Taxation of a Partnership Profits Interest: The Intersection of Income Tax Theory and Partnership Principles

Carter G. Bishop

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TAXATION OF A PARTNERSHIP PROFITS INTEREST:
THE INTERSECTION OF INCOME TAX THEORY
AND PARTNERSHIP PRINCIPLES

CARTER G. BISHOP†

We shall not cease from exploration
And the end of all our exploring
Will be to arrive where we started
And know the place for the first time.¹

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† Professor of Law and Director of the Graduate Tax Program, William Mitchell College of Law; Of Counsel, Lindquist & Vennum, Minneapolis, Minnesota. B.S. 1971, Ball State University; M.B.A. 1973, J.D. (with honors) 1975, Drake University, 1975; LL.M. (Taxation) 1975, New York University.

Ideally, income tax laws should shadow the economic effects of commercial transactions. This shadowing effect promotes predictability, certainty, and stability. The ideal can be difficult to achieve when an uncooperative commercial transaction straddles two or more independent, but related, economic models that have dramatically dissimilar tax implications. Under such equivocal circumstances, a court must choose sides. Is one of the existing economic models appropriate or should the court create a new model? Courts normally resolve this choice through an analogical legal reasoning process which attempts to associate the current transaction with the existing economic model it most closely resembles.

The results of this myopic judicial search for analogies are not always satisfying. New economic transactions tend to replicate the formal characteristics of existing arrangements that have known tax outcomes. As a result, the tax law no longer shadows economics; it dictates the economic structure. This places a premium on sophisticated and expensive tax advice. If

2. While the substance of a transaction will normally control its form, in these cases form is elevated over substance simply because little substance separates the two arrangements.
the tax treatment can be predicted with confidence, then the result is moderately acceptable. However, when the judicial reasoning process consists of simply listing factual comparisons, uncertainty will develop. Left unchallenged, this uncertainty eventually develops into stability, as practitioners are lulled into a false sense of confidence. But when tragedy strikes in the form of a surprising challenge to what was once thought secure, it brings with it renewed doubt. Such is the case with regard to the tax treatment accorded to the receipt of a partnership profits interest under the Tax Court decision in *Campbell v. Commissioner* and its subsequent reversal by the Eighth Circuit Court of Appeals.

This Article concludes that the Eighth Circuit Court of Appeals reached the correct result in *Campbell* by not taxing the receipt of the profits interest, but its fair market value rationale was critically flawed. The decision does little to resolve future controversy over the taxation of the receipt of a profits interest in exchange for services rendered. The Eighth Circuit’s resolution of the case on the basis of the value of the interest received may have been the most narrow and convenient approach, since the case will be limited to its facts. Unfortunately, adequate opportunity existed to resolve the broader legal issue that has persisted since 1970—is the receipt of a profits interest generally taxable upon receipt? The government conceded in its appellate brief to the Eighth Circuit in *Campbell* that such a receipt is generally not taxable. It is therefore astonishing that the Eighth Circuit did not seize the opportunity to clarify this historically murky area of tax law.

Despite the Eighth Circuit’s reticence to resolve this issue,

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3. For purposes of this article, a “profits interest” is defined as a partnership interest under which the service partner is entitled to only a share of partnership profits and partnership asset appreciation occurring after the receipt of the interest. Subsequent partnership profits therefore include undistributed profits that become part of post-receipt capital. This definition excludes partnership interests under which the service partner shares in any partnership capital existing at the time the profits interest is received. Pre-receipt capital includes contributed capital, pre-receipt unrealized appreciation or depreciation attributable to that capital, and pre-receipt undistributed profits. See Daniel S. Kleinberger & Barbara A. Wrigley, *Who Owns the Christmas Tree? The Disposition of Property Used by a Partnership*, 39 Kan. L. Rev. 245, 266-67 (1991).


6. See infra Part V.B.
the lingering question is why the government does not simply amend its regulations to conform to its own appellate concession in *Campbell*. At the very least, the government should issue a revenue ruling clarifying its position.\(^7\) Considering the longstanding failure of the government to issue any such regulatory clarification, the Eighth Circuit should have resolved the legal standard.

II. Economic Analysis: Understanding the Alternatives

Comparing the established method of taxing the receipt of a capital interest to possible methods of taxing directly a receipt of a profits interest exposes the consequences of different treatment for profits interests.

A. Receipt of a Capital Interest

A partner who renders services to a partnership in exchange for an interest in partnership capital is taxed when the capital interest is received.\(^8\) The transaction is treated as if a current interest in the ownership of the partnership assets were paid to the receiving partner and re-contributed to the partnership.\(^9\) Both the receiving partner (the service partner) and the partners who relinquished an interest in the partnership capital (the non-service partners) must account for the transfer.

7. At the American Bar Association's February 14, 1992, meeting in San Antonio, Texas, Mary Harmon, Assistant to the Chief Counsel of the IRS, spoke at the Tax Section's Partnership Committee meeting. She explained that the Service's concession only applied to the particular facts of *Campbell I*. She added that the Service is actively considering the issue of whether a partner recognizes income on receipt of a profits interest and hinted that the question of whether the partner is acting in an employee or a partner capacity would be important. In the meantime, field agents are to check with the IRS National Office if they have a *Campbell I* type issue. Lee A. Sheppard, *News Roundups from the ABA Tax Section's Midyear Meeting: Harmon Discusses Partnership Interest Issues of Campbell Case*, 54 Tax Notes 936-37 (1992).

8. See United States v. Frazell, 335 F.2d 487, 489 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965); Farris v. Commissioner, 22 T.C. 104 (1954), rev'd, 222 F.2d 320 (10th Cir. 1955); Lehman v. Commissioner, 19 T.C. 659 (1953).

9. I.R.C. § 83(a) (1988). Ownership of the capital interest is subject to the terms of the partnership agreement. Depending upon the agreement's terms, the service partner's interest in the partnership is withdrawn either as an operating or liquidating distribution. This interest is considered the equivalent of the service partner's share of the partnership's liquidation value.
1. **Non-Service Partners**

   a. **Gain or Loss on Transfer**

   If the aggregate fair market value of the partnership assets at the time of transfer is greater or less than their aggregate adjusted bases, the non-service partners must recognize a percentage of the difference equal to the percentage of the capital transferred. The character of any gain or loss is determined by the nature of, and holding period for, each asset of the partnership.

   b. **Deductions**

   A transfer of a capital interest is regarded as a guaranteed payment to be deducted or capitalized by the non-service partners according to the nature of the services rendered to the partnership. Payments for services rendered prior to the formation of the partnership are normally capitalized as section 709 organization or syndication expenses. Payments for services rendered after partnership formation are more likely to be deductible as an ordinary business expense.

   11. See United States v. Davis, 370 U.S. 65, 74 (1962); see also Treas. Reg. § 1.83-6 (1978). For example, assume that the AB Partnership had only two assets and no liabilities when it transferred a 10% capital interest from A to B. Its assets were (1) accounts receivable with a $1,000 fair market value and $0 basis, and (2) land (a capital asset of the partnership with a two year holding period) with a $1,000 fair market value and $200 basis. The partnership must recognize $100 in ordinary income from the accounts receivable transfer and $80 in long term capital gain from the land transfer:

<table>
<thead>
<tr>
<th>Accounts Receivable Transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100 FMV (10% × $1000)</td>
</tr>
<tr>
<td>$ 0 Basis (10% × $ 0)</td>
</tr>
<tr>
<td>$100 Ordinary Income</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Land Transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100 FMV (10% × $1000)</td>
</tr>
<tr>
<td>$ 20 Basis (10% × $ 200)</td>
</tr>
</tbody>
</table>

   $ 80 Capital Gain

   Assuming that A contributed the accounts receivable and land to the partnership and rendered services prior to the formation of the partnership, section 704(c) would require A to recognize the $80 gain. I.R.C. § 704(c) (1988).

   14. Guaranteed payments for ordinary and necessary expenses, such as payments for services rendered, are deductible as business expenses under section 162. See
2. Service Partner

a. Income

A service partner who receives an interest in partnership capital in exchange for services rendered to the partnership, in the past or to be rendered in the future, realizes ordinary income in an amount equal to the fair market value of the partnership interest. The service partner must include the full value of the capital interest in income in the year the partnership "accounts" for the payment. As a result, the service partner must include the fair market value of the capital interest as income even if the non-service partners capitalize the guaranteed payment. The service partner realizes the income even if no money was received.


To assure that the service partner does not share in the tax deduction attributable to the transfer of the capital interest, the partnership agreement should make a section 704(b) special allocation of the deduction to the non-service partners. I.R.C. § 704(b) (1988). Using the example of the AB Partnership, infra, Part II.A.3, if A had contributed cash to the partnership, which had in turn acquired the assets, the partnership should make a special allocation of any gain or loss to A under section 704(b). The special allocation would prevent B from recognizing income twice: when he or she receives the capital interest and later when the partnership recognizes gain.

Id.

15. The income realized from the assets in exchange for services rendered is always ordinary income. I.R.C. § 83(a) (1988).

16. Treas. Reg. § 1.707-1(c) (as amended in 1983). If the partnership interest is subject to a substantial risk of forfeiture as defined in sections 83(a) and (c), the partnership would not account for the transfer until the service partner's interest no longer was subject to such risk or became transferable. I.R.C. § 83(a) (1988); Treas. Reg. § 1.83-7(a). If the service partner's full enjoyment of the capital interest is conditioned upon the future performance of substantial services, the interest is usually considered to be subject to a substantial risk of forfeiture. I.R.C. § 83(c)(1) (1988).

Up until the time when the restrictions on the service partner's interest lapse, the partnership remains the owner of the interest. Treas. Reg. § 1.83-1(a)(1) (as amended in 1978). In order for the partnership to avoid taxation as the owner during this time, the service partner may elect, under section 83(b), to include the interest's value in income at the time of receipt. There is, however, one drawback to this election. If, after including the capital interest in current income, the partner must forfeit the interest, the resulting loss is not deductible. See Treas. Reg. § 1.83-2(a) (1978).


18. Using the example of the AB Partnership, infra Part II.A.3., B would have $400 ordinary income at the time the partnership accounts for the transfer of the capital interest. Assuming the interest transferred to B is not subject to a risk of forfeiture under section 83, the partnership must account for any gain or loss at the time of the transfer, regardless of whether the partnership must capitalize the expense of the transfer. See I.R.C. § 83(h) (1988); Treas. Reg. § 1.83-6 (1978).
b. Basis

The service partner is treated as if the capital interest were received and recontributed to the partnership.\(^{19}\) The basis of the capital interest is equal to its fair market value at the time of transfer.\(^{20}\) This basis prevents the service partner from recognizing the same income twice—first at the time of receipt and second when the interest is sold by the service partner or the partnership.\(^{21}\)

3. Capital Account and Balance Sheet Analysis

In order to visualize this transaction in a slightly different manner, the following capital account analysis reflects a hypothetical partnership balance sheet. In the pre-transfer balance sheet assume that \(A\) and \(B\) form the AB Partnership by contributing $500 each, which is used to buy $1,000 in IBM stock. By the time \(A\) and \(B\) wish to admit \(C\) by transferring a 10% capital interest for architectural services performed in designing the plans for the new partnership business headquarters, the IBM stock has appreciated to $1,200. The original partnership balance sheet would appear as follows:

<table>
<thead>
<tr>
<th>AB PARTNERSHIP; ORIGINAL BALANCE SHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSET: ADJUSTED BASIS:</strong></td>
</tr>
<tr>
<td>Cash</td>
</tr>
<tr>
<td>$1,000</td>
</tr>
<tr>
<td><strong>Book Value:</strong></td>
</tr>
<tr>
<td>$1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>$1,000</td>
</tr>
</tbody>
</table>

| **CAPITAL: ADJUSTED BASIS:**          |
| A                                      |
| $500                                   |
| **Book Value:**                       |
| $500                                   |
| B                                      |
| 500                                    |
| **Total**                             |
| $1,000                                |

Immediately before the contemplated transfer to \(C\), the partnership balance sheet would appear as follows:

---

21. Partnership assets attributable to the interest can be sold by the partnership or by the service partner following an asset distribution. A partner with a capital interest is entitled to a share of the partnership's net assets upon the liquidation of the partnership or withdrawal of the owner-partner. See, e.g., Treas. Reg. § 1.704-1(e)(1)(v) (as amended in 1988). However, many other factors affect the value of the interest. For example, the partnership interest may be subject to a buy-sell agreement at a formula price that depresses its value, the interest may be subject to a minority share discount, or the partnership may own intangible assets that are difficult to value. See Treas. Reg. § 1.83-5(a) (1978); Edgar v. Commissioner, 56 T.C. 717, 762 (1971).
AB PARTNERSHIP; PRE-TRANSFER BALANCE SHEET

