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# Income Tax - Taxable Income - Contributions of Service and Property to Corporation

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gave every benefit to the selling shareholder. Particularly, the court was unwilling to preclude the defendant from selling his controlling interest as a block when a less restrictive interpretation was available.<sup>19</sup>

Thus, while the instant case only assumes the validity of restrictions on the alienability of stock,<sup>20</sup> it increases the likelihood that such restrictions will be accepted in Louisiana. Moreover, the case clearly aligns Louisiana with the majority position that such restrictions will be strictly construed.

*Marshall B. Brinkley*

#### INCOME TAX — TAXABLE INCOME — CONTRIBUTIONS OF SERVICE AND PROPERTY TO CORPORATION

Appellee, a geologist, agreed with others in a partnership to look for and buy potentially productive oil and gas properties in return for a monthly drawing salary and expenses and a partnership interest in the properties after the others recovered their costs. The arrangement proved successful, and when it became evident that costs would be recovered, the original agreement was terminated and all the oil and gas properties that had been acquired were transferred to a newly-formed corporation. Appellee received 13% of the stock but included no part of the value of the stock in his income tax return for that year.<sup>1</sup> The Commissioner ruled that the fair market value of the stock should have been included in gross income and assessed a defi-

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19. 166 So.2d at 360: "To uphold plaintiff's position would be to put Newland in a position where he would be unable to sell a controlling interest in the corporation."

20. The court in the instant case, 166 So.2d at 360, states that "restrictions are valid under Louisiana law," citing *State ex rel. Scott v. Caddo Rock Drill Bit Co.*, 141 La. 353, 75 So. 78 (1917). The *Scott* case, however, expressly avoided ruling upon the validity of the provision in question. *Id.* at 359, 75 So. at 80.

1. The facts in the court of appeal opinion are stated very briefly, but according to the district court opinion it appears that from February 9, 1951, through March 31, 1955, the partnership advanced capital in the sum of \$1,245,106 and recovered from oil and gas production on the properties the sum of \$1,008,613. The partnership expected the properties to be paid out by November 30, 1955, and accordingly the corporation was formed to which were transferred all the properties acquired through the efforts of appellee under the agreement, with each party receiving "shares of stock in the corporation proportionate to his respective interest in the properties." *Frazell v. United States*, 213 F. Supp. 457, 460 (W.D. La. 1963). The 13% stock interest of appellee in the newly-formed corporation was determined to have a fair market value of \$91,000.

ciency which appellee, paying under protest, sought to recover in the district court on the ground that the 13% stock interest was received as the result of a tax free exchange to a corporation.<sup>2</sup> The district court upheld appellee. On appeal by the Commissioner, the Fifth Circuit Court of Appeals reversed. *Held*, fair market value of corporation stock received as a result of rendering services to an existing partnership was ordinary income as compensation for services rendered except to the extent of contribution of a valuable oil map. *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *rehearing denied*, 339 F.2d 885.

The acquisition and development of oil and gas properties can be an expensive undertaking<sup>3</sup> and it is not uncommon to find the owner of an oil and gas lease or other mineral interest without sufficient funds to develop it. In such circumstances he may transfer all or part of his interest to another operator for development under what is known as a carried interest arrangement. Under this arrangement the transferee will pay all costs and receive all income until his costs are recouped, after which time the parties will share income and expenses in an agreed proportion.<sup>4</sup> One kind of carried interest transaction is known as the *Manahan* type.<sup>5</sup> Generally, in the *Manahan* type carried interest, *A*, the transferor, assigns all of his share of the working interest to *B*, the transferee, subject to a right of reversion in favor of *A*. The reversionary right entitles *A* to the reassignment of a specified fraction of the working interest, after *B* has

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2. INT. REV. CODE of 1954, § 351(a), provides that no gain or loss shall be recognized upon a transfer of property to a corporation in exchange for stock therein provided certain elements are met. See note 11 *infra*.

