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INSIDE THIS ISSUE

Taxation of Partnership Interests in Exchange for Services – *Part 1 of 2.*

This is the first of a two part article which discusses the uncertain and complex tax issues which arise when a partnership interest is issued in exchange for past or future *services*.

Introduction – The Receipt of a Partnership Interest for Services May be Taxable

Under §721 of the Internal Revenue Code (the "Code"), the contribution of *money* or *property* to a partnership (or limited liability company) does not result in tax to the partnership, its partners or the contributing partner. Section 721 reflects the general rule that contributions to a partnership are not taxable.

Section 721 does not apply to *services*. As a result, the receipt of a partnership interest in exchange for either past or future *services* can be a taxable event. Worse, the transaction is taxable even if the service partner receives no cash (resulting in tax on so-called "phantom income").

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The receipt of a partnership interest in exchange for services arises in multiple and unique contexts. Real estate syndicators typically locate property, gather investors and secure financing. In exchange, they receive an interest in the new ownership entity, typically as a manager or general partner. Unless structured properly, the syndicator will be taxed, at ordinary income rates, on day one, on the value of his or her interest in the new entity.

The issue also arises with developers. For example, assume A owns vacant land worth $1 million and B is an experienced developer. A and B agree to form a partnership with A contributing the land and B agreeing to use his experience and expertise to entitle it, develop it, and sell it once completed. Assume further that A and B each receive a 50% interest in the new partnership. Under this hypothetical, B has $500,000 of *ordinary* income the day the partnership is created. It does not matter that B never received $500,000 in cash. From the perspective of the IRS, a 50% interest in land worth $1 million is the same as $500,000 cash.

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Introduction, continued.

The problem is not limited to real estate partnerships. The most infamous example of the service partner is the hedge fund manager. These individuals and firms raise money, invest it and manage it. In exchange, they receive an interest in the investment entity. Another common example is the broker who in lieu of a cash commission receives a partnership interest.

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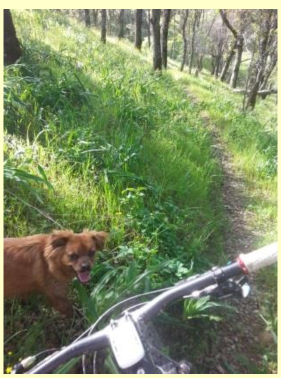
The issue can arise in a host of other situations. For example, assume that X owns a patent to create a new widget and Y has significant experience producing and marketing widgets. If X and Y form a partnership, with X contributing the patent and Y agreeing to produce and market it, Y will be taxed in an amount equal to his interest in the partnership.

The taxation of service partners does not depend on whether the partnership interest is given for past or future services. Thus, if C performs valuable work for D, and D chooses to compensate C by giving him an interest in a partnership, C will be taxed the day he receives his interest.

There are ways to structure deals to avoid taxation of the service partner on his or her receipt of a partnership interest, but these methods substantively affect the business deal itself. Before discussing those structures, the history of the "service" partner problem needs further elaboration.



For those new to the Flynn Law Newsletter, I like to share pictures of my recent bike adventures. This is a picture of my mountain biking companion "Brownie", a hyperactive one-year-old terrier mix. When not chewing everything in sight, joining me on a mountain bike ride is pretty much his favorite thing to do.

A Brief History of the Problem

Under §61(a) of the Code, "gross income means all income from whatever source derived," including, without limitation, "compensation for services." Under the §61 regulations, "if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation" (Treas. Reg. §1.61-2(d)(1)). Thus, if A performs services, and receives a partnership interest – *and that interest is considered "property"* – A has recognized income equal to the fair value of that property.

Easy enough, but the complexity and confusion stems from defining *what is property?* The answer to this question often turns on *what type* of partnership interest is being received. In this regard, the IRS and the courts have typically drawn a distinction between a "capital interest" and a "profit interest."

These concepts will be explored in further detail below. For now, it is sufficient to observe that the receipt of an interest in the *capital* of a partnership is (and always has been) considered "property." Section 1.721-1(b)(1) of the Regulations provides:

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History, continued.

> 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 [the general non-recognition rule] does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.

Under §1.721-1(b)(1), anytime a service partner receives an interest in partnership property for which he does not pay fair value, it is treated as the receipt of a capital interest in exchange for services and is immediately taxable as ordinary income.