<table>
<thead>
<tr>
<th>Asset:</th>
<th>Adjusted Basis:</th>
<th>Fair Market Value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

CAPITAL: Adjusted Basis: Book Value:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$500</td>
<td>$600</td>
</tr>
<tr>
<td>B</td>
<td>500</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

Immediately after the contemplated transfer to C, the partnership balance sheet would appear as follows, assuming that the architectural fees were capitalized as a future construction cost of the building:

AB PARTNERSHIP; POST-TRANSFER BALANCE SHEET

<table>
<thead>
<tr>
<th>Asset:</th>
<th>Adjusted Basis:</th>
<th>Fair Market Value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock-90%</td>
<td>$900</td>
<td>$1,080</td>
</tr>
<tr>
<td>IBM Stock-10%</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Architectural Fees</td>
<td>120</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$1,140</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

CAPITAL: Adjusted Basis: Book Value:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$510</td>
<td>$540</td>
</tr>
<tr>
<td>B</td>
<td>510 (500 + 10 gain)</td>
<td>540</td>
</tr>
<tr>
<td>C</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Total</td>
<td>$1,140</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

This third and final balance sheet reflects that (1) A and B have recognized $20 ($120 fair market value less $100 adjusted basis) on the 10% capital interest transferred to C, (2) A and B have not yet taken a deduction for the $120 value transfer to C since the expense of the transfer was capitalized, but A and B will be entitled to $120 in additional depreciation deductions through a $120 basis increase to the building when constructed, (3) A and B will recognize the $180 ($1,080 fair market value less $900 adjusted basis) remainder of their original $200 ($1,200 fair market value less $1,000 adjusted basis) pre-transfer gain when the IBM stock is sold, and (4) C has recognized $120 income. In effect, C has transferred the capital interest back to the partnership and received a basis in the partnership interest equal to its current fair market value. Having recognized the receipt as income at the time of receipt, C will not recognize income again at the liquidation of the partnership through a receipt of an amount of money equal to the earlier income recognition.
4. Economic Liquidation Analysis

In order to test the economic reality of the above arrangement, the AB Partnership may be hypothetically liquidated immediately after the transfer to C by selling all the assets for cash and distributing the proceeds to the partners in accordance with their capital account ratios. If the IBM stock were sold after the transfer when it had not changed value, A and B would recognize $180 gain and receive a $120 deduction for the abandonment of the building plans. In total, A and B would have recognized the $200 pre-transfer gain and received a $120 deduction for the value of the capital interest transferred to C. C would wind up with $120 in cash. A and B would wind up with $1,080 in cash, their original contribution of $1,000 plus $20 gain on the transfer plus $180 gain on the liquidation sale less $120 transferred to C for services rendered. C would recognize no gain or loss on the liquidation of the partnership interest for $120 since the income was correctly recognized as ordinary income on receipt.22

B. Receipt of a Profits Interest

Contrasted with the taxation of the receipt of a capital interest, the taxation of the receipt of a profits interest is considerably more problematic. The difficulty stems from the fundamental characteristics of the respective interests. A capital interest is a static target. Once the service partner includes the value of the capital interest in income, any changes in the value of the interest merely constitute unrealized gain or loss. If, prior to a liquidating distribution of the partnership capital, any portion of the interest is sold or otherwise disposed of in a taxable transaction, gain or loss would be recognized at that time as "profit or loss."23 In contrast, the value of a profits interest will include the value of any anticipated realized gains or losses attributable to the capital, profits, and services.

As a moving target, the taxation of the receipt of a profits interest primarily presents a question of timing. Timing the taxation of the receipt of a profits interest is particularly prob-

22. In addition to denying C an unwarranted tax deferral as compared to other similarly situated taxpayers, this procedure prevents C from converting ordinary income from services rendered into capital gain on the sale of a partnership interest under section 741.
lematic because of the aggregate approach of partnership tax law, which treats a partnership as a conduit for the conduct of business by its partners. Under the aggregate theory, a partnership would not recognize income from future profits until they were actually received. Since the service partner's income is completely tied to the partnership's future profits, he or she likewise should not recognize income from a profits until it is actually received.

In resolving the timing issue, one question is whether to allow the service partner to use the open transaction method. Should the transaction be held open where the service partner recognizes income only when the partnership realizes, recognizes, and allocates a distributive share to the service partner? Alternatively, should the transaction be deemed closed when the service partner recognizes income on the receipt of the profits interest? The latter treatment is more favorable to the service partner since it will (1) defer the payment of taxes on income realized in connection with the receipt of the profits interests to future years when the partnership actually realizes the associated income, and (2) conceivably permit the service partner to convert the ordinary income for services rendered into capital gain if the future associated partnership distributive share or liquidation payment is capital gain income.

Since partners who receive a capital interest for services rendered cannot obtain the benefits of the open transaction method, the natural tendency is to deny its use to partners

24. The "aggregate" approach insists that all income and loss of the partnership flow through to the individual partners. Under this concept, each partner would report such items for tax purposes according to each partner's share under the partnership agreement. See Carter G. Bishop & Jennifer J.S. Brooks, Federal Partnership Taxation 6 (1990). The aggregate approach characterizes a partner's sale or exchange of an interest in the partnership as more like the sale of a going concern. The selling partner will be deemed to have sold his or her share of each partnership asset. Id. at 274.

In contrast, the "entity" concept of partnership taxation treats the partnership as a separate entity in order to determine the amount, character, and timing of income and loss of the partnership. This concept ignores the individual tax circumstances of the partners. Therefore, it sometimes permits the conversion of ordinary income into capital gain, or the assignment of income among partners. Id. at 6. When there has been a sale or exchange of a partnership interest, the entity theory would view the partner as transferring the partnership interest itself, independent of the partner's interest in the partnership assets. Id. at 273-74.

25. The legislative history of the Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (1980), indicates Congress' intention to reduce the justifications for treating transactions as "open" and permitting the use of the cost recov-
who receive a profits interest unless there is an extraordinary reason to do so. One reason to give the recipient of a profits interest such “preferential” treatment is that the partnership interest received represents, at most, an unsecured and unfunded promise to pay a speculative sum of money in the future. The receipt of such a “mere promise to pay” does not constitute a taxable event under the common law economic benefit doctrine and does not constitute property under section 83. Therefore, no service provider would, or should, be taxed on the receipt of such an interest under section 83 or the section 61 economic benefit analysis.

1. Non-Service Partners

   a. Gain or Loss on Transfer

   Because the partnership has not yet realized future profits, the non-service partners’ interest in the future profits has an adjusted basis of zero. Therefore, the non-service partners will recognize as income the full fair market value of the profits interest transferred to the service partner. Generally, any gain
from the transaction will be characterized as ordinary income as an anticipatory assignment of future partnership income.\textsuperscript{29}

\textbf{b. Deductions}

The non-service partners should be entitled to a business deduction to offset their economic loss in relinquishing the profits share.\textsuperscript{30} Since the non-service partners have a zero basis in the future profits interest, the amount of the deduction will exactly offset the amount of income recognized.\textsuperscript{31} Thus, the transfer of a profits interest will be a non-taxable event for the non-service partners unless the income is treated as a capital gain and the offsetting deduction is considered an ordinary deduction, or the offsetting deduction is deferred to a different period than the income recognition because of a required capitalization.\textsuperscript{32}

\textbf{2. Service Partner}

The service partner must account for the receipt of the profits interest in the current year ("closed transaction") or account for the receipt of the profits interest by including in income a distributable share of future partnership profits as the partnership realizes the profits ("open transaction"). The resolution of the timing question affects the amount of income recognized by the service partner and his or her future basis in the partnership profits interest.\textsuperscript{33}

\begin{flushleft}\textsuperscript{29} Arguably, the gain could be characterized as a capital gain if the transfer is considered a sale or exchange of a partnership interest under section 741. See I.R.C. § 741 (1988). It is unlikely, however, that the future profits would be considered "unrealized receivables" under section 751. Future profits are not receivables at the time of the transfer. See I.R.C. § 751 (1988). To date, the case law has focused on whether the service partner is taxed on the mere receipt of a profits interest. The courts have not yet considered the collateral effect on the non-service partners. For an anticipatory assignment of income analysis, see Stephen A. Lind, Fundamentals of Partnership Taxation 88-91 (3d ed. 1992) (quoting Tax Section Comm. on Partnerships, American Bar Ass'n, Proposal to Amend the Regulations Under Sections 83 and 721 (April 1987)).
\end{flushleft}

\begin{flushleft}\textsuperscript{30} I.R.C. § 162 (1988).
\end{flushleft}

\begin{flushleft}\textsuperscript{31} Like the transfer of a capital interest, a transfer of a profits interest should be regarded as a guaranteed payment, which will either be deducted or capitalized according to the nature of the services rendered to the partnership. Treas. Reg. § 1.721-1(b)(2) (1960).
\end{flushleft}

\begin{flushleft}\textsuperscript{32} Id.
\end{flushleft}

\begin{flushleft}\textsuperscript{33} A decision to tax the receipt of a profits interest as the profits are realized by the partnership means that the service partner will defer taxation of the present value of the partnership profits interest. In future years, the service partner will recognize
a. Current Income Recognition Treatment

The income received by the service partner is a distributive share of the partnership's future income. Thus, the decision to tax the receipt of the interest is equivalent to a decision to tax the present value of the future estimated partnership profits. This will raise metaphysical questions about the proper valuation of the partnership interest.³⁴

The current recognition of income will create a corresponding basis.³⁵ Like the receipt of a capital interest, the service partner will be treated as if the service partner received the interest and contributed it back to the partnership.³⁶ If the fair market value of the profits interest is recognized as current income, both the service partner and the partnership will acquire a basis in the future profits equal to the amount of income recognized under sections 722 and 723.

Taxation of the service partner and the partnership when the partnership realizes the profits attributable to the profits interest depends upon whether the partnership is entitled to amortize its section 723 basis. The profits interest was given a present value that contemplated some liquidation point. Therefore, the amortization period should be the same. The Service should not, on the one hand, be entitled to assume a liquidation timing model for purposes of income inclusion and, at the same time, deny the use of the same time period for purposes of straight-line amortization.³⁷

³⁴. As reflected by Judge Scott in Campbell I, difficult valuation questions are not an effective roadblock to current taxation. Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 254 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991). At this point, the arguments translate into factual questions of valuation which become, in part, a battle of experts. The trial court is relegated to weighing the expert testimony and making a calculated decision. See id.
³⁷. An ABA proposal issued in 1987 suggests an artificial 60-month amortiza-
If the partnership is not entitled to amortize its inside basis in the profits interests, the service partner's outside basis would exceed the partnership's basis in the cash now collected. Since such an event as profits realization is not specified in either section 734 or section 743, the triggering mechanisms for a section 754 election basis adjustment to partnership assets would not occur. Accordingly, an uncorrectable inside-outside basis discrepancy would exist. This is exactly what section 754 corrects and any taxation theory creating such a mismatch should be disfavored.

b. Deferred Income Recognition Treatment

Under a deferred income scenario, the service partner would recognize no current income upon receipt of the profits interest. Instead, he or she would recognize an allocable share of the partnership income in the same year that the partnership recognizes the income. Since the service partner recognizes no income on receipt, the non-service partners receive a basis in the profits as they are reported.

Although fraught with concerns over an unwarranted deferral and potential conversion of income, this approach is clearly preferable. It avoids the double taxation issues arising from inadequate basis recovery methods. It also sidesteps the lack
of an established response under Subchapter K of the Internal Revenue Code for the income and deduction offset to the non-service partners.

