is derived by finding 25% of $200,000 (fair market value of $1,000,000 less liabilities of $800,000 equals $200,000).

164. The investing partner's capital gain results from transferring 25% of the property which has appreciated in value from $900,000 to $1,000,000.

results in overall tax savings of more than $5,000.[165]

If the exchange is characterized as a capital interest in payment for future services and the interest is to vest in increments of one-third in each of the next three years, and assuming there is no substantial increase in the value of the properties, the outcome is the same as with a capital interest in payment for past services and not subject to a substantial risk of forfeiture except that income recognition and deductions are spread over three years. Again assuming an optimal match of tax brackets, overall tax savings could increase to approximately $10,000.[166]

If the exchange is characterized as a profits interest, the outcome is different than with a capital interest. It is assumed that the parties hope to hold the complex for five years and then sell it. It is further assumed that the agreement stipulates that the investor will recover his initial investment of $900,000 plus 10% per annum before the service partner receives any return. For purposes of illustration, the probabilities assigned are as follows:

(1) There is a 40% probability that the building will appreciate to $1,350,000, in which case the service partner realizes no profit.

(2) There is a 40% chance that the building will appreciate to $1,450,000, in which case the service partner will realize $25,000.

(3) There is a 20% chance that the building will appreciate to $1,550,000, in which case the service partner will realize $50,000.

Taking the sum of the probabilities ([.40 × $0] + [.40 × $25,000] + [.20 × $50,000]), the value of the interest in five years is $20,000. After discounting at an annual rate of 10%, the present value of the interest is approximately $12,420. Beyond this point, the tax consequences and further opportunities for minimizing them are identical to those discussed above in Example One.

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165. Assuming that the service partner has other taxable income of $11,900 and is married and filing a joint return, this transaction results in additional taxes to him of $14,881. At the same time, the investor in the 50% bracket recognizes total savings of $20,000 as a result of receiving a $50,000 current deduction coupled with a $25,000 long-term capital gain.

166. Spreading recognition of the $50,000 in compensation income over three years results in increased taxes to the service partner of $3,372 each year. At the same time, the investing partner saves $20,000 over the three year period, resulting in total savings of $9,884.

What should be obvious in these examples is that the tax consequences differ greatly, depending on whether the interest transferred is one of partnership capital or one of partnership profits. Thus, in a very real sense, the application of section 83 to both capital and profits interests provides the planner with great flexibility in controlling the tax consequences of such a transfer. In cases where the collateral consequences are beneficial, the capital interest method should be used. In the majority of cases, where the major concern is minimization of tax consequences, the profits interest method should be used. Even further minimization of tax consequences may be achieved through step-vesting of the profits interest. In addition to the flexibility afforded by section 83, the application of section 83 to both capital and profits interests has an added advantage of establishing with certainty when the transaction will close for purposes of determining the future character of any payments received.

G. *Application to Tax Shelters*

Partnerships, in particular, are the playgrounds of the tax shelter industry. Certainty in planning the consequences of these transactions is critical. The application of section 83, especially to "profits" interests, fills an important gap by providing a bridge between the service partner's status as an employee and his status as a partner. Section 83 provides the guidelines by which the tax planner can draft an agreement which assures that the service provider will be treated as a partner.

By way of illustration, the basic facts set forth in Example Two above are used in the following example. It is assumed that net cash flow is negative in an amount equal to principal amortization ($10,000 per year) and that depreciation equals $60,000 per year, resulting in an annual tax loss of $60,000.[167] It is further assumed that the building is sold at the end of five years for $1,500,000. From beginning to end, the consequences to the service partner are as follows:

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167. In its simplest form, the tax consequences of such a transaction may be reduced to the following formula: Taxable Income = Net Cash Flow + Principal Amortization − Depreciation. This formula assumes that all cash expenditures, except principal amortization, are deductible. Since net cash flow exactly offsets principal amortization in this example, the tax loss each year equals the depreciation.

	Taxable Income	Tax Loss	Net Effect On Taxable Income
Year One	$12,000[168]	$15,000	$ (3,000)
Year Two	0	15,000	(15,000)
Year Three	0	15,000	(15,000)
Year Four	0	15,000	(15,000)
Year Five	35,200[169]	15,000	20,200

For the service partner in the 50% bracket, the impact of this arrangement is a total tax savings of $13,900 over the five-year period and the receipt of $25,000 in cash on the last day of year five. The beauty of this arrangement lies in the fact that at no point in the transaction has the service partner had to invest any money. Instead, the entire benefits of the package result from his exchange of services for a "profits" interest in accordance with the rules set forth by section 83.