3. For an outline of the costs and planning that goes into a typical oil and gas development arrangement, see Alexander, *Financing of Oil and Gas Interests*, FIFTH ANNUAL INSTITUTE ON MINERAL LAW 3 (LSU 1957).

4. See BREEDING & BURTON, INCOME TAXATION OF OIL AND GAS PRODUCTION § 2.08 (1961); 2 WILLIAMS & MEYERS, OIL AND GAS LAW §§ 424-424.44 (1959).

5. The name of this type comes from the leading case where this particular arrangement was used. *Manahan Oil Co.*, 8 T.C. 1159 (1947). Other varieties are known as the *Abercrombie* and the *Herndon* types, likewise taking their names from the leading cases of *J. S. Abercrombie Co.*, 7 T.C. 120 (1946), *aff'd*, Commissioner v. *J. S. Abercrombie Co.*, 162 F.2d 388 (5th Cir. 1947) and *Herndon Drilling Co.*, 6 T.C. 628 (1946). In the usual *Abercrombie* type the carried party gives a lien or mortgage on his retained interest to secure development costs advanced on his behalf by the grantee, but is not personally liable on the obligation for the development advances. In the usual *Herndon* type the owner of a share of the working interest assigns an oil payment, payable out of the working interest, equal in amount to the share of development costs attributable to his working interest plus operating costs during the pay-out period of the oil payment. See generally, BREEDING AND BURTON, INCOME TAXATION OF OIL PRODUCTION §§ 8.15-8.18 (1961); 2 WILLIAMS & MEYERS, OIL AND GAS LAW §§ 424-424.4 (1959).

recovered the designated development and operating costs from production. This kind of carried interest has also been drafted so that a springing executory interest is conveyed by the carrying party to the carried party, such interest becoming possessory upon recoupment of costs.<sup>6</sup> Since it is not unusual to find an interest in oil and gas property conveyed to a person for valuable services rendered,<sup>7</sup> a troublesome problem arises as to whether an interest received for services through a carried interest arrangement will be taxable upon receipt.

As a general rule, section 61 of the Internal Revenue Code includes in gross income "all income from whatever source derived" unless expressly excluded, and it specifically includes as taxable income compensation for services and gains derived from dealings in property.<sup>8</sup> Compensation for services, though usually thought of in terms of money, can also take the form of any property or economic benefit transferred for services rendered.<sup>9</sup> Gains derived from dealings in property may include the fair market value of stock in a corporation or a proprietary interest in a partnership received in exchange for property transferred, unless such a transfer can be classified as tax free under the Code.<sup>10</sup>

When a person wishes to form a corporation, section 351(a) of the 1954 Code gives the statutory basis for a tax free transfer by providing that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities of the corporation, and if immediately thereafter the transferors are in control of the corporation.<sup>11</sup> This provision encompasses the incorporation of a

6. See 2 WILLIAMS & MEYERS, OIL AND GAS LAW § 424.1 (1959); see generally *id.* §§ 424-424.4; *cf.* *Prater v. Commissioner*, 30 T.C. 1262, 9 Oil & Gas Rep. 588 (1958); *reversed*, 273 F.2d 127 (5th Cir. 1959).

7. See, *e.g.*, *Massey v. Commissioner*, 143 F.2d 429 (5th Cir. 1944); *Walls v. Commissioner*, 60 F.2d 347 (10th Cir. 1932); *Thomas Blake*, 20 T.C. 721 (1953).

8. INT. REV. CODE OF 1954, § 61: "General definition. — Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, and similar items; . . . (3) Gains derived from dealings in property . . ."

9. *Treas. Regs.* § 1.61-1 (1957); *id.* § 1.61-2 (1963); see *Commissioner v. Smith*, 324 U.S. 177 (1945); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929); see also *Commissioner v. LoBue*, 351 U.S. 243 (1956).

10. See *Treas. Regs.* § 1.61-6 (1957); *cf. id.* § 1.351-1 (1955); *id.* § 1.721-1 (1956); see also cases cited in note 9 *supra*.