For example, assume A and B form a partnership and each has a 50% interest in the capital of the partnership. If A contributes $100,000 and B receives his 50% interest in exchange for past services, A has effectively "given up" $50,000 in favor of B because if the new partnership were liquidated immediately after its creation, A would receive $50,000 and B would receive $50,000. Under this scenario, A has "given up his right to be repaid his contribution" in favor of B as compensation for services, and the transaction is taxable.

Or, assume C and D are partners in a partnership with property worth $1 million. If C and D admit E and give him a right to 1/3rd of the capital of the partnership, D has received $333,333 in income because C and D have each "given up" this amount.

Note that §1.721-1(b)(1) appears to carve out "a share in partnership *profits*" from the rule a service partner is taxed in receipt for an in a partnership. Thus, what happens if the service partner only receives a right to the profits of the partnership? For example, assume X and Y form a partnership. X contributes $500,000 and Y agrees to provide services. It is agreed that Y only has a right to 50% of the *profits* of the partnership, but no right to the $500,000 contributed by X. Does this affect the analysis?

The answer to the question has not been consistent. In *Diamond v. Commissioner* (1971) 56 T.C. 530, the taxpayer, a mortgage broker, received a 60% profits interest in a partnership in compensation for services rendered obtaining a mortgage loan. Three weeks after acquiring the partnership interest, the taxpayer sold it for $40,000. The taxpayer reported the income as short term capital gain. The IRS challenged this claiming it was ordinary income received for services.

The Tax Court held Diamond's receipt of a "profits interest" was property and thus taxable. The court rejected the taxpayer's argument that §1.721-1(b)(1) carves out profits interests and found the value of the profits interest was readily determinable because it was sold 3 weeks after it was acquired.

In *Campbell v. Commissioner* (8th Cir. 1991) 943 F.2d 815, the taxpayer, a real estate syndicator, bargained for a profits interest in each new limited partnership he helped create, form and finance.

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"In Campbell, the Eight Circuit acknowledged the distinction between a profits interest and a capital interest in that the former involved no 'capital shift.' Stated differently, when a profits interest is granted 'prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account.'"

Relying on *Diamond,* the tax court held the receipt of a profits interest was taxable upon its acquisition in accordance with §83 (see below). The Eight Circuit reversed.

The Eight Circuit acknowledged the distinction between a profits interest and a capital interest in that the former involved no "capital shift." Stated differently, when a profits interest is granted "prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account" (*id.* at 822). As explained by the court:

> The same is not true when a service partner receives a profits interest. In the latter situation, prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account. Receipt of a profits interest does not create the same concerns because no transfer of capital assets is involved. That is, the receipt of a profits interest never affects the nonrecognition principles of section 721. Thus, some justification exists for treating service partners who receive profits interests differently than those who receive capital interests (*id.*).

However, despite acknowledging the distinction, the court ultimately held the granting of the profits interest was non-taxable on the grounds the profits interest granted *in that case* was not capable of being valued.

The court reasoned that the partnership interest Campbell received had restrictions on transferability and no participation rights in management. Further, the partnership was newly created, and therefore had no "track record" and as such, predictions in the offering memorandum "as to the ultimate success of the operations were speculative" (*id.* at 823). The court also rejected a valuation based on what certain Class A limited partners paid for their partnership interests because those interests had superior rights to cash distributions as well as some rights of participation. Thus, the court left open the possibility a profits interest *could* be taxable if its value were not speculative.

Adding more confusion to the treatment of profits interest was §83, enacted in 1969. Section 83(a) provides:

> If, in the connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property . . . at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services.

Section 83 does not answer the question of "what is property", or whether a profits interest is or is not "property." Further, §83 is generally regarded as a *timing* statute as opposed to a statute defining *what is* income. Thus, §83 (unlike §61) does not define what is income, but merely sets forth the timing rule that property received in exchange for services is taxable when the interest in such property is either transferrable or not subject to a substantial risk of forfeiture.

Nevertheless, relying on §83, some courts concluded that under certain circumstances, the receipt of a profits interest by a service partner could be taxable, at least where the value was non-speculative (*Caldwell v. Commissioner*, TCM 1990-236; *St. John v. United States*, No. 82-1134 (C.D.Ill. 1983).

Preview of Part 2

Part 2 of this article will discuss the most recent treatment of profits interests under Revenue Procedures 93-27 and 2001-43, as well as the proposed (but not finalized) regulations under §721 (which do away with the distinction between capital and profits interests. Part 2 will also address how to structure and draft a "profits interest" for a service partner.