3. Capital Account and Balance Sheet Analysis

Using the same example of the AB Partnership above, assume that A and B, who each hold a 50% capital interest, wish to admit C by transferring a 10% profits interest for architectural services performed. Assume that A, B, and C realistically agreed that the partnership profits interest had current present value of $100. The original partnership balance sheet would appear as follows:

AB PARTNERSHIP; ORIGINAL BALANCE SHEET

<table>
<thead>
<tr>
<th>ASSET:</th>
<th>ADJUSTED BASIS:</th>
<th>BOOK VALUE:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>CAPITAL:</td>
<td>ADJUSTED BASIS:</td>
<td>BOOK VALUE:</td>
</tr>
<tr>
<td>A</td>
<td>$ 500</td>
<td>$ 500</td>
</tr>
<tr>
<td>B</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Immediately before the contemplated transfer to C, the partnership balance sheet would appear as follows:

AB PARTNERSHIP; PRE-TRANSFER BALANCE SHEET

<table>
<thead>
<tr>
<th>ASSET:</th>
<th>ADJUSTED BASIS:</th>
<th>FAIR MARKET VALUE:</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>CAPITAL:</td>
<td>ADJUSTED BASIS:</td>
<td>BOOK VALUE:</td>
</tr>
<tr>
<td>A</td>
<td>$ 500</td>
<td>$ 600</td>
</tr>
<tr>
<td>B</td>
<td>500</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

Immediately after the contemplated transfer to C, the partnership balance sheet would appear as follows, assuming that the profits interest was taxable upon receipt and the architectural fees were capitalized as a future construction cost of the building:
AB PARTNERSHIP; POST-TRANSFER BALANCE SHEET

<table>
<thead>
<tr>
<th>Asset:</th>
<th>Adjusted Basis:</th>
<th>Fair Market Value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Architectural Fees</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Profits Interest</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,200</strong></td>
<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital:</th>
<th>Adjusted Basis:</th>
<th>Book Value:</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$550 (500 + 50 gain)</td>
<td>$550</td>
</tr>
<tr>
<td>B</td>
<td>550 (500 + 50 gain)</td>
<td>550</td>
</tr>
<tr>
<td>C</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,200</strong></td>
<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

The last balance sheet reflects that (1) A and B have recognized $100 ($100 agreed fair market value less $0 adjusted basis) on the 10% profits interest transferred to C, (2) A and B have not yet taken a deduction for the $100 transfer to C since the expense of the transfer was capitalized but A and B will be entitled to $100 in additional depreciation deductions through a $100 basis increase to the building when constructed, (3) A and B will continue to recognize 90% of future profits, and (4) C has recognized $100 income on the receipt of the profits interest and thereby receives a $100 basis in the partnership interest, and (5) the partnership obtains a section 723 hypothetical contribution basis. If the partnership is not entitled to amortize this inside basis, such basis effectively transfers to the money profits, as collected, an artificial inside-outside basis distortion beyond the scope of section 754. Thus, if a profits interest is taxed upon receipt, the partnership, and hence the partners, must be entitled to amortize the partnership's inside basis.

Assuming that C's 10% profits interest maintains its original $100 value, and the partnership is not entitled to amortize its basis, C will recognize another $100 in partnership profits but the partnership will have only $100 to distribute to C on liquidation. Thus, C will recognize ordinary income in the year of receipt, ordinary income at the time the partnership realizes its profits, and a capital loss at the time the partnership liquidates. Ignoring the deferral and characterization issues, C will not incur ultimate double taxation.

Immediately after the contemplated transfer to C, the partnership balance sheet would appear as follows assuming that the profits interest was not taxable upon receipt but the
architectural fees were capitalized as a future construction cost of the building:

**AB PARTNERSHIP; POST-TRANSFER BALANCE SHEET**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBM Stock</td>
<td>$1,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Architectural Fees</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,100</strong></td>
<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital</th>
<th>Adjusted Basis</th>
<th>Book Value</th>
</tr>
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<tbody>
<tr>
<td>A</td>
<td>$550 (500 + 50 gain)</td>
<td>$550</td>
</tr>
<tr>
<td>B</td>
<td>550 (500 + 50 gain)</td>
<td>550</td>
</tr>
<tr>
<td>C</td>
<td>0</td>
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<td><strong>$1,200</strong></td>
</tr>
</tbody>
</table>

The last balance sheet reflects that (1) A and B have recognized $100 ($100 agreed fair market value less $0 adjusted basis) on the 10% profits interest transferred to C, (2) A and B have not yet taken a deduction for the $100 value transfer to C, since the expense of the transfer was capitalized, but A and B will be entitled to $100 in additional depreciation deductions through a $100 basis increase to the building when constructed, (3) A and B will continue to recognize 90% of future profits, and (4) C has not recognized $100 income on the receipt of the profits interest and thereby does not receive a $100 basis in the partnership interest.

4. Economic Liquidation Analysis

Assuming that C’s 10% profits interest maintains its original $100 value, C will recognize $100 in partnership profits as the partnership realizes the profits, and the partnership will have only $100 to distribute to C on liquidation. Therefore, C will recognize no gain or loss when the $100 is distributed on liquidation. Under this scenario, C will recognize income only once as the partnership realizes the income.

III. The Diamond Legacy

Prior to 1971, tax practitioners assumed that a partner’s receipt of a profits interest (as opposed to a capital interest) in exchange for services rendered to the partnership would not be taxable on receipt. Income attributable to the profits interest was reported as an allocable share of partnership profits.

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40. See generally 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 5.06[2], at 5-34 to 5-35 (1977).
as those profits were recognized by the partnership. Since the service partner was not taxed on the receipt, the profits interest had a zero tax basis in order to preserve future taxation of the absolute profits.41

This assumption was shaken in 1971 by the United States Tax Court's decision in Diamond v. Commissioner (Diamond I),42 and was affirmed by the Seventh Circuit Court of Appeals (Diamond II).43 Diamond I held that section 721 of the Internal Revenue Code did not shield a service partner's receipt of a profits interest in exchange for services rendered; therefore, the value of the interest should be taxed as current income under section 61.44 The Tax Court had little difficulty valuing the profits interest in Diamond because it was sold only eighteen days after it was received.45

The peculiar facts of Diamond, a 1977 General Counsel Memorandum46 and subsequent case law47 provided tax practitioners with some comfort that the receipt of a partnership profits interest generally was not taxable on receipt if the interest had no ascertainable value because it was not sold immediately following receipt. This complacency was once again shaken in 1990 by the Tax Court's decision in Campbell I,48 which made it clear that valuation of a profits interest was simply a question of fact. After Campbell I, valuation of a profits interest was no longer a significant bar to taxation of its receipt.49 In Campbell II, the Eighth Circuit Court of Appeals reversed the Tax Court on the basis that the profits interests had only speculative value, if any.50 Adding to the confusion, Campbell II questioned whether the receipt of a profits interest was generally taxable at all.51

41. See id.
42. 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).
43. Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).
44. Diamond, 56 T.C. at 546.
45. Id. at 547. Adding to the confusion, the Seventh Circuit noted that the unusual circumstances of the 30-day receipt and sale constituted one of the rare cases where a profits interest would be capable of valuation for tax purposes. Diamond, 492 F.2d at 291.
46. Gen. Couns. Mem. 36,346 (July 25, 1977); see infra Part IV.A.
47. See infra Part IV.B-E.
49. Id. at 266.
51. Id.
The cycle and its conclusion are evident. As long as the taxability of the receipt of a profits interest turns on the factual question of its fair market value, uncertainty will persist. William Campbell won his case, but at great expense. Following *Campbell II*, the remaining question is whether the Eighth Circuit's decision advanced the fairness, certainty, and predictability of tax law, or whether the controversy surrounding the taxation of a profits interest will continue to rage.

**A. Diamond I**

Sol Diamond received a partnership profits interest in 1961 in return for mortgage loan brokerage services. Diamond had rendered the services before the formation of a partnership by obtaining a mortgage loan commitment on real property to be acquired and contributed to the partnership. When the property was distributed to the partnership, Diamond received 60% of the partnership profits or losses, while his partner, Kargman, received the remaining 40%. Thus, Kargman located the property and Diamond located the financing for its acquisition. Eighteen days later, Diamond sold his partnership interest to Kargman for $40,000.

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53. *Id.* at 536. Diamond obtained a $1,100,000 mortgage loan equal to the total purchase price of the property. Under the partnership agreement between Diamond and Kargman, Kargman was required to contribute any necessary partnership funds above the $1,100,000 mortgage loan. *Id.* In the event of a premature liquidation of the partnership, Kargman was entitled to a priority return of any future cash contribution before Diamond was to realize any profits. *Id.* at 537. Under the terms of the arrangement, the partnership did not receive any capital contributions. *Id.*

Arguably, the interest in the partnership shared between Kargman and Diamond was an interest in partnership capital, rather than merely a profits interest. A profits interest is a relative ownership interest, because such an interest is determined by comparing the interest with the rights accorded to the other partnership interests. The Diamond and Kargman partnership interests arguably should have been characterized as a full partnership interest in both capital and profits since at the time of the formation of the partnership, there existed no independent interests in pure capital.

54. *Id.* at 544. The sale of Diamond's interest to Kargman was the conduit for a transfer to a third party. *Id.* at 539. Diamond assigned his 60% interest to Kargman for $40,000. Kargman immediately sold 50% of Diamond's interest to the third party for $40,000. *Id.*

Interestingly, the additional 10% "control" had a significant value, since Kargman retained it on resale. If this was the case, could Diamond's interest have been worth more than the $40,000 sale price? The Tax Court did not discuss this issue.

Diamond reported no income on the receipt of the interest which resulted in a
1. Section 721

Recognizing that a capital interest was taxable upon receipt, Diamond nevertheless asserted that, under the section 721 regulations, a partnership profits interest was not taxable on receipt. Regulation 1.721-1(b)(1) states in pertinent part:

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.\(^{55}\)

Diamond argued that the parenthetical implied that the receipt of a capital interest as compensation for services rendered is taxable to the service partner but that the receipt of a profits interest is not. Accordingly, the proceeds from the subsequent sale of the interest should be reported as a short-term capital gain.\(^{56}\) The government countered that the partnership interest was a capital interest rather than a profits interest and was therefore taxable when received under section 61 and regulation 1.61-2(d)(1).\(^ {57}\)

Judge Raum determined that Diamond received "property" in exchange for services rendered before the formation of the partnership, which was taxable under section 61.\(^ {58}\) The court expressly rejected Diamond's argument that section 721, as interpreted by regulation 1.721-1(b)(1), exempted the receipt of a profits interest from the section 61(a)(1) definition of income.\(^ {59}\) Judge Raum noted that the section 721 non-recognition provisions apply only to a partner who contributes zero basis in the interest. On the $40,000 sale three weeks later, Diamond reported a $40,000 short-term capital gain. The gain was utilized to absorb a short-term capital loss carryover to 1961. The government asserted that Diamond should report $40,000 ordinary income from services rendered to the partnership measured by the value of the partnership profits interest received in return. Under this theory, Diamond was entitled to a commensurate $40,000 adjusted basis in the profits interest. As a result, when Diamond sold the interest to Kargman, he needed to report no gain or loss from the sale. The net effect of the recharacterization of the short-term capital gain to ordinary income was to deny Diamond the ability to offset the short-term loss carryovers against the income.


\(^{56}\) Diamond, 56 T.C. at 544.

\(^{57}\) Id.

\(^{58}\) Id. Section 83 was enacted in 1969 and was therefore inapplicable to the years in issue. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 321, 83 Stat. 487, 588 (1969).

\(^{59}\) Diamond, 56 T.C. at 546.
"property" to a partnership in exchange for a partnership capital or profits interest. The judge concluded, "it is clear that a contribution of services is not a contribution of 'property.'”

Having determined that section 721 did not apply, Judge Raum examined Diamond’s contention that, even if section 721 only applies to the contribution of "property," the parenthetical reference in regulation 1.721-1(b)(1) expands non-recognition protection to the contribution of services in exchange for a profits interest. The judge found that the language of the parenthetical clause meant only that the receipt of a profits interest was not governed by the regulation which considered only the receipt of a capital interest for services. Judge Raum concluded, “the effect of the first parenthetical clause . . . is obscure . . . . To apply section 721 [in the present case] would call for a distortion of statutory language, and we cannot believe that the regulations were ever intended to require that result.”

2. Valuation

Having determined that the receipt of a profits interest for services was not governed by the non-recognition provisions of section 721 or Treasury Regulation 1.721-1(b)(1), Judge Raum concluded that the receipt must be included in income under section 61, provided the interest has an ascertainable fair market value. Diamond asserted that his interest had no ascertainable value at the time of receipt because the interest could not be assigned without Kargman’s consent. Judge Raum rejected this argument and accepted the government’s valuation of Diamond’s interest at $40,000, reasoning that Diamond’s interest was actually sold subject to the transfer

60. Id. at 545.
61. Id. at 544-45 (citing Treas. Reg. § 1.721-1(b)(1) (1954)).
62. Id. at 546.
63. Id. at 545-46.
64. Diamond did not argue, and the Tax Court did not discuss, whether it was proper to include the receipt of a profits interest in income under the economic benefit theory of section 61. The Court simply concluded without further analysis that since section 721 did not apply, the receipt of the interest was taxable under section 61. Id.
65. Id. at 546-47.
66. Id. at 546.
67. Id. at 547.
B. Diamond II

Diamond appealed the Tax Court decision to the Seventh Circuit Court of Appeals. Consistent with the lower court’s opinion, the Seventh Circuit confined its analysis to essentially two issues: whether, by negative implication, section 721 and Treasury Regulation 1.721-1(b)(1) prevented Diamond’s profits interest from being taxed on receipt; and, if not, whether the profits interest had an ascertainable fair market value at the time of receipt.