11. INT. REV. CODE OF 1954, § 351(a): "General Rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section

new venture, an existing proprietorship or partnership, or the creation of a subsidiary corporation.<sup>12</sup> The term "property" includes real or personal property, stock or securities of another corporation, and money.<sup>13</sup> However, by statutory exception, stock or securities issued for services, such as promotional shares issued for services rendered by an underwriter, promoter, or attorney, are not issued for property.<sup>14</sup> Consequently, stock or securities issued for services are not treated as though issued for property entitling them to tax free treatment, and the fair market value of the securities when received is taxable as compensation under section 61 of the Code.

The statutory basis for the tax free formation of a partnership is found in section 721 of the Internal Revenue Code, which provides that no gain or loss shall be recognized by a partner or a partnership where property is contributed to the partnership in exchange for an interest therein.<sup>15</sup> There were no corresponding provisions in the 1939 Code, but under the prior law the courts treated transfer of property in formation of a partnership as tax free,<sup>16</sup> and the only jurisprudence involving the receipt of a partnership for services rendered is in two decisions relating to the law as it stood prior to the enactment of section 721 in 1954. The Tax Court has held that a partnership interest received for services rendered is taxable as ordinary income.<sup>17</sup> However, in *Farris v. Commissioner*<sup>18</sup> the Tenth Circuit, reversing the Tax Court, held that the partner who receives as partnership interest in return for services performed for the partnership is not chargeable with ordinary income on

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368(c) [relating to 80% control requirements of the corporation]. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property." See also *Mailloux v. Commissioner*, 320 F.2d 60 (5th Cir. 1963).

12. See *Treas. Regs. § 1.351-1* (1955).

13. See *Halliburton v. Commissioner*, 78 F.2d 265 (9th Cir. 1935); *George M. Holstein, III*, 23 T.C. 923 (1955).

14. *INT. REV. CODE of 1954 § 351(a)*, quoted note 11 *supra*; see *Treas. Regs. § 1.351-1(a)*.

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

16. See *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (1934); see generally 6 MERTINS, *FEDERAL INCOME TAXATION* § 35.37 (1957). Indications are that § 721 represents a statement of the law as it existed prior to 1954. See S. Rep. No. 1622, 83d Cong., 2d Sess. 388 (1954). See generally *Nicholson, Interest in Partnership Capital Received in Exchange for Services*, N.Y.U. 19TH INST. ON FED. TAX. 227 (1961).

17. *Leonard A. Farris*, 22 T.C. 104 (1954); *Harry W. Lehman*, 19 T.C. 659 (1953).

18. 222 F.2d 320 (10th Cir. 1955).

the receipt of the interest. The court reasoned that the partner had made a contribution of his services to the partnership in exchange for his right to share in the assets, profits and losses, and that, like any other contributing partner, he should receive his interest tax free.<sup>19</sup>

After the passage of section 721 there were suggestions that this section provided for the tax free treatment of the receipt of a partnership interest in return for services on two grounds: that the statutory reference to "any partner"<sup>20</sup> may be read to mean that upon a contribution by "any partner" in the formation of a partnership, all partners receive a tax free interest, even though the interest received is for past services or for the promise to render future services;<sup>21</sup> or that services are "property" within the meaning of the statute.<sup>22</sup> However, the regulations under section 721 specifically point out that this section is not applicable to a partner who in return for services receives an interest in the capital contributions made by other partners and that the value of the interest so received is compensation and constitutes income under section 61 of the Code.<sup>23</sup>

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19. *Ibid.* It is significant, however, that the Commissioner sought to assess the tax at the partnership's dissolution and evidently did not attempt to assess a tax at the time the service partners acquired their interests. The court found that the service partners were chargeable with capital gains at the partnership's dissolution.

20. See note 15 *supra*.

21. McDONALD, DOHAN & PHILLIPS, *FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS* 34 (1957).

22. See Nicholson, *Interest in Partnership Capital Received in Exchange for Services*, N.Y.U. 19TH INST. ON FED. TAX. 227, 229-30 (1961); cf. Roberts Co., 5 T.C. 1 (1945); but see Mojonner & Son, Inc., 12 T.C. 837 (1949).

