taxnotes® state

Volume 98, Number 8 ■ November 23, 2020

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Reprinted from *Tax Notes State*, November 23, 2020, p. 779

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Noncompensatory Partnership Interests: Consistent Inconsistencies

by Raymond Placid and Kevin Carmichael

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In this article, Placid and Carmichael examine the tax effects of exchanging a noncompensatory partnership interest for services under the aggregate and entity theories, arguing that the U.S. government's move toward the entity theory will produce unintended tax consequences.

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The United States has regulated the tax consequences of the exchange of a partnership interest for services since the 1950s. At first, the aggregate theory was used to analyze the tax consequences. At the turn of the millennium, the U.S. government moved toward the entity theory to regulate the exchange. The aggregate and the entity theories produce different income tax results to the partnership and its partners when a partnership interest is exchanged for services. This article examines the tax effects of exchanging a noncompensatory partnership interest for services under both theories, and postulates that the move toward the entity theory by the U.S. will produce unintended tax consequences in which a noncompensatory partnership interest is exchanged for services.

Introduction

At the turn of the millennium, the U.S. government noticed a dramatic shift in the growth of partnerships and other flowthrough entities.[1] The number of partnerships in the United States grew by 47 percent from 2002 to 2011.[2] During the same period, the number of corporations decreased by 22 percent.[3] The government also noticed that the size of the partnerships increased significantly during the same period. Partnerships with 100 or more partners and $100 million or more in assets tripled in number.[4] Several partnerships in this country have over 1 million partners.[5]

At the same time, service capital became an important element of the U.S. economy. Corporations had very favorable tax laws that allowed them to attract service capital with incentive stock options.[6] Partnerships did not have a set of tax laws that were designed to address the use of compensatory partnership interests to attract service capital. Instead, practitioners had to struggle with the aggregate

[1] *See* U.S. Government Accountability Office, "Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency," GAO-14-732 (Sept. 18, 2014).

[2] Entities classified as partnerships include six entity formats: domestic general partnership, domestic limited partnership, domestic limited liability company, domestic limited liability partnership, foreign partnership, or "other" partnership. In 2016 LLCs accounted for 69.6 percent of all partnerships. Ron DeCarlo and Nina Shumofsky, "Partnership Returns, Tax Year 2016," Statistics of Income Bulletin (Fall 2018).

[3] GAO, *supra* note 1.

[4] *Id.*

[5] *Id.*

[6] Section 83.

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and the entity theories to address the tax consequences of exchanging a partnership interest for services, which tended to produce inconsistent results.[7] Given the increase in partnership activity in the United States, practitioners needed guidance from the federal government in the area of compensatory partnership interest transactions.

In 2005 the Treasury Department issued proposed regulations that provide some guidance in this area.[8] The proposed regulations essentially bring the taxation of the exchange of a partnership interest for services in line with the taxation of corporate stock options. Under the proposed regulations, the tax consequences of exchanging a compensatory partnership interest for services and exchanging corporate stock options are now consistent.

The exchange of a noncompensatory partnership interest for services was not addressed by the government in the proposed regulations.[9] For discussion purposes, a noncompensatory partnership interest is an interest in an existing partnership that is exchanged for services provided to the partners — not the partnership. This article addresses noncompensatory partnership interests to highlight the inconsistencies in this area of tax law, which in many ways is consistent for partnership tax law.

The tax consequences of exchanging a partnership interest for services is a complex area of law; aggregate and entity theories, state partnership statutes, and contract and property law principles all collide when analyzing these issues.[10]

Discussion

Partnership tax laws were established using two legal theories: aggregate and entity.[11] Under the aggregate theory, a partnership does not have a separate legal existence; rather, the partners are viewed as co-owners of the enterprise.[12] Under the entity theory, a partnership is a legal entity that is separate from its partners.[13] These theories produce different income tax consequences when an interest in a partnership is exchanged for services, as explained later.

Aggregate Theory

The aggregate theory is a creature of contract.[14] In the early stages of partnership law evolution, a partnership was considered to be nothing more than a contractual relationship between two or more sole proprietors to conduct business as a joint enterprise.[15] At common law, a sole proprietorship did not have a separate legal existence from its owner and, therefore, it followed that a partnership should

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[7] *See* Sheldon I. Banoff, Paul Carman, and John R. Maxfield, "Prop. Regs. on Partnership Equity for Services: The Collision of IRC Section 83 and Subchapter K," *J. Tax'n* 69 (Aug. 2005). *See also* Charles R. Gehrke, "Section 83 Applied to Partnership Transactions: The Road to Certainty in Planning and Controlling the Tax Consequences of Exchanges of Partnership Interests for Services," 13 *Fla. St. U. L. Rev.* 325 (1985).

[8] Notice 2005-43, 2005-24 IRB 1221.

[9] *Id.*, "Prop. §1.704-1(b)(2)(iv)(*b*)(*1*) provides that . . . a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership."