1. Section 721

Like the Tax Court in Diamond I, the Seventh Circuit panel reviewed the language of section 721 and Treasury Regulation 1.721-1(b)(1), but was unwilling to conclude that, by negative implication, those provisions excluded the receipt of a profits interest in exchange for services from current taxation. The court noted that the legislative history of section 721 and Treasury Regulation 1.721-1 was “equivocal.” In addition,

68. Id. While a transfer restriction is one factor to be considered in determining value, it is not necessarily a determinative factor. Id. at 546. In any event, the $40,000 sale of the interest subject to the transfer restriction properly considered the value of the restriction.

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

70. The Seventh Circuit did not review the Tax Court’s conclusion that a contribution of personal services was not “property” for purposes of section 721. Id. at 289. The court did, however, observe that section 721 was silent on the issue of a contribution of services unless the term “property” included services. Id.

71. The court noted that a number of statements in the hearings and committee reports regarding the legislative history of section 721 and Treasury Regulation 1.721-1, paralleled the parenthetical phrase “as distinguished from a share in partnership profits” in Treasury Regulation 1.721-1(b) and provided that section 721 does not apply when a taxpayer receives only a profits share. Id. (quoting S. Rep. No. 1616, 86th Cong., 2d Sess. 117 (1960)). The court also noted a statement by Arthur Willis, the chairman of the Internal Revenue Code Subchapter K Advisory Group, that “if the service partner were to receive merely an interest in future profits in exchange for his services, he would have no immediate taxable gain because he would be taxed on his share of the income as it was earned.” Id. (citing Hearings on the Advisory Group Recommendations on Subchapters C, J and K of the Internal Revenue Service Before the House Comm. on Ways and Means, 86th Cong., 1st Sess. 53 (1959)). The court reasoned that the “lack of concern over an income tax impact when only a profit-share was conferred might imply that such conferring of a profit-share would not be taxable under any circumstances, or might imply an opinion that it would be income or not under § 61 depending upon whether it had a determinable market value or not.” Id. at 290.
previous administrative and judicial interpretation of the sections provided little guidance. The court acknowledged numerous commentators’ opinions on the issue, and recognized that they were unanimous in their decision that the conferral of a profit share as compensation for services is not income at the time of the conferral. After calling upon the government to issue regulations to resolve the issue, the court determined that, in view of the widespread nature of the controversy, the wisest policy was to defer to the expertise of the government and the Tax Court. Therefore, without analysis, it affirmed that the receipt of a profits interest with a determinable market value is income at the time of receipt.

2. Valuation

The Seventh Circuit also affirmed the Tax Court’s decision that Diamond’s profits interest had an ascertainable fair market value at the time received. The court had little difficulty agreeing that the profit interest had a determinable market value because Diamond’s services had been completely performed, and the prospect of earnings from the real estate activity was evidently very good. In discussing the valuation of a profits interest, however, the court recognized that in most cases the value of the profits interest would be speculative at best.

72. In considering the government’s interpretation of section 721 and Treasury Regulation 1.721-1, the court noted that the Service had not, since its victory in Diamond I, “asserted delinquencies where a taxpayer who received a profit-share with determinable market value in return for services failed to report the value as income, or [by regulation] has otherwise acted consistently with the Tax Court decision.” Id.

The court also noted that judicial interpretation of the provisions was sparse. Only one unexplained statement by the Tax Court, a footnote in Hale v. Commissioner, 24 T.C.M. (CCH) 1947, 1502 n.3 (1965), squarely addressed the question: “under [Treasury Regulation 1.721-1(b),] the mere receipt of a partnership interest in future profits does not create any tax liability.” Id.

73. Id. at 289 & n.4. The court noted that although unanimous in their treatment of the profits interest, the commentators had provided little explanation or statutory analysis to support the conclusion that the receipt of a profits interest in exchange for services rendered is not income at the time the interest is conferred. Id.

74. Id. at 291.

75. Id.

76. Id. Since neither the government, Diamond, nor the Tax Court raised the issue of whether the receipt of a profits interest constituted a currently taxable economic benefit under section 61, the issue was not addressed by the Seventh Circuit.

77. Id. at 290.

78. The court explained:
3. Double Taxation

Unlike the Tax Court, the Seventh Circuit expressed concern regarding Diamond's argument that he would be taxed twice if he were not permitted to amortize the value of the interest originally treated as income. The court was unwilling to conclude that the absence of a recognized procedure for amortization is a reason to not include the value of the profits interest in income when received.

C. Analysis

The Tax Court's conclusion in Diamond I, that a partner's contribution of services to a partnership should not be considered a contribution of "property" for purposes of section 721, was accurate. However, it does not necessarily follow that merely because the contribution of services is not protected under section 721's non-recognition provisions, the receipt is automatically taxable. In such cases, the quality of the "receipt" must be examined in order to determine if the receipt is affirmatively taxable under section 61. In failing to discuss this

There must be a wide variation in the degree to which a profit-share created in favor of a partner who has or will render service has a determinable market value at the moment of creation. Surely in many of the typical situations it will have only speculative value, if any.

Id. at 290 (emphasis added).

79. Id. at 290-91. Diamond argued that he would be subject to double taxation if he were taxed on the market value of a profit share at the time it was received and later taxed on the full share of partnership earnings as realized by the partnership. Diamond contended that the problem could be avoided by permitting a service partner to amortize the value originally included in income. Id. at 290.

80. The Tax Court's analysis was arguably flawed. To support his conclusion, Judge Raum stated that it was "clear" that services are not property within the meaning of section 721 and cited as authority cases that primarily referenced section 351, the provision that governs tax-free transfers to a corporation. Diamond v. Commissioner, 56 T.C. 530, 545 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974). Section 721 governs tax-free transfers to a partnership.

Entity transfer non-recognition provisions such as sections 351 and 721 were intended to encourage a simple reorganization of a business from one form to another by facilitating the transfer of property. See Carter G. Bishop, A Tale of Two Liabilities, 16 WM. MITCHELL L. REV. 1, 23 (1990) (discussing the legislative history of section 351). The provision of services to the entity does not engender the same tax policies for deferred recognition as the provision of property. A partner who provides services is simply being paid for work performed and should be taxed under the general provisions of sections 61 and 83 governing the quantity, quality, and timing of ordinary income recognition. Accordingly, a transfer of services to either a partnership or a corporation should not be regarded as property.
second point, the court failed to provide a guide for future resolution of this issue.

Sections 83 and 61 govern the taxability of receipts, while section 721 overrides their provisions with regard to certain partnership transfers. The theory of section 721 is that receipts otherwise taxable under sections 83 and 61 should not be taxable if the taxpayer has merely altered its form of doing business. However, nothing in section 721 requires a receipt to be taxable if the receipt would otherwise be nontaxable under sections 83 and 61.

Under sections 83 and 61, the first question is whether the service partner has received a currently taxable economic benefit in exchange for the services rendered. This economic benefit issue is resolved by determining, as a matter of federal law, whether the rights acquired by the service partner in exchange for the services constitute more than a "mere promise to pay." A mere promise to pay will not be taxable, even if it has an ascertainable market value and is not subject to forfeiture. In the final analysis, it is not uncertain value or market risk exposure that blocks the current taxability of a mere promise to pay. It is simply where the line must be drawn to preserve separate treatment for cash and accrual method taxpayers. Without this line, there would be little difference between the two methods of accounting.

Given the Tax Court's failure to analyze the economic benefit question, the Seventh Circuit's deference to the Tax Court is both problematic and troubling. The court's "automatic" approval of the Tax Court's denied Diamond effective review of the lower court decision, and complex issues of partnership tax law were left unresolved.

The Seventh Circuit also added some confusion to the debate in its discussion of the double taxation issue. The court incorrectly implied that Diamond would have been taxed twice on his partnership interest if he had not been permitted to amortize it against future profits. The following illustration establishes that if Diamond had retained his profits interest, the net tax recognition would have only been $40,000. Upon receipt of his interest, Diamond would have a $40,000 "tax cost" basis from including the receipt of the interest in income.

81. Minor v. United States, 772 F.2d 1472, 1475 (9th Cir. 1985).
When the partnership actually realized the $40,000 future profits in future years, Diamond's outside basis in his partnership interest would have been increased from $40,000 to $80,000. Finally, when the $40,000 cash from the partnership profits were actually received in return for Diamond's partnership interest, either through a partnership distribution or a sale, Diamond would have a $40,000 loss. Thus, any double taxation which occurs is only temporary. The proper debate focuses on the timing and character of the income and deductions.

While the above illustration ignores matters of timing and characterization, it casts the transaction in its proper perspective. It is clear that the double taxation envisioned by the Seventh Circuit does not occur.

IV. THE POST-DIAMOND AND PRE-CAMPBELL ERA

The aftermath of Diamond I and Diamond II resulted in confusion. Concerned that it may have won the battle but lost the war, the government quickly conceded that the receipt of a profits interest was generally not taxable. And yet, surprisingly, the government continued to litigate the issue.

Whatever confusion existed within the government, the Tax Court was not similarly afflicted. Relying on Diamond I, the Tax Court continued to hold that the receipt of a profits interest was includable in income while determining in many cases that the interest had no ascertainable fair market value. Valuation, therefore, became an important and controversial part

83. This pyrrhic victory could occur because the government would be required to separately value the interest in each case. The compliance costs associated with the taxation may well outweigh the revenue and policy victories, if any, and may well convert ordinary income into capital gain where the valuation was unrealistically low compared to the value of the services rendered.

84. See Gen. Couns. Mem. 36,346 (July 25, 1977). The government implied that Diamond I and Diamond II did not suggest otherwise since Diamond actually received a capital interest, not a profits interest. See id.

85. In its appellate brief in Campbell II, the government again conceded that the receipt of a profits interest was not taxable. See Campbell v. Commissioner, 943 F.2d 815, 818 (8th Cir. 1991). In Campbell II, however, the Eighth Circuit ignored the government's concession. Id.

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

of the profits interest taxation scheme.\textsuperscript{88} The following discussion chronicles the developments that occurred before the \textit{Campbell} decisions.

\textbf{A. General Counsel Memorandum 36,346\textsuperscript{89}}

In the wake of \textit{Diamond I} and \textit{Diamond II}, the government released General Counsel Memorandum 36,346.\textsuperscript{90} The Memorandum stated that the government would not recognize \textit{Diamond H} "to the extent that it holds that the receipt of an interest in future partnership profits as compensation for services results in taxable income."\textsuperscript{91} In support of \textit{Diamond II}, the Memorandum stated that Diamond received "an interest in capital, as distinguished from an interest in future profits."\textsuperscript{92}

The Memorandum also considered the issue of valuation in cases involving the receipt of profits interests. Specifically, the Memorandum rejected any method that considered whether the taxpayer rendered services in the capacity of a partner.\textsuperscript{93} The government indicated that this valuation method incorrectly "placed a premium on whether the partnership is formed before or after the services were rendered."\textsuperscript{94}

\begin{align*}
88. & \text{In valuing the profits interest in a partnership, the government generally utilized the liquidation method. Under this method, the total value of the partnership assets is multiplied by the taxpayer's profits interest percentage. The government contended that the profits interest should be calculated by multiplying the fair market value of the partnership assets, at the time of the receipt of the interest, by the profits percentage. Taxpayers argued that because any potential liquidation receipt was significantly subordinated, and therefore unlikely, a value could not be subject to double taxation. No value could be determined. Until the Tax Court's decision in \textit{Campbell I}, taxpayers' valuation arguments were often successful.} \text{See infra Parts IV.B.-E.}

& \text{In \textit{Campbell I}, Judge Scott determined that the zero valuation game was at an end.} \text{Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 254-55 (1990), rev'd, 943 F.2d 815, 815 (8th Cir. 1991); see infra Part V.A.3. This opinion set the stage for the Eighth Circuit's disappointing opinion in \textit{Campbell II}, which has simply reignited the zero valuation controversy.} \text{Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991); see infra Part V.B.3.}

89. & \text{Gen. Couns. Mem. 36,346 (July 25, 1977).}

90. & \text{Id. Although the proposed Revenue Ruling in the Memorandum has not been adopted by the Service, the Memorandum itself has never been revoked.}

91. & \text{Id.}

92. & \text{Id.}

93. & \text{Id.}

94. & \text{Id. The Memorandum also reflected that simply because a person owns the right to a partnership's profits does not make that person a partner. An examination of the facts and circumstances is necessary to determine whether the services were}
\end{align*}
B. St. John v. United States

In St. John, a taxpayer received a 15% profits interest in a health care partnership. The Service contended that the profits interest should be valued using the liquidation method. The taxpayer argued that the value of the profits interest was zero because the oral partnership agreement provided that it "would receive nothing upon liquidation of the partnership unless and until the other partners first received their initial cash contributions." The court accepted the taxpayer’s argument that the profits interest was subordinate and that the partnership’s assets were insufficient to receive anything predictable upon liquidation. The court nevertheless found that the liquidation method was the appropriate method for calculating the fair market value of the taxpayer’s subordinate interest in the partnership. In support of this conclusion, the court reasoned that the profitability of the partnership was uncertain because it "was not licensed nor operational and the partnership operated at a loss . . . for that year."