23. Treas. Regs. 1.721-1(b)(1) (1956): "Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation) section 721 does not apply. The value of an interest in such partnership capital so transferred as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest . . ." (Emphasis added.) But see FISKE, *FEDERAL TAXATION OF OIL AND GAS TRANSACTIONS* § 2.10 (1964).

On denial of rehearing (339 F.2d at 885) the court held that the "capital" referred to in the emphasized language above was any capital of the partnership and not necessarily the originally contributed capital. See note 32 *infra*.

Where the property interests involved pertain to oil and gas, the problem of what is the applicable law is further complicated by the fact that GCM 22730<sup>24</sup> indicates that anyone contributing either materials or services for the acquisition and development of oil and gas property, in exchange for an economic interest therein, is to be treated as having made an investment in the property by contributing to the pool of resources, and not as having received a payment for the materials or services.<sup>25</sup> To receive this treatment, however, certain conditions must be met.

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24. GCM 22730, 1941-1 CUM. BULL. 214.

25. See FISKE, FEDERAL TAXATION OF OIL AND GAS TRANSACTIONS § 2.10 (1964); Kirgis, *Tax Aspects of the Receipt of an Economic Interest in Oil and Gas Property in Return for Services Rendered*, P-H OIL & GAS TAXES ¶ 1008 (1963); *Assignment of an Economic Interest for Personal Services*, 1 OIL & GAS TAX Q. No. 4, 18 (1952). The portion of the ruling giving rise to this implication reads: "If . . . the mere stipulation for oil payments to a person having an investment or capital interest in oil properties amounts, in effect, to a retention of a depletable economic interest in oil in place to the extent of such oil payments, then it would seem to follow that an agreement entitled on making an investment (thereby acquiring a capital interest) in such properties to such payments would give him a corresponding depletable economic interest therein. The point assumes importance in view of the many contracts entered into by owners of lessee interests with well drillers to drill wells, equipment dealers to furnish equipment, and investors to furnish money for use in developing the leased property in return for agreements to make stated payments out of a share of the oil. By such arrangements, a lessee commonly lessens his own investment and the risks and burdens attending development by agreements to share the investment obligation and the proceeds of production. The lessee or assignee, like the lessor or assignor who retained a share interest in production having a value equivalent to that of the lessor's prior interest but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. *If the driller or equipment dealer is making an investment by which he acquires an economic interest in oil and gas in place, expenditures made by him represent capital expenditures returnable tax-free through the depletion allowance rather than by way of expense deduction, and the oil payment rights acquired do not represent payment in property for services rendered or supplies furnished.* Similarly, one who, in return for an oil payment right, furnishes money which the lessee is pledged to use in developing the property would be regarded as making an investment representing an addition to the reservoir of capital investments in oil and gas in place (as distinguished from the purchase of an oil payment right from the lessee wherein there is no such pledge to invest the proceeds in development and the buyer's capital investment would replace the lessee's capital investment allocable to the interest sold). Such a transaction, involving a pledge to use the money furnished in developing the property is distinguishable from a sale the proceeds of which are unqualifiedly received by the seller. This view seems to accord with the realities of the transactions. In none of such cases has the lessee parted with a capital asset, and the investments involved are not his investments." (Emphasis added.) GCM 22730, 1941-1 CUM. BULL. 214, 221. The view that this supports the proposition that an interest received for services or materials furnished is an interest received in exchange for a capital contribution rests on the premise that the contributor of services, in the proper factual situation, has relieved the actual developer from having to make actual cash outlays for such services and has therefore contributed to the pool of capital to develop the property. See *Assignment of an Economic Interest for Personal Services*, 1 OIL & GAS TAX Q. No. 4, 18, 20 (1952).