[10] "Are Partnerships Aggregates or Entities When Determining the Availability of Investment Credit for Used Property?" 35 *Wash. & Lee L. Rev.* 1013 (1978).

[11] *See* Reg. section 1.701-2(e)(1) "The Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder." *See also* *Coggin Automotive Corp. v. Commissioner*, 115 T.C. 349 (2000), in which the court stated, "For tax purposes, a partnership may be viewed either (1) as an aggregation of its partners, each of whom directly owns an interest in the partnership's assets and operations, or (2) as a separate entity, in which separate interests are owned by each of the partners. Subchapter K of the Internal Revenue Code (Partners and Partnerships) blends both approaches."

[12] *See* Uniform Partnership Act (1914) sections 6 and 25; *see also* "Are Partnerships Aggregates?" *supra* note 10.

[13] USLegal, "Aggregate Theory of Partnership Law and Legal Definition." *See also* Peter Winship, "Drafting General Partnership Laws on the 'Aggregate' or 'Entity' Theory," 68(3) *SMU L. Rev.* 629 (2015).

[14] Bradley T. Borden, "Aggregate-Plus Theory of Partnership Taxation," 43 *Ga. L. Rev.* 717 (2008-2009).

[15] Joseph H. Drake, "Partnership Entity and Tenancy in Partnership: The Struggle for a Definition," 15 *Mich. L. Rev.* 609-30 (1917). *See also* UPA, section 6, in which a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit."

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not have a separate legal existence from its partners.[16] These concepts form the foundation of the aggregate theory.

Eventually, the common law paved the way for the first codification of U.S. partnership laws, the Uniform Partnership Act (UPA).[17] The UPA was created in 1914 and used the aggregate theory for most of its provisions.[18] Under the aggregate theory, a partnership cannot be a party to a lawsuit either as a plaintiff or a defendant. If a partnership is sued, each partner is named as a defendant.

A key UPA concept dealt with the ownership of partnership property. Under the UPA, the partnership was considered to be the owner of the partnership property, but the partners also had an interest in the property known as a "tenancy in partnership."[19] In a tenancy in partnership, each partner has an equal undivided interest in the assets of the partnership, but no right to transfer the interest to someone outside the partnership. For example, X contributes a building, Y contributes cash, and Z contributes inventory to a partnership. X, Y, and Z co-own the partnership property and have an indivisible interest in the cash, inventory, and building. If X dies, her interest in the partnership property will vest with the remaining partners, and X's heirs will inherit her share of the partnership's profit, loss, and capital interest.[20]

Soon after the UPA was implemented, states began to develop their own partnership acts to regulate the business activities of partnerships. Most states initially embraced the aggregate theory and property concepts of the UPA; however, states eventually abandoned the tenancy-in-partnership concept in favor of the entity approach for regulating partnership activities, which is discussed later.

When the federal government was creating the tax laws that govern partnership activities, it used both the aggregate and entity theories.[21] For example, aggregate principles govern a partnership's liabilities.[22] An increase in those liabilities can increase a partner's outside basis in her partnership interest.[23] A drop in a partnership's liabilities can decrease a partner's outside basis in her partnership interest. To illustrate, X transfers land with a basis (that is, cost) of $10 in exchange for a 50 percent interest in a partnership. X's outside basis of her partnership interest is $10. If the partnership borrows $300, X's outside basis is increased by her share of the liability ($10 + 50 percent of the liability).

Aggregate principles are also used by the federal government to determine the year-end of a partnership.[24] The Internal Revenue Code provides that a partnership shall not have a tax year other than (1) the tax year-end used by a majority of its partners; or (2) if there is not a majority, the tax year used by all the principal partners of the partnership; or (3) if there is not a majority nor a common principal partner year-end, choose the year-end that produces the least aggregate deferral.[25] It is beyond the scope of this article to address all three methods, but the following example illustrates how the aggregate principles are used to determine the year of a

[16] *See* William Draper Lewis, "The Uniform Partnership Act," 24 *Yale L.J.* 617, 620 (1915) — the fundamental nature of partnership law was that it is a residual body of law that governs all relationships that are not statutory.

[17] UPA. *See also* Donald J. Weidner, "A Perspective to Reconsider Partnership Law," 16 *Fla. St. U. L. Rev.* 1 (1988).

[18] *See* UPA, Commissioners' prefatory note — At the conclusion of the discussion, the experts present recommended that the act be drafted on the aggregate or common law theory.

[19] UPA, sections 8(1) and 25; *see also* Drake, *supra* note 15.

[20] UPA section 25(2).

[21] *See* H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954), which states the general proposition that aggregate or entity principles are applied as appropriate under the circumstances: "Both the House provisions and the Senate amendment provide for the use of the 'entity' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. An illustration of such a provision is section 543(a)(6), which treats income from the rental of property to shareholders as personal holding company income under certain conditions." *See also* Monte A. Jackel, "Summaries of Aggregate and Entity Authorities," July 25, 2017.

[22] Section 752.