C. Kenroy, Inc. v. Commissioner

In Kenroy, the taxpayer received an 88.2% profit and loss interest in a land development partnership in exchange for brokerage services. The government contended that the fair

rendered by a partner, as distinguished from an employee or independent contractor. Id. The proposed revenue ruling attached to the Memorandum explains:

[A] person who acquires an interest in the future profits of a venture as compensation for services rendered or to be rendered will not be treated as a partner unless there is an intent to invest his services in the enterprise. In other words, it must be intended that the return for the services be contingent upon the future success of the venture. The fact that a future profits interest acquired as compensation for services is sold shortly after it is acquired may be evidence that the seller of the interest intended to receive a fixed amount for the services rather than investing the services in the enterprise and that, therefore, it was not intended that the seller become a partner.

Id.

95. 84-1 U.S. Tax Cas. (CCH) ¶ 9158, at 83,194 (C.D. Ill. 1983).
96. Id. at 83,195.
97. Id. at 83,194.
98. Id. at 83,198.
99. Id. at 83,197.
100. 47 T.C.M. (CCH) 1749 (1984).
101. Id. at 1754.
market value of the interest was currently taxable. The taxpayer argued that the partnership interest was not compensation for services, but could be characterized as a contribution to capital under section 351 or section 721. In the alternative, the taxpayer claimed that the net fair market value of the interest was zero.

The Tax Court agreed with the government that a receipt of a partnership profits interest is includable in ordinary income under sections 61(a)(1) and 83, and Treasury Regulations 1.61-2(d)(1) and 1.721-1(b)(1). However, the court ultimately determined that the fair market of the profits interest was zero. Accordingly, the taxpayer consequently did not receive any income at the time the interest was received.

D. National Oil Co. v. Commissioner

In National Oil, the taxpayer was the primary organizer and managing general partner for two oil exploration and drilling limited partnerships. Because the taxpayer was not obligated to make an initial investment, he received none of the exploration tax advantages. Instead, he received only an interest in potential future profits.

The government first maintained that the taxpayer received a capital interest in the partnership in exchange for services rendered in its formation. In the alternative, the govern-

102. Id. at 1755-56. The Service valued the interest at $367,320. Id. at 1756.
103. Id.
104. Id.
105. Id.
106. Id. at 1758-59. In valuing the profits interest, the Tax Court considered the conflicting opinions of three different real estate appraisers. The government contended that the sales price was not indicative of the true value of the property because it was not clearly an arms-length transaction. Id. The court disagreed with the government’s conclusion, and instead gave weight to (1) a lender’s refusal to base a loan amount on the higher value proposed by the Service, (2) the value of comparable property, and (3) the actual sales price of the parcel in question. Id.
107. 52 T.C.M. (CCH) 1223 (1986).
108. Id. at 1224. The partnership agreement provided that the taxpayer was to receive a certain percentage of the partnership income. In return, he was to pay a corresponding percentage of the completion costs of test wells, as well as operations costs related to the drilling and completion of all subsequent wells. Id. All up-front costs were to be borne by the limited partners. Id.
109. Id. at 1229.
110. Id. at 1228.
111. Id. at 1227-28. The Service valued the capital interests as “at least the portion of leasehold costs and intangible drilling costs of test wells attributable to Na-
ment argued that the expenditure of initial costs by the limited partners, on behalf of the partnership as a whole, created an economic benefit to the taxpayer.112 The taxpayer argued that he received nothing more than a profits interest, and that no capital shift occurred, since he was required to pay a proportional share of leasehold costs and initial drilling costs.113 The court found that the receipt of a capital interest in any partnership was taxable and should be valued by determining the fair market value of the interest received.114 In this case, however, the court held that the taxpayer had received no economic benefit and therefore no taxable income.115

E. Kobor v. United States116

In Kobor, the taxpayer was a general partner in a property development venture.117 The partnership agreement provided that he would receive a share of the future profits in exchange for services rendered, including managing the construction and improvement of undeveloped real property and financing construction overage costs.118 The taxpayer's right to a share of the profits was subordinate to the return of the limited partners' capital and repayment of any outstanding liability.119 In addition, the partnership interest was subject to a transfer restriction.120

The Service argued that the taxpayer's profits interest was taxable, and that it should be valued at 40% of the anticipated value of the interest.121 Finding that the taxpayer's interest was not freely transferable and was subject to substantial risk of forfeiture, the court held that the receipt of the partnership interest in the partnerships but paid by the limited partners or the investors." 112. Id.
113. Id.
114. Id.
115. Id. at 1228-29. "National received nothing from the partnerships. National did not acquire the right to be paid any of the initial capital contributions if the partnerships were liquidated." Id. at 1228.
116. 88-2 U.S. Tax Cas. (CCH) ¶ 9477, at 85,312 (C.D. Cal. 1987).
117. Id. at 85,313.
118. Id. Part of Kobor's responsibility for financing the construction overages included providing a personal guarantee for $500,000. Id.
119. Id.
120. Id. The taxpayer's profits share could not be transferred without the approval of a majority of the limited partners. Id.
121. Id. The 40% figure was the estimated present value of the future income. Id.
interest was not taxable. The court also noted that any valuation of the interest would be speculative because the taxpayer's right to share in the profits was subordinate to the return of the limited partners' capital and other partnership obligations.

V. THE CAMPBELL ERA

A. Campbell I

William Campbell was employed principally by Summa T. Realty, Inc., a real estate brokerage and consulting affiliate engaged in the business of the formation and syndication of real estate limited partnerships. Campbell's employment responsibilities with Summa Realty included locating, negotiating, and acquiring properties. In addition, Campbell obtained the financing necessary to acquire the properties and organize the partnerships that would eventually acquire those properties. Under the employment arrangement, Campbell was to receive compensation equal to 15% of the proceeds of each limited partnership syndication and a special limited partnership interest in each limited partnership he promoted.

In 1979 and 1980, Campbell was involved in the organization and syndication of three limited partnerships, each of which was to acquire and operate a hotel. Campbell received a 2% special limited partnership interest in Phillips House Associates, Ltd., a 1% special limited partnership interest in The Grand, Ltd., and a 1% special limited partnership interest in Airport 1980, Ltd.

Under the terms of his employment arrangement with Summa Realty, Campbell received the three limited partnership interests in exchange for services rendered in the forma-

122. Id. The taxpayer would forfeit his profits interest if he failed to perform future services for the partnership and fund future obligations. Id. The interest could also be forfeited if the taxpayer transferred his interest to a third party without first obtaining the approval of a majority of the limited partners. Id.

123. Id.


125. Id. at 237.

126. Id.

127. Id. at 238-45.

128. Id. at 238. The special limited partnership interests provided immediate tax benefits and a residual value. Id.
tion of the partnerships and a nominal cash contribution.¹²⁹ Each of the special limited partnership interests was subject to similar restrictions: (1) a second tier priority to cash distributions,¹³⁰ (2) specified tax benefits,¹³¹ and (3) a third tier priority to refinancing and liquidation proceeds.¹³² The partnerships also restricted transfer of the limited partnership interests without the consent of the general partner.¹³³

Campbell did not report the 1979 and 1980 receipt of the three special limited partnership interests as income. The government issued a notice of deficiency, asserting that Campbell had received taxable income equal to a value of $42,084 for Phillips House, $16,968 for The Grand, and $20,683 for Airport.¹³⁴

1. **Section 721**

Campbell's primary argument was that he should not be taxed on the receipt of the three special limited partnership profits interests because of the special non-recognition provisions of section 721 and Treasury Regulation 1.721-1(b)(1).¹³⁵ Like the taxpayer in *Diamond*, Campbell argued that, even though the express non-recognition provisions of section 721

¹²⁹. *Id.*

¹³⁰. *Id.* at 238-45. For example, under the Phillips House partnership, the Class A limited partners were entitled to a "priority return" of their 10% capital contributions per year. The special limited partners were entitled to a special priority return of $7,391 per year. The general partner was entitled to a $7,391 return per year. After these identified "priority returns," any money was distributed according to the profit and loss sharing ratios under the agreement. However, the Phillips House partnership was not expected to show a profit for about seven years. *Id.* at 239.

¹³¹. *Id.* at 238-45. For example, in Phillips House, most of the early year tax deductions were due to expense deductions attributable to: (1) various fees paid to the members of the Summa T. Group; (2) a charitable contribution of a conservation easement of $1,200,000 for the facade of the hotel; (3) investment tax credits attributable to certain rehabilitation expenditures; and (4) depreciation. *Id.* at 239-40.

¹³². *Id.*

¹³³. *Id.* at 238.

¹³⁴. *Id.* at 247. The partnership values in the government's notice of deficiency were based on the following three factors: (1) the size of the special limited partnership interest; (2) the amount paid by the Class A limited partners for their limited partnership interests; and (3) the number of Class A units outstanding at the end of each year in question. *Id.* at 253.

In an amended answer, the government also asserted a negligence penalty against Campbell for failing to include the value of the special limited partnership in income on receipt and for taking exaggerated deductions from the partnerships. *Id.* at 247.

¹³⁵. *Id.*
only apply if "property" is contributed to the partnership, Treasury Regulation 1.721-1(b)(1) extends non-recognition protection to the contribution of services in exchange for a profits interest. Campbell argued that the receipt of a profits interest for services rendered to the partnership is not a taxable event. He argued that the regulation distinguishes between a service partner's receipt of a capital interest, which is clearly taxable under section 721(a), and receipt of a profits interest, which is not taxable.

Rejecting Campbell's invitation to overturn Diamond I, Judge Scott of the Tax Court reaffirmed that section 721 does not apply to a partner's contribution of services, and that the court's decision in Diamond I was supported by the policy considerations underlying section 721. She explained that while the profits parenthetical in Treasury Regulation 1.721-1(b)(1) was unclear, Campbell's argument for non-recognition was inconsistent with the plain language of section 721, which makes no distinction between a partner's receipt of a capital interest or a profits interest. The court reasoned that it was inconsistent for Campbell to argue that the receipt of a service partner's capital interest is taxable but the receipt of a profits interest is not. The court, however, gave no explanation why this interpretation of section 721 is necessarily inconsistent with the statute's treatment of a partner's capital interest.

Judge Scott also explained that the policy supporting non-recognition for transfers to a partnership are much stronger for a transfer of property than for a transfer of services. When property is contributed, there is merely a change in the "form of an asset which the taxpayer already owns." In contrast, when services are transferred, the receipt of a partnership interest represents compensation for services rendered. In support of this conclusion, the court cited United States v. Stafford, for the proposition that services do not constitute

136. Id. at 248. The Tax Court accepted Campbell's characterization of the special limited partnership interests as "profits interests." Id. at 247-50.
137. Id. at 249.
138. Id.
139. Id. at 248.
140. Id.
141. Id. at 249.
142. Id.
143. 727 F.2d 1043, 1048 (11th Cir. 1984).
"property." The Tax Court made it clear that to invoke the non-recognition provisions of section 721, the partner must contribute property.

2. Section 83

After rejecting Campbell's section 721 argument, the Tax Court focused on section 83 to determine whether the value of the three special limited partnership interests were includable in income in the year they were transferred to Campbell. The court addressed what it viewed as the three elements of section 83: (1) "property" must be transferred, (2) the transfer must be in connection with the performance of services, and (3) the transferred property must either be transferable or not subject to a substantial risk of forfeiture.

The Court first considered whether a pure profits interest is "property" under section 83. Campbell argued that his profits interests were not property within the meaning of section 83 since they represented nothing more than an unfunded and unsecured promise to pay money in the future. However, relying on the definition of partnership interest found in the Uniform Limited Partnership Act and the laws of Missouri and South Carolina, the Tax Court concluded that a profits interest is "property" for the purposes of section 83.