The person furnishing the materials or services must receive in return solely an economic interest in the oil and gas for which the services are performed or the materials used, and the materials or services so contributed must add to the common pool of investment necessary for the development of the property.<sup>26</sup> If the materials or services are not furnished under these conditions, then presumably the general rules will apply and the value of the interest received in the property will be taxed as ordinary income.<sup>27</sup> However, dictum in the recent Fifth Circuit case of *James A. Lewis Engineering, Inc. v. Commissioner*<sup>28</sup> indicates that the general rules might apply even though the taxpayer did bring himself within these conditions.

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26. *Assignment of an Economic Interest for Personal Services*, 1 OIL & GAS TAX Q. No. 4, 18, 21-24 (1952): "It must be agreed and prearranged between the parties that the services are contributed and that the contributor is to receive a share right in production, marked by the assignment of an economic interest to him, in return for his contribution. . . . The services contributed may not effect a substitution of capital, rather they must add to the pool of capital already invested in the oil and gas in place. . . . The contribution must perform a function necessary to bringing the property into production or augment the pool of capital already invested in oil and gas in place. . . . The contribution must be specific to the property in which the economic interest is acquired. . . . The contribution must be definite and determinable. . . . The contributor must look only to the economic interest acquired for his 'possibility of profit.'" See also Kirgis, *The Tax Aspects of the Receipt of an Economic Interest in Oil and Gas Property in Return for Services Rendered*, P-H OIL & GAS TAXES ¶ 1108.3 (1963).

27. *Of. Lewis Engineering, Inc.*, 39 T.C. 482 (1962), *aff'd*, *James A. Lewis Engineering, Inc. v. Commissioner*, 339 F.2d 706 (5th Cir. 1964). See generally FISKE, *FEDERAL TAXATION OF OIL AND GAS TRANSACTIONS* § 8.02 (1964); Kirgis, *Tax Aspects of the Receipt of an Economic Interest in Oil and Gas Property in Return for Services Rendered*, P-H OIL & GAS TAXES ¶ 1008 (1963); *Assignment of an Economic Interest for Personal Services*, 1 OIL & GAS TAX Q. No. 4, 18 (1954).

28. 339 F.2d 706 (5th Cir. 1964). In *Lewis* the court had before it the question whether a taxpayer rendering engineering services in a secondary recovery operation in return for an interest in a producing property received ordinary income. The court held that this was compensation for services under Internal Revenue Code § 61, stating that it was not necessary to go behind the reasoning of GCM 22730 since this was a production and not a development operation. In so holding, however, the court said: "Unless a careful analysis of the reasons underlying the issuing of GCM 22730 compelled it, the Court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income. Sec. 61(a)(1). . . . In this case, however, it is not necessary to go behind the GCM to determine whether there is an exception for compensation in the form of an assignment of a depletable interest in oil for the engineering services performed by the petitioner. The taxpayer, concedes, as it must, that it is entitled to prevail only if it received compensation in connection with 'the acquisition, exploration or development' of the Seay lease." 339 F.2d at 709. Since the court did not have before it the question whether GCM 22730 allows an exception to the general rules of § 61, it is submitted that under the proper circumstances GCM 22730 will allow an exception. See notes 25-26 *supra*. It may be significant to note, however, that the *Lewis* case and the denial of rehearing in the instant case (339 F.2d at 885) were handed down on the same day. See notes 32, 35 *infra*.



In the instant case the district court thoroughly analyzed the question whether appellee's relationship with the existing partnership was one of employment or of joint venture; and, upon finding that a joint venture existed, the court summarily concluded that this was a tax free exchange, under section 351(a), of appellee's property interest in the joint venture for the stock interest in the newly-formed corporation.<sup>29</sup> The court of appeals took no issue with the district court's finding that the arrangement prior to incorporation was a joint venture, but found that this categorization did not control the question whether the appellee's transfer to the corporation was tax free and found that classifying the transaction as a *Manahan* carried interest arrangement did not change the result.<sup>30</sup> The court reasoned that when appellee's interest in the partnership became vested after the other parties had recovered their costs, he then received an interest as compensation for his services taxable as ordinary income. The court felt that the incorporation resulted in ordinary income to appellee whether his partnership interest became possessory on termination of the original contract (with a subsequent tax-free transfer of his interest to the corporation) or whether the 13% stock interest was given in substitution for the partnership interest originally contemplated.