Alternatively, the service partner who is not in need of a tax shelter himself nonetheless has a valuable commodity in the form of his profits interest. At the end of year one, this profits interest could well be worth $35,000[170] to the right investor. If the service partner made such a sale, he would realize $35,000 in cash, recognize a $3,000 tax loss in year one, and recognize a long term capital

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168. This income recognition assumes that the interest transferred is a "profits" interest only.

169. The taxable income of $35,200 results from a long-term capital gain of $88,000 upon the disposition of the partnership interest. The gain is computed as follows:

(1) The service partner's basis in his 25% profits interest is the sum of his capital account balance (a negative $63,000 as the result of an initial balance of $12,000 reduced by $75,000 in loss allocations over the five years) plus his share of the partnership liabilities (25% of the $750,000 remaining on the loan or $187,500) for a total basis of $124,500.

(2) If the building is sold for $1,500,000, the investor will recoup $900,000 (his original investment), $450,000 (the 10% return on investment), and $50,000 (the negative cash flow for five years), leaving profits of $100,000 of which the service partner has a 25% share. On disposition of the partnership interest, the service partner has a total amount realized of $25,000 received in cash *plus* the $187,500 in liabilities assumed by the purchaser. Thus, the total amount realized of $212,500 less the adjusted basis of $124,500 results in a capital gain of $88,000.

170. For example, to a purchaser in the 50% bracket, this arrangement results in tax savings of $7500 in years two, three, and four of the model for a total of $22,500. In the fifth year of the model the taxpayer recoups $25,000 in cash. This results in a long-term capital gain of $50,000 (amount realized of $212,500 less adjusted basis of $162,500). This in turn results in a net effect on taxable income in year five of $5,000 ($2,500 in taxes, assuming the 50% bracket). Thus, for a net investment of $10,000, the purchaser saves $20,000 in taxes over the four-year period.

gain of $38,000 upon the disposition.[171] Once again, the beauty of the transaction lies in the fact that the service partner has expended no money. In this scenario, he has converted his interest to cash early in the deal, and, most importantly, he has ensured that the monies actually received will be treated as capital gains rather than as compensation.

This one simple example, of course, only scratches the surface of the almost limitless possibilities which the application of section 83 to all partnership interests might open up for the tax-shelter industry.[172] However, this example does at least illustrate the exciting possibilities and should, in fact, arouse further support among practitioners for the viewpoint that the application of section 83 to the transfer of all partnership interests is an idea whose time has come.

V. Conclusion

Section 83 is broad in scope and was intended to provide a comprehensive set of guidelines for the tax treatment of the receipt of all types of property in exchange for services. The application of section 83 to partnership capital interests and partnership profits interests given in exchange for services leads to results which are generally consistent with those found in case law. Admittedly, capital and profits interests are very different, but both are property. The resolution of the differences in treatment given to these interests in a manner favorable to the taxpayer lies not in the issue of whether section 83 should be applied to both but rather in the different methods of valuation which must be associated with each. It is in this latter realm that the greatest planning opportunities are to be found and the taxpayer victories won. Consequently, the latter is the area on which practitioners should be focusing. In light of these inherent differences and because of various other provisions of the statute, the application of section 83 to all partnership interests continues the great flexibility generally associated with the

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171. The long-term capital gain of $38,000 results from the fact that the service partner's basis at the end of year one is $194,500 (capital account of negative $3,000 plus 25% of $790,000 in liabilities) and his amount realized is $232,500.

172. In many of the more highly leveraged tax shelter partnerships, the "profits" expected at the end of the deal are far less, and the tax savings generated are far greater, than in the case of the example used in this Comment. Perhaps with the exception of those situations where interests are actively traded and have a readily ascertainable fair market value, the application of § 83 to a profits interest could result in considerably less income recognition, while at the same time confer in the recipient the rights to a commodity of far greater value than that used in the example.

planning of partnership transactions. Implicit in the application of section 83 to a profits interest is the recognition of the recipient as a partner, thus opening new and exciting opportunities with respect to tax shelters.

In conclusion, section 83 is a bridge between the status of employee and that of capitalist. The application of section 83 to the receipt of both partnership capital and profits interests represents a roadway to certainty in planning and controlling the tax consequences of such transactions.