The Tax Court distinguished Campbell's profits interest from a mere promise to pay. The court reasoned that the recipient of a promise to pay is entitled to a fixed sum of money, unrelated to the profits of a business. In contrast, the

144. Campbell, 59 T.C.M. (CCH) at 249.
145. Id. at 250.
146. Id. at 249-53.
147. Id. at 249-50.
148. Id. at 250.
149. Id. Campbell apparently characterized his interest as an "unfunded and unsecured promise to pay money or property in the future." Treas. Reg. § 1.83-3(e) (1978). Because the interest was not "property" under section 83, Campbell maintained that section 61 should govern whether the transfer was taxable. Campbell, 59 T.C.M. (CCH) at 250.
150. Campbell, 59 T.C.M. (CCH) at 250. The court reasoned that under Treasury Regulation 1.83-3(e), the term "property" includes real and personal property. Under section 701 of the Uniform Limited Partnership Act, as well as the laws of Missouri and South Carolina, a partnership interest is considered personal property. The court saw no reason why a partnership interest should be characterized differently for federal income tax purposes. Id.
151. Id. As a practical matter, though, when no funds have been set aside to se-
holder of a profits interest is completely subject to the exigencies of the partnership's business, which could result in a windfall or nothing at all. Since a profits interest, like a capital interest, bore no resemblance to a mere promise to pay, the Court determined that such an interest was not excluded from the definition of "property" under section 83.

The court next considered whether the profits interest was a "transfer for services" within the meaning of section 83. Campbell argued that no section 83 "transfer" occurred with respect to his acquisition of the special limited partnership interests. Campbell had acquired these interests for a modest sum at the time the partnerships were first formed and before the limited partner capitalization of the partnership occurred. According to Campbell, any increase in the value of the interest was the result of "sweat equity" and was merely unrealized appreciation, much the same as stock in a closely held business.

Judge Scott made short work of this argument and rejected Campbell's argument as one of form over substance. The court concluded that the substance of the transaction was an acquisition of increased value for services rendered in syndicating and selling the limited partnership interests. There-
fore, the interests were deemed transfers for services within the meaning of section 83.

Finally, the court considered whether the transferred property was subject to "a substantial risk of forfeiture" as defined by section 83 and the accompanying regulations. Campbell argued that, even if his profits interest was property according to section 83, the interest was not includable in income in the year transferred because his right to full enjoyment of this interest was "conditioned upon the future performance of substantial services" within the meaning of section 83(c)(1). Campbell contended that he would not receive anything unless his future efforts made the partnerships successful because his profits interests were conditioned with significant subordination rights. Campbell also likened his interest to an "earn-out" in that the property would be valueless unless he performed future services.

The Tax Court determined that Campbell's arguments were spurious, stating that Campbell's future services arguments were concerned with valuation and not forfeiture issues. In addition, the Court noted that no evidence was presented that Campbell's right to retain his profits interest was contingent on future performance.

3. Valuation

In its brief to the Tax Court, the government contended that the Phillips House and Grand interests were worth more than...
stated in the notice of deficiency and that the Airport interest was worth less. The government changed its valuation of Campbell's partnership interests by "discounting the future value of the tax benefits and cash distributions which, according to the projections contained in each partnership's offering memorandum, Mr. Campbell would be entitled to receive from the inception of the partnerships until liquidation." The government's valuation was based on the discounted present value of the projected tax benefits to each limited partner, assuming each partnership was liquidated in 1989. Applying the discount rates, the government determined new values of $67,000, $30,000, and $19,000 for Campbell's special limited partnership interests in Phillips House, The Grand, and Airport, respectively.

Campbell advanced two arguments on the valuation issue. He first argued that the value of the profits interests were so speculative that nothing could be included in income in the year of receipt. Second, he contended that even if the profits interests had value, they were worth less than the government's valuation reflected in its notice of appeal and brief.

a. Speculative Zero Valuation

To support the position that the value of the profits interest...
was too speculative to include in income, Campbell relied primarily upon the Seventh Circuit's statement in *Diamond II*, which recognized that in many cases the profits interest will have a speculative value, if any.\(^{171}\)

Judge Scott acknowledged that the determination of the appropriate valuation criteria is a matter of law, but the determination of the value itself is a question of fact.\(^{172}\) To appropriately resolve such a fact issue, the court could rely upon or reject expert testimony and evidence.\(^{173}\) On this point, Judge Scott determined that the speculative valuation language from *Diamond II* was not dispositive, since there were sales of "similar" limited partner investor interests shortly after the special limited partnership interest was transferred to Diamond.\(^{174}\) Thus, Judge Scott indicated the value of these profits interests were not speculative.\(^{175}\)

b. Minimal Valuation

If any value was to be set by the Tax Court, Campbell stated that it should be determined by expert testimony, and not by the government's unsupported and undocumented valuation.\(^{176}\) Having rejected the speculative test of *Diamond II*, Judge Scott reiterated that the appropriate test for valuation is the price at which the property would change hands between "a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."\(^{177}\) Moreover, since section 83(a) requires that the fair market value of property be determined "without regard to any restriction other than a restriction which by its terms will never lapse," the transfer restrictions attached to Campbell's profits interests were given no effect.\(^{178}\) In addition, Judge Scott needed to determine the conclusiveness of expert testimony since Campbell produced expert testi-

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\(^{171}\) *Id.* (citing *Diamond v. Commissioner*, 492 F.2d 286, 290 (7th Cir. 1974)).

\(^{172}\) *Campbell I*, 59 T.C.M. (CCH) at 254.

\(^{173}\) *Id.* at 254-55.

\(^{174}\) *Id.* at 255. The court disregarded the fact that Campbell's interests were subject to a transfer restriction, since under section 83(a), the transfer restriction was not one which, by its own terms, would never lapse. *Id.* at 254.

\(^{175}\) *Id.* at 255.

\(^{176}\) See *id.* at 254.

\(^{177}\) *Id.* (citations omitted).

\(^{178}\) *Id.*
mony and the government produced none.\textsuperscript{179} Judge Scott discredited Campbell's expert minimal valuation testimony on the basis of the expert's failure to attach any value to the tax benefits associated with the profits interests. The expert reasoned that the tax benefits had no value since the ultimate deductions carried a substantial risk of being disallowed.\textsuperscript{180} The court also discredited the expert's failure to account for the overall economic substantiality of the interests.\textsuperscript{181}

Judge Scott also discredited the government's valuation, because the discount rates used to determine the value of Campbell's respective profits interests were unreasonable.\textsuperscript{182} Judge Scott reasoned that it was unrealistic for the government to assume that the limited partners would prematurely liquidate the partnership when the tax benefits dwindled and simply abandon their right to receive future cash distributions, not to mention their entire cash investment.\textsuperscript{183} Accordingly, the Tax Court determined that the no cash investment return was artificially low. Therefore, the discount rate was also artificially low, which resulted in the ultimate value being overstated.\textsuperscript{184}

Having determined that the government's valuation was too high because of a low discount rate, Judge Scott accepted Campbell's expert's higher discount rate but also applied it to

\textsuperscript{179} Id. The court reasoned:
The testimony of experts on valuation may well assist the trier of fact in making this determination. However, such evidence must be weighed in light of all evidence in the record. Although we may not, without sound reason, disregard expert testimony on the question of valuation, we may reject all or a portion of the opinion of any expert which is contrary to our sound judgment. Id. at 254-55 (citations omitted).

\textsuperscript{180} Id. at 255. Judge Scott appropriately noted that, although many of the deductions were subject to disallowance, the limited partners still paid substantial amounts of money for them. Id. This argument fails to recognize, however, that Campbell was, in fact, a promoter. Therefore, he was not entitled to rely on anyone else when making an investment based upon the promised tax deductions. The regular limited partners, however, had a cause of action against the promoter if the deductions failed. This factor should have been considered by the Tax Court.

\textsuperscript{181} See id.

\textsuperscript{182} Id. The Service had determined the applicable discount rate by discounting the projected cash and tax benefits attributable to a regular limited partner's partnership interest assuming: (1) a 1989 liquidation of each partnership, and (2) the receipt of no cash from the partnership relative to their investment. Id.

\textsuperscript{183} Id.

\textsuperscript{184} Id. Valuation and discount rates are inversely proportional. Therefore, as the discount rate decreases, the value increases.
the tax benefits.\textsuperscript{185} Thus, Judge Scott arrived at her own determination of the value of the partnerships.\textsuperscript{186}

B. Campbell II

The character of this case changed on appeal as several new issues were considered which had not been considered at the Tax Court.\textsuperscript{187} Campbell once again argued that the receipt of a profits interest was not a taxable event.\textsuperscript{188} The Internal Revenue Service, in contrast to its position in the Tax Court, conceded on appeal that the receipt of a profits interest in a partnership, in return for services rendered by a partner to the partnership, is generally includable in the partner's gross income.\textsuperscript{189} However, the government contended on appeal that Campbell did not receive the profits interest in return for services contributed to the partnership. The government contended that he received the interest in his capacity as an employee of his corporate employer. Thus, the interest looked

\begin{itemize}
\item \textsuperscript{185} Id.
\item \textsuperscript{186} The Tax Court held that, using this new formula, the value of The Grand profits interest was $16,818, approximately the same as determined by the government in its original notice of deficiency, and the Airport interest was to be valued at $15,000. \textit{Id.} at 256. The Phillips House was valued at $50,000 on this basis, but Judge Scott determined that since the completion of the funding of that partnership was considerably more problematic at the end of 1979 when the profits interest was actually received, it should be discounted an additional 50\% to compensate for the risk of incomplete funding. Therefore, this interest was valued at $25,000. \textit{Id.}
\item The Tax Court also sustained the government's assessment of a negligence penalty. The negligence penalty was assessed because of over-aggressive deductions, not because Campbell failed to include the profits interest income. \textit{See id.} at 258.
\item \textsuperscript{187} Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991).
\item \textsuperscript{188} \textit{Id.} at 818.
\item \textsuperscript{189} Brief for Appellee at 13-14, Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991) (No. 90-2730). In its brief, the Service stated:
\begin{quote}
We have no quarrel with the general statements of the law of partnership taxation set forth in the briefs of taxpayer and the amici, and do not here argue that the receipt of a profits interest in a partnership in return for services rendered or to be rendered by a partner to the partnership is includable in the partner's gross income. The principles governing partnership taxation set forth in Subchapter K or the Code, and the regulations thereunder, generally would apply to determine the tax consequences of such transactions between a partner and a partnership. But those partnership taxation rules are inapplicable here because, as we will demonstrate below, taxpayer did not receive the partnership interests in return for services he contributed to a partnership. On the contrary, he received the partnership interests as compensation for services he rendered to a third party—his corporate employer. The tax treatment of such compensation is governed by Sections 61 and 83 of the Code, not the partnership provisions of the Code.
\end{quote}
\textit{Id.}
\end{itemize}
less like a promise to pay from the partnership than a transfer of corporate-owned property by a corporate employer.

The Eighth Circuit rejected the government's attempt to characterize Campbell's receipt of the profits interest as compensation for services rendered to his own corporate employer, rather than to the partnership. However, the court concurred in the Tax Court's conclusion that the non-recognition principles of section 721 were not applicable to service partners. Additionally, the court presented a new theory that section 707(a) should control taxability. Ultimately, the court reversed the Tax Court's valuation determination, concluding that the interests were too speculative.

1. Section 721

The Eighth Circuit noted that since the Internal Revenue Code of 1986 does not expressly exempt the receipt of a profits interest by a service partner from taxation, commentators have relied upon three interrelated theories to support the position that the receipt of a profits interest is not a currently taxable event. The Tax Court and the Seventh Circuit rejected the first two of these theories in Diamond I and II. The Eighth Circuit agreed that section 721 did not shield the receipt of a profits interest from taxation, because a service partner does not contribute "property" to the partnership in

190. Campbell, 943 F.2d at 818. The government's argument raised a question of fact that had not been argued before the Tax Court; therefore, the Eighth Circuit refused to consider it. Id. However, the court did suggest that the record implied that Campbell had agreed to forego compensation from his employer in return for the opportunity to receive a partnership profits interest. Id. at 818 n.2.

191. Id. at 818.

192. Id.

193. Id. at 823.

194. Id. at 820. The non-taxable event theories are: "1) based upon Treasury Regulation 1-721.1(b), a profits interest is not property for purposes of sections 61 and 83; 2) a profits interest may have no fair market value; and 3) the non-realization concepts governing transactions between partner and partnership preclude taxation." Id.