The instant case presents a fact situation to which application of code section 351(a) and 721 and the corresponding regulations seem appropriate. Section 351(a) specifically provides that stock issued for services is not a tax free exchange,<sup>31</sup> and

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29. 213 F. Supp. 457 (W.D. La. 1963). The district court seemed to assume that when the operation is classified as a joint venture or a partnership the taxability of the service contribution is not at issue. However, even though such a relation would not be one of employer-employee, there may still be a realization of income for professional services rendered on a fee basis under § 721 of the Code and the regulations thereunder unless an exception under GCM 22730 can be found. See notes 23, 25, 26 *supra*; *cf.* Parr v. Scofield, 185 F.2d 535 (5th Cir. 1950); Massey v. Commissioner, 143 F.2d 429 (5th Cir. 1944); Walls v. Commissioner, 60 F.2d 347 (10th Cir. 1932).

30. The court made no mention of the effect of finding the transaction was a carried interest arrangement other than to conclude that a carried interest may be created as "compensation for services rendered, e.g., by a geologist" and that the "interest created by the . . . contract most nearly fits into the 'Menahan' (sic) category of 'carried interests;' that is, 'a springing executory interest conveyed by the carrying party . . . to the carried party . . . , such interest to become possessory upon the satisfaction of [the carrying party's] costs.'" 335 F.2d at 490. The court then found that even if appellee were considered to have had some interest in the properties from their acquisition, his interest would not have become possessory until the carrying parties had recouped their costs, at which time the value of the interest would have been taxable to him under Regulation § 1.721-1(b)(1). *Ibid.*

31. *But see* Rev. Rul. 64-56, 1964 INT. REV. BULL. No. 8, at 9-10, which

the regulations under section 721 indicate the same result for a partnership interest.<sup>32</sup> Since appellee received a stated salary to compensate him for his services during the payout period, he, in reality, made no contribution to the pool of capital to acquire the properties and thus, conceivably, was not an "investor" to fall within the exception of GCM 22730.<sup>33</sup> *Farris* may arguably be distinguished on its facts,<sup>34</sup> but it is significant that the court in *Frazell* mentioned neither *Farris* nor GCM 22730.<sup>35</sup>

It is submitted that, while the result in the instant case appears correct under the facts, to accept it as a broad rule will place the partner, who has nothing to offer but his talent and services, in an unfortunate tax situation, and presumably he is the party with the least amount of capital and the most need for concessions.<sup>36</sup> On the other hand, to limit the holding to the facts presented will allow oil and gas property developers, at

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holds that stock received from a foreign corporation in exchange for secret processes and "know-how" will be considered as a tax-free exchange in certain circumstances.

32. In denying rehearing (339 F.2d at 885) the court continued to interpret Regulation § 1-721-1(b) (1), note 23 *supra*, as requiring appellee be held taxable, notwithstanding the fact that the investing partners had the right to, and were in fact repaid, the entire amount of their contributions. The court took the position that the "capital" referred to in this regulation is whatever partnership capital exists, whether it is the form of original contributions or capital existing after the contributor's costs were recouped. Consequently, when the original partners gave up their 13% interest "they necessarily gave up their own capital interests." 339 F.2d at 886. Regulation § 1-721-1(b) (1) appears to be susceptible of this construction since it was evidently not seriously contended that the original partners were receiving a return of their "capital" rather than skimming off the profits when they recouped their original investment.

33. See notes 25-26 *supra* and accompanying text.

34. See notes 18-19 *supra* and accompanying text.

35. The failure to mention GCM 22730 may lose some of its significance in view of the fact that the *James A. Lewis Engineering, Inc. v. Commissioner*, 339 F.2d 706 (5th Cir. 1964), discussed note 28 *supra*, wherein the court considered GCM 22730, and the denial of rehearing in the instant case, were handed down on the same day, with the court continuing to rely on Regulation § 1-721-1(b) (1). See note 32 *supra*.