195. Id. at 820-21 (citing Diamond v. Commissioner, 56 T.C. 530 (1971); Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974)). The court recognized the distinction between a capital and profits interest in Treasury Regulations 1.83-1(a), 1.83-3(f) and Proposed Regulation 1.721-1(b)(1)(i). The court noted that these provisions implied that the receipt of a profits interest was not taxable under Treasury Regulation 1.721-1(b)(1). Campbell, 943 F.2d at 820-21. For purposes of section 83, Treasury Regulation 1.83-3(e) includes all personal property within the definition of property. Id.
exchange for an interest.\textsuperscript{196} However, the court did recognize the distinction between the receipt of a capital interest and a profits interest. In the former case, the non-recognition provisions of section 721 are necessary to either tax or shield a transfer of assets from one partner to another.\textsuperscript{197} In the case of a profits interest, the court noted that the non-recognition principles of section 721 are superfluous, as no transfer of capital assets is involved.\textsuperscript{198}

2. \textit{Section 707}

Continuing to look for a solution to the taxation riddle relating to the receipt of a profits interest, the court recognized the importance of section 707(a).\textsuperscript{199} The court noted that, as a general matter, a partner receives a distributive share of the income of the partnership, rather than compensation from the partnership.\textsuperscript{200} Section 707(a) provides that when a partner receives a fee for work performed for the partnership, the payment will be treated as though between the partnership and one who is not a partner.\textsuperscript{201}

The court noted that section 707(a) was not intended to apply when a service provider, such as Campbell, acts in a partnership capacity.\textsuperscript{202} The court reasoned that if all transfers of profits interests were taxable upon receipt, section 707(a) would be unnecessary since every transfer would be taxable.\textsuperscript{203}

3. \textit{Valuation}

Ultimately, the court reversed the Tax Court’s valuation as being clearly erroneous.\textsuperscript{204} The Eighth Circuit was troubled

\textsuperscript{196} Id. at 821.  
\textsuperscript{197} Id. at 822.  
\textsuperscript{198} Id. This is really a response without a meaning.  
\textsuperscript{199} Id.  
\textsuperscript{200} Id.  
\textsuperscript{202} Campbell, 943 F.2d at 822.  
\textsuperscript{203} Id.  
\textsuperscript{204} Id. at 823. The court remarked: More troubling, however, is Campbell’s argument that the profits interests he received had only speculative, if any, value. We fully agree with this contention and we reverse the tax court. . . . Recognizing that the tax court’s determination of value is a factual finding subject to clearly erroneous review, and that the tax court does not have to accept an expert’s opinion as to value, we are, nonetheless, left with the firm belief that the court’s valuation was erroneous.  
Id. (citations omitted).
that the Tax Court had ignored the expert testimony concerning the speculative nature of the tax benefits. It concluded that the Service and the Tax Court placed too much weight upon the income projections in the offering memoranda, particularly since the Service did not support its valuation with expert testimony. The Eighth Circuit held that the profits interest had no market value.

C. Analysis

The Tax Court steadfastly adhered to its twenty-one-year-old *Diamond I* rationale. Unfortunately, the *Campbell I* court attempted to justify its decision in *Diamond I* to rebut the substantial adverse commentary that had been levelled at the decision. Unfortunately, the rationales offered by the court contain analytical flaws that create a suspicion that *Diamond I* was wrongly decided to the extent it held that section 721 does not shield the receipt of a profits interest in exchange for services rendered.

The first problem with the court’s analysis under section 721 was its resolution of the section 721 “property” issue. The court cited *United States v. Stafford* for the proposition that a partner’s contribution of services is not a contribution of “property” for purposes of section 721’s income shield. The court’s determination, however, was based upon an inaccurate characterization of *Stafford*. In that case, the taxpayer received a full limited partnership, not just a profits share. Thus, *Stafford* merely confirms the language of section 721 and its regulations—when a taxpayer receives an interest in partnership *capital* in exchange for services, section 721 does not apply. *Stafford* is not helpful in resolving the fundamental issues raised by the taxation of a profits interest under section 721.

The court also rejected Campbell’s argument that a profits

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205. Id.
206. Id.
207. This is not surprising given the great deference accorded by the Seventh Circuit in *Diamond I*.
208. 727 F.2d 1043 (11th Cir. 1984).
209. Id. at 1048.
210. Of course, that is exactly the language of Reg. 1.721-1(b)(1); therefore, the conclusion is not particularly startling and certainly is not a proposition with which Campbell would likely quibble.
interest, unlike a capital interest, is not taxable under section 721 and Treasury Regulation 1.721-1(b)(1) because the argument is inconsistent with the terms of section 721. The court did not explain why it had reached this conclusion. At one level, the Tax Court's reasoning incorrectly presumes that any attempt by the government to regulate a distinction between a capital and a profits interest would fail.211 At another level, the Tax Court implicitly assumed that because section 721(a) was silent on the matter, Congress did not intend to draw a distinction between capital and profits interests.212 This latter statement is self-serving, since it reinforces Judge Raum's conclusion regarding the legislative history of section 721 in Diamond I. That implication is not so clear, however, as illustrated by the Seventh Circuit's review of the same legislative history in Diamond II.213 Given the Seventh Circuit's findings, it is surprising that the Tax Court's interpretation of section 721 legislative history in Diamond I has carried so much weight.

Even the court's tax policy justifications in support of section 721 non-recognition for transfers of property do not withstand close scrutiny, although the court's arguments have some superficial appeal. The decision implies that because a transfer of services is not shielded under section 721, all receipts of profits in exchange for services will be immediately taxable. However, it is too simplistic to suggest that property transfers should be treated differently from service transfers to a partnership simply because of the difference between property and services. The real question is whether the service partner has received a taxable economic benefit.

211. However, the court expressly failed to consider whether Treasury Regulation 1.721-1(b)(1) would be invalid if a negative implication was attributed to the profits interest parenthetical.
213. For example, Arthur Willis, a member of the Internal Revenue Code Subchapter K Advisory Group, discussed the legislative intent of section 721 in his partnership tax treatise, which supports the argument that a profits interest was never intended to be taxed upon receipt. Arthur Willis, Partnership Taxation 117-22 (2d ed. 1971). He reported that "[n]o one in the group ever suggested that a partner who received an interest in future profits of a partnership had any income at the time he received the profits interest. He would report his share of income as it was earned." Id. at 120. Willis further reported that "[i]t was felt that this would give the same result as in the case where an individual is employed and part of his compensation as an employee is contingent on the future income produced by the property he is managing." Id.
It can hardly be argued that all receipts in exchange for services are immediately taxable. The taxation of services has its own natural boundaries, as does the mere change in the form of doing business analysis for property transfers. In order for a service provider to be taxable for services rendered, he or she must receive a taxable economic benefit. Thus, if the receipt of an unfunded, unsecured promise to pay does not constitute an economic benefit, its receipt is not currently taxable.\footnote{214}

Equally problematic was the Tax Court's application of section 83 to Campbell's profits interest. As Judge Scott recognized, a partnership profits interest is a partnership interest, which in turn, is either personal or real property under state law. The Tax Court's reliance on state law to define a covered property transaction was misplaced. The definition of the term "property" under section 83 is clearly within the realm of federal law. State law should only relate to the definition of property in section 83 as to the nature and characteristics of the profits interest. Rather than rely upon state law to determine if a profits interest is property under section 83, the Tax Court should instead have referred to state law only to determine whether the state law characteristics of property amounted to "property" under the federal standard which means determining whether it constituted an "unfunded and unsecured promise to pay money or property in the future."\footnote{215}

The real issue, however, is not the classification of the interest as "property" but whether the profits interest is an "unsecured promise to pay money or property in the future."\footnote{216} Judge Scott erroneously resolved this issue by focusing too narrowly on the precise wording of the statute. This focus led her to compare a "promise to pay" with a profits interest and conclude that they are fundamentally different because a profits interest does not promise a payment of a fixed amount.\footnote{217}

\footnote{214. For precisely this reason, the section 83 definition of property does not even include such receipts. This means that such a receipt would not be taxable under section 83 even if the promise were non-forfeitable since no "property" has been received.}

\footnote{215. See, e.g., Treas. Reg. § 301.7701-1(c) (as amended in 1977); Wheeler v. Commissioner, 37 T.C.M. (CCH) 883 (1978).}

\footnote{216. See Treas. Reg. § 1.83-3(e) (1978).}

\footnote{217. The Tax Court rejected Campbell's argument because (1) its referenced state law definition of a partnership interest makes no distinction between a profits and
The history of the economic benefit doctrine does not confine itself to promises to pay a fixed amount. Normally, the receipt of an unfunded and unsecured promise to pay a speculative or uncertain amount in the future would not be taxable to a cash method taxpayer on receipt. If anything, such uncertainty is an argument in favor of non-taxation.

More intriguing, however, was Judge Scott's conclusion that the profits interest was not a "promise to pay" since Campbell was entitled to tax losses regardless of when or whether any amount of money was to be received in the future. No authority was cited for this proposition and it was not fully developed. Since the promise also pays money or property currently in the form of a reduced tax liability, it is not merely a "promise to pay" money or property in the future, but is an actual payment. Although novel, this argument is spurious as well. Such a "payment" is only an interest-free loan of the deferred tax liability. The tax must eventually be repaid in the future if the deduction was not accompanied by a true economic loss. It

capital profits interest and (2) it noted certain fundamental differences between the profits interest and a mere promise to pay:

The recipient of a promise to pay is generally entitled only to a fixed amount of money that is not specifically geared to the profits of a business. This is the case even though no funds have been set aside to secure payment of the fixed amount so that the payment may in fact be affected by the success of the business. In contrast, the holder of a profits interest in a partnership is not promised a fixed amount of money but, rather, is subject to the exigencies of the partnership's business. He may receive a windfall or he may receive nothing at all. Furthermore, in the instant case, the interest received by Mr. Campbell in each partnership was in profits and losses so that he was entitled to share in the partnership deductions. In fact, any partner, whether he holds a capital or profits interest, will generally be allocated a distributive share of his partner's losses and charitable deductions as was Mr. Campbell in this case.

Because of the differences in the interests received by Mr. Campbell and a "promise to pay," we consider it immaterial whether the bundle of rights Mr. Campbell received in such partnership is denominated as a profits interest or a capital interest. In either event, they bear no resemblance to "an unfunded and unsecured promise to pay money or property in the future" which, along with money, is excluded from the definition of property within the meaning of section 83 by section 1.83-3(e), Income Tax Regs. Therefore, we conclude that the interest transferred to Mr. Campbell in each of the partnerships was property within the meaning of section 83.

Campbell v. Commissioner, 59 T.C.M. (CCH) 236, 250 (1990), rev'd, 943 F.2d 865 (8th Cir. 1991).

In addition, the Eighth Circuit's analysis of the section 83 "property" definition was far inferior to the analysis of Judge Scott in the Tax Court. At least the Tax Court specifically analyzed whether a profits interest was sufficiently analogous to the receipt of an "unfunded and unsecured promise to pay." Id. at 250.

218. See, e.g., Minor v. United States, 772 F.2d 1472, 1475-76 (9th Cir. 1985).
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is also circular to tax a "payment" of a tax deduction since the taxation would negate the purpose and form of the authorized deduction.

The point that Judge Scott missed is that a profits interest is quite similar to an unfunded and unsecured promise to pay money or property in the future, which is controlled by the terms of the partnership agreement.219 Accordingly, the profits interest should be no more taxable than the receipt of an unfunded and unsecured promise to pay an uncertain or speculative amount under the section 61 economic benefit doctrine. The section 83 definition of "property" embodied in Treasury Regulation 1.83-3(e) and its exclusion for an unsecured and unfunded promise to pay was designed to default the receipt of such promises to the regime of section 61 and its common law economic benefit doctrine.220 Section 83 was not designed to alter the pre-existing section 61 non-taxation rule governing the receipt of such promises by a cash method taxpayer.221

Despite its problems with the classification of the profits interest as "property," the Tax Court correctly concluded that the profits interest was transferred for services rendered. Campbell received a "bargain purchase" of special interests in fully-capitalized limited partnerships, not for capital, but in contemplation for services rendered. What other reason explains Campbell's bargain purchase of the interest compared to the other limited partners whose price was based exclusively on capital contributed? The only explanation is that Campbell

219. Judge Scott did not question that the profits interest was not unfunded or unsecured.


221. See Bishop & Durkin, supra note 26, at 106-07. Section 83 was principally directed at preventing the conversion of ordinary income from restricted non-statutory employee stock plans into capital gains when the property was later sold. Id. at 146-47. Section 83 did not change the common law economic benefit doctrine, however. See id. at 106-07. Treasury Regulation § 1.83-3(e), which defines the term "property" for purposes of section 83(a), excludes property that represents an "unfunded and unsecured promise to pay money or property in the future." Treas. Reg. § 1.83-3(e) (as amended in 1985). This language parallels the economic benefit test under the common law doctrine. Generally, an economic benefit has been found under the common law economic benefit doctrine when (1) the property is secured against the employer's creditors, and (2) the interest is non-forfeitable. See Minor, 772 F.2d at 1474 (citing cases applying the common law economic benefit doctrine).
received the beneficial ownership interests in exchange for services rendered and should be taxed accordingly. 222

Clearly, the most troubling aspect of the Eighth Circuit's decision, however, was the court's failure to give effect to the Service's concession that the receipt of a profits interest for services rendered to a partnership is not taxable. The Court acknowledged the concession, but dismissed it along with the Service's alternative argument that the receipt was from Campbell's employer and not directly from the partnerships. 223 Such a ruling did not require a failure to recognize the Service's concession on the appropriate tax standard. The result is that the concession is confined to Campbell I and has no precedential effect for other similarly situated taxpayers. 224 The government is now free to reargue this issue in the Eighth Circuit and in all other Circuits.