36. There was proposed legislation to amend and revise the partnership provisions in Subchapter K of the Internal Revenue Code which passed the House of Representatives in 1960 (H.R. 9662, 86th Cong., 2d Sess. (1960)) but did not pass the Senate for reasons not pertaining to the partnership provisions. Under the proposed legislation, any interest in the capital of a partnership received in return for services rendered would be taxable as ordinary income — in effect a codification of the regulations and the approach in the instant case — unless the interest received were subject to a substantial restriction. Since the legislation was defeated for reasons not pertaining to the partnership provisions it has been suggested that the legislation will be re-introduced, although this has not yet occurred. See Nicholson, *Interest in Partnership Capital Received in Exchange for Services*, N.Y.U. 19TH INST. ON FED. TAX. 227, 238 (1961); see also Anderson & Coffee, *Proposed Revision of Partnership and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K*, 15 TAX L. REV. 285 (1959).

least, to draft a carried interest agreement that would come within the possible exception of GCM 22730, rather than within the general partnership rules,<sup>37</sup> giving a possible stimulus to development and production of oil and gas.<sup>38</sup> For example, the service partner might be vested with an interest at the beginning of the venture and assign his interest to the other parties, subject to reassignment to the service partner upon recoupment of the others' costs. If the service partner receives no compensation in the form of a salary, but receives solely an interest in the properties, it would appear that there is no reason to tax this interest.<sup>39</sup> If this arrangement is not available under the instant case, the prospective developers may find that their only resort, at best, is to minimize the tax consequences by tailoring such devices as stock options<sup>40</sup> or stock dividends<sup>41</sup> to the needs of their particular circumstances.<sup>42</sup>

*James S. Holliday, Jr.*

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37. Under INT. REV. CODE of 1954, § 761 members of an unincorporated organization engaged in the joint production, extraction, or use of property may elect not to come within the partnership provisions of Subchapter K.

38. Because of the expense of the investment and the need of oil and gas for the nation's security and economy, it has been suggested that the oil and gas industry be accorded some tax concessions. Cf. *Panhandle Eastern Pipe Line Co. v. Federal Power Comm'n*, 316 F.2d 659 (D.C. Cir. 1963); see Galvin, *The "Ought" and "Is" of Oil-and-Gas Taxation*, 73 HARV. L. REV. 1441, 1442 (1960).

39. For sample drafting arrangements see Galvin, *Another Look at Sharing Arrangements—Some Drafting Suggestions, Supplement to Lecture Notes*, 16TH ANNUAL INST., OIL & GAS LAW TAX. (Southwestern Legal Foundation, 1965). For a form apparently intended to apply to the facts of the instant case see *id.* Appendix D.

40. Arguably, the parties in the instant case could have partially accomplished their desired objective by means of the stock options provided by the Code which would have given appellee an option to buy into the corporation over a period of years at a reduced amount, provided certain elements are met. See INT. REV. CODE of 1954, §§ 421-425, and regulations thereunder. It is questionable, however, whether such a device lends itself to speculative acquisition and development of oil and gas properties as involved in the instant case.

41. A stockholder employee may be able to trade compensation for capital gain benefits if he is willing to forego immediate cash. If the corporation can—by expansion or otherwise—avoid incurring liability for the Code § 531 tax on improper accumulation of surplus, he can "invest" his services in the corporation. His services will presumably increase the over-all value of the business, at least to the extent they are not offset by withdrawal of immediate monetary compensation. This increase in value can then be "capitalized" by periodic stock dividends. The stockholder-manager would realize no taxable income when the stock is received, and later, when he sells it, the gain would be capital gain rather than ordinary income. However, the circumstances must be such that it does not appear that the stock dividends are in reality given as compensation for services. See *Joy Mfg. Co. v. Commissioner*, 230 F.2d 740 (3d Cir. 1956); 1 CCH 1965 STAND. FED. TAX GUIDE ¶ 289.

42. In the future, relief might also be obtainable through the newly modified income averaging features of the Code. See INT. REV. CODE of 1954, §§ 1301-1305.