The Eighth Circuit took a markedly different approach than the Tax Court in considering the taxation of a profits interest under the partnership tax provisions. The court's analysis of the importance of the application of section 707(a) creates a strong inference that the receipt of a profits interest is not a taxable event. However, the vague reference to section 707 was unnecessary and did not illuminate the best way to proceed. 225 By applying the more inclusive common law economic benefit doctrine, the issue could have been resolved in a manner that is completely consistent with the partnership taxation principles. Under an economic benefit interpretation, partnership tax rules simply serve as an ordering process for general income tax rules as they apply among partners. Thus, when partnership rules do not explicitly resolve an issue, the

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222. This of course is irrelevant if the profits interests were neither section 83 property nor a taxable section 61 economic benefit. Judge Scott's analysis of the transfer for services perspective of section 83 does prevent the manipulation of the statute in other contexts. Likewise, substantial risk of forfeiture analysis under section 83 is irrelevant if the profits interests are not section 83 property. The analysis on these points are useful, however, as a section 83 perspective on the true receipt of section 83 property interests.


224. Campbell was entitled to the full effect of the concession and although he got it indirectly by a ruling that the interests had only a speculative value, the Court's negligence in accepting the concession has far broader consequences for taxpayers.

225. Section 707(a) has many other unrelated applications on transfer payments between a partner and a partnership, including non-compensatory transfers for a partner's loan to a partnership.
default analysis should be general income tax theory—not an attempt to read partnership rules in a contorted manner.

The Eighth Circuit’s consideration of the section 721 “property” issue also did little to dispel any confusion created by the Tax Court. The court concluded that a transfer of services to a partnership was not a transfer of property under section 721,226 but that a receipt of a profits interest from a partnership in return for services was property under section 83. The Eighth Circuit’s “no asset transfer” analysis raises a more fundamental question that the court summarily dismissed in a footnote, stating that a profits interest is a property interest under section 83.227

This is not to suggest that merely because a transfer of services fails to be shielded from taxation that all such transfers to a partnership should be taxable. The Eighth Circuit analysis failed to consider that only those transfers that are coupled with the receipt of a currently taxable economic benefit should be taxed. This suggests that the appropriate interpretation for the negative parenthetical reference to the taxability of the receipt of a profits interest in Treasury Regulation 1.721-1(b)(1) is that these interests are taxable, if at all, under section 61, not that section 721 shields them from taxation.228

Since the Eighth Circuit reversed the Tax Court on the basis of the valuation of the partnership interests, that aspect of the trial court factual determination should be closely scruti-

226. As discussed in Part III.A.1. of this Article relating to Diamond I, a transfer of services is not a transfer of property and should not be accorded non-recognition treatment because of the nature of the interest transferred. Such a transfer does not engender the same non-recognition policies involving the mere change in form of doing business. Thus, section 721 appropriately does not shield taxation of a transfer of services to a partnership.

227. The Court recognized that the Diamond decisions were pre-section 83, and that the distinction between a capital and profits interest in Treasury Regulations 1.83-1(a), 1.83-3(f), and Proposed Regulation 1.721-1(b)(1)(i) all created the implication that the receipt of a profits interest was not taxable under Treasury Regulation 1.721-1(b)(1). Nevertheless, the court held that “Regulation 1.83-3(e), . . . includes all personal property within the definition of property for purposes of section 83.” Campbell, 943 F.2d at 821 n.7.

228. See Willis, supra note 213, at 120-21. Willis suggests that the inclusion of the parenthetical was nothing more than a clarification of the law existing before the enactment of section 721. This interpretation means that the receipt of a profits interest was not thought taxable under the version of 61 existing when section 721 was adopted. A profits interest was a speculative payment—not a currently taxable economic event.
Unfortunately, the Eighth Circuit's failure to resolve the issue on broader legal grounds, instead of more narrow factual grounds, means that future taxpayers will face similar valuation controversies.

VI. Analysis

This is not a new topic. With all the scholarship already available, what does this Article hope to add? I hope it will elevate the debate on the fundamental issues that traditionally have controlled the resolution of the taxation of the receipt of a profits interest. The choices are fairly obvious: tax the receipt of the profits interest or tax the receipts from the profits interest.

Most cases and commentators have concentrated upon the tax treatment of the receipt of the profits interest. Theoretical discussion has centered primarily upon the application of two sections of the tax code, sections 721 and 83. Resolution of the issue is complicated because neither section's language or underlying theory appears to contemplate the precise issues raised by a partner's receipt of a profits interest in exchange for services. The language of section 721 addresses only contributions of property to the partnership, and section 83 addresses only the partner's receipt of property in exchange for services rendered.

In addition to the barriers created by the statutory language, misconceptions have surrounded the consequences of taxing the receipt of the profits interest. One reason frequently advanced in support of non-taxation is that the income to be earned from the profits interest will be taxed twice—once at the time of receipt in the form of the present value of the future estimated earnings and again when the earnings actually mature. This reasoning is flawed because it does not ade-

229. This is particularly important in light of the Eighth Circuit's determination that its review of the Tax Court on the factual valuation issue was subject to a clearly erroneous standard.


231. See, e.g., Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).
quately consider the tax consequences attendant to the disposition of the interest. The current taxation of the interest will establish a "tax cost" basis equal to the value of the interest included in income. Subsequent income recognition will further increase the basis to well above the fair market value of the interest. Accordingly, when the service partner disposes of the interest, an offsetting loss will occur. Under these circumstances, double taxation does not occur.

The fact that double taxation does not prevent taxation of the receipt of the profits interest does not suggest that current taxation upon receipt is the best response. When the taxation of the receipt of a capital interest, which is clearly taxable under section 721 and its regulations, is compared to the receipt of a profits interest, which may or may not be taxable, several analytical features evolve. First, the reasons for current taxation of a shift of partnership capital from one partner to another in exchange for services rendered are reasonably clear. The receipt of a capital interest in exchange for property represents merely a change in the form of an asset that the taxpayer already owns. These same reasons do not apply to the profits interest, since the profits interest represents compensation for services rendered, not property transferred. Second, in terms of maintaining parity between aggregate inside and outside basis of the partnership, current taxation of the profits interest creates a basis disruption that cannot be corrected by a section 754 election. Basis disparity was an obvious problem sought to be cured with the enactment of section 754.

This is not to suggest that simply because section 721 does

233. Id. § 1016.
234. Id. § 1001(a). Assume that ST is single taxation, X is tax on receipt of the profits interest, Y is tax on actual receipt of the profits interest, and Z is tax deduction on liquidation of the profits interest. The equation would be represented as follows: X + Y - Z = ST. In this case, $1000 + $1000 - $1000 = $1000.
235. This example ignores the fact that the liquidation loss may be a capital loss and significantly deferred from the time of the taxation of the income from the profits interest.
236. "Outside" basis is the aggregate basis of all partners in their partnership interests. Aggregate "inside" basis is the aggregate basis of the partnership's assets.
237. See I.R.C. § 754 (1988). If elected, section 754 adjusts the partnership's inside basis in the partnership property. The adjustment makes the purchasing partner's share of inside basis equal to the purchaser's outside basis in the partnership interest.
238. See Bishop & Brooks, supra note 24, at 318.
not exempt the transfer of services from taxation that every receipt of a profits interest is taxable. Taxation depends upon the nature of the receipt. Thus, the focus should shift from an analysis of what was transferred to the partnership to what was received from the partnership in exchange for the partnership interest.

The focus on the receipt of the profits interest will initially be governed by section 83. Like the analysis under section 721, the decision to tax under section 83 will turn upon an interpretation of a statutory definition of "property." This question of whether the profits interest received is more than an unfunded and unsecured promise to pay money in the future, for purposes of section 83, should be resolved by a critical analysis of the service partner's property rights as created and defined by state law.239

Finally, if the profits interest is, in fact, an unfunded and unsecured promise to pay within the meaning of the section 83 regulations, and this Article suggests that it is, then section 83 is no longer relevant. The general income tax principles of section 61 and the common law economic benefit doctrine must control. This final point is crucial to the determination of current taxability. Under the section 61 common law economic benefit analysis, a receipt for services is taxable only if it constitutes a currently taxable economic benefit.240 A currently taxable economic benefit excludes an unfunded and unsecured promise to pay money in the future—the same definition that excludes the receipt of such an interest from the reach of section 83.241

Recognition of the symbiotic relationship between sections 83 and 61 permits the two sections to be applied consistently. Such a reading also reconciles partnership tax theory with general income tax principles by reinforcing the notion that a partnership neither creates nor destroys income. The partnership tax provisions are designed simply to order the taxation of

239. The issue of whether the profits interest is property is not, as suggested by Campbell I, controlled by rights that are treated as "property" by mere reference to state law. See supra Part V.C.

240. See Minor v. United States, 772 F.2d 1472 (9th Cir. 1985); see also United States v. Bayse, 410 U.S. 441 (1973); Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983); United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950).

241. Minor, 772 F.2d at 1475.
items among the partners as determined under general income tax theory.

This Article therefore proposes that a service partner should be taxable only upon the partnership's realization of the income attributable to the partner's distributable share, not upon the actual receipt of the partnership interest.

VII. Conclusion

Complex problems in law and society often are found at the intersection of related practice areas because of the colossal tension at such junctions. Since income taxation shadows the economic effects of commercial transactions, the tax law is affected by other areas of law claiming contextual relevance to the same commercial transaction. Such is the case with sections 721, 83 and 61. In each case, the taxability of the receipt of a partnership profits interest for services rendered to the partnership may be resolved at a number of different levels. Only one such resolution is satisfactory since only one resolution can finally reconcile the tensions that are in ultimate conflict.

It is now obvious that no court will hold that the receipt of a profits interest is not taxable by relying on the parenthetical profits interest exclusion in Treasury Regulation 1.721-1(b)(1). Once beyond section 721, the general provisions of sections 83 and 61 must govern taxability. In Diamond I, Judge Raum noted that since the fair market value of the interest was not at stake, the matter was to be resolved by taxing the receipt.\footnote{242. Diamond v. Commissioner, 56 T.C.M. 530, 544 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974).} The Seventh Circuit affirmed in a deferential opinion.\footnote{243. Diamond v. Commissioner, 492 F.2d 286 (7th Cir. 1974).}

This resolution unduly burdened the irrelevant market valuation question and ultimately relegated future resolutions to a factual market valuation question. As Judge Scott demonstrated in Campbell I, simple valuation matters are factual questions that trial courts are capable of resolving. Predictably, the Diamond I eighteen-day resale standard would ultimately bend to a standard based on facts and circumstances that govern the quantum of taxability. Rightly so, for what difference in the nature of a profits interest justifies a completely separate valuation standard?
In Campbell II, the Eighth Circuit Court of Appeals had a historic opportunity to resolve the issue of the taxability of a profits interest by resolving the issue at the lowest common denominator. After all, “in crafting rules at the appellate level, courts must always be aware that primary consideration should be given to cases not in court.”244 Unfortunately, the court yielded the opportunity by once again resolving the issue at the wrong level. The court argued, contrary to the Tax Court, that the particular profits interest in question had no market value. This is always an uncomfortable position for an appellate court—arguing that the factual determination of the trial court was clearly erroneous. It would have been far better for the Eighth Circuit to resolve the issue as a matter of law and remand the case to the Tax Court for a factual determination of whether the profits interest was nothing more than a mere promise to pay and hence not a currently taxable economic event under the correct federal legal standard. Its failure to do so perpetuates the problem. There has been no broad-based solution to the situation.

This is particularly troubling in light of the government’s concession that such interests generally are not taxable upon receipt. Of course, the ultimate responsibility for this failure belongs with the government for failing to promulgate regulations clarifying the position advanced in its brief. Considering nearly forty years of confusion, why has the government failed to amend its regulation to conform to its litigation position? The argument that it is too busy with other regulatory projects is wearing thin. Taxpayers like William Campbell will continue to face expensive and unnecessary structuring, accounting, and legal costs to win this issue when the government intends an eventual concession at the appellate level. The government does not want to try these cases. An amendment to the regulation would send the same message to the audit level.

It is hoped that the insights presented by this article will inform the judicial and regulatory process in a new and meaningful way. If the Treasury Department continues to shirk its responsibility for amending its regulation, the appellate courts must resolve the issue on the appropriate economic benefit grounds. Either solution would be a marked improvement.

244. Reddy v. Community Health Found. of Man, 298 S.E.2d 906, 915 (W. Va. 1982).
In the interim, one cannot escape the haunting realism associated with T.S. Eliot’s telling quotation. Do we really know the place we are for the first time?