[23] *Id.*

[24] Section 706.

[25] Section 706 (b).

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partnership: X and Y form a partnership. X owns 51 percent of the partnership and uses a June 30 year-end to file her tax return. Y owns 49 percent of the partnership and uses a December 31 year-end to file his tax return. Since X owns a majority interest in the partnership, the partnership must use a June 30 year-end on its tax return.

Aggregate principles are used to govern the character of the gain on the sale or exchange of partnership interest.[26] If a partner sells or exchanges his partnership interest, he is deemed to have sold his pro-rata share of the ordinary income assets of the partnership for their fair market value.[27] For example, if X owns 50 percent of a partnership and sells his partnership interest when the partnership owns inventory that has a market value of $100 and a basis (that is, cost) of $10, X will be deemed to have sold his share of the partnership inventory under the aggregate theory and will recognize $45 of ordinary income (50 percent x ($100 - $10)) from the transaction.

Entity Theory

The entity theory is a creature of statute. The partnership is viewed as an entity separate and apart from its owners.[28] Most states have adopted the entity theory to regulate a partnership's activities.[29] Under the state statutory schemes, a partnership is a legal entity that can conduct business in the same manner as any person, corporation, or other legally recognized business entity.[30]

Under the entity theory, a partnership can enter into a contract, own property, and borrow money in the name of the partnership. The partnership can be a party to a lawsuit either as a plaintiff or a defendant. If the partnership borrows money, the general partners remain liable for all unpaid debts of the partnership under state law.

The term "interest in a partnership" has different connotations under the entity and aggregate theories. As mentioned, an interest in a partnership under the aggregate theory grants a partner co-ownership rights in the partnership property. An interest in a partnership under the entity theory does not grant the partners co-ownership rights in the partnership property and is more akin to a personal property right.[31]

Under most state systems, the laws governing partnerships are divided into two categories, limited partnerships and general partnerships, which in turn creates two types of partnership interests: general partnership interests and limited partnership interests. General partners manage the affairs of the partnership and remain personally liable for the debts of the partnership. Limited partners do not have the right to manage the partnership and are not personally responsible for the liabilities of the partnership. Limited partnerships are required to have at least one general partner to manage the partnership's affairs. For the purposes of this article, use of the term "partnership interest" means a general partnership interest.

The federal government uses entity principles to regulate the tax consequences of a newly formed partnership.[32] Under federal tax law, a partnership can be created tax free provided the partners transfer qualifying property (not services) to the partnership solely in exchange for a partnership interest.[33] The partner's basis of the property transferred to the partnership is used to determine both the partnership's basis in the assets it receives from the partners[34] as well as the partner's basis in her partnership interest.[35] To illustrate, if X transfers land with a basis (for example, cost) of $10 and an FMV of $100 to a partnership in exchange for a partnership interest,

[26] Section 741.

[27] *See* sections 741 and 751.

[28] Winship, *supra* note 13.

[29] See USLegal, "State Laws Governing Partnerships," for a list of the states that have adopted the Revised Uniform Partnership Act.

[30] *See* Weidner, "Three Policy Decisions Animate Revision of Uniform Partnership Act," 46 *Bus. Law.* 427-470 (Feb. 1991). The Revised Uniform Partnership Act, now being finalized, moves the law closer to an entity theory of partnerships.

[31] Revised Uniform Partnership Act, section 501.

[32] IRC section 707; *see also* section 7701(a)(1), in which the definition of a person includes a partnership. *See also* IRC section 761(a): Partnership. "For purposes of this subtitle, the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and that is not, within the meaning of this title, a corporation or a trust or estate."

[33] Section 721.

[34] Section 723.

[35] Section 722.

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the basis of the land on the books of the partnership is $10, which is referred to as inside basis. The partner's basis of her partnership interest is also $10, which is referred to as outside basis. These are classic entity principles.

The federal government uses a blend of entity and aggregate theory principles in other areas of partnership tax law.[36] A partnership is a tax reporting — not taxpaying — entity. Each year a partnership is required to file a federal tax return: Form 1065, "U.S. Return of Partnership Income."[37] The tax return is for reporting purposes only, as the net income earned by the partnership is taxed at the partner level.[38] Partnerships file Forms W-2, "Wage and Tax Statement," and Forms 1099-MISC, "Miscellaneous Income," to account for their tax activities with other persons.[39] The partnership is an entity for federal tax reporting purposes, but an aggregation of its partners for federal income taxpaying purposes.[40]

The Nature of a Partnership Interest

A partnership is a relationship built upon privity of contract. A partnership is created when two or more persons agree to carry on a business as co-owners for profit.[41] The agreement is generally written, and each partner is required to sign the document as evidence of mutual assent. The executed partnership agreement serves as the partner's indicia of ownership in the partnership. The indicia of ownership is commonly referred to as the interest in a partnership.

An interest in a general partnership usually grants a partner two fundamental rights: the right to manage and an economic interest in the profits, losses, and equity of the partnership.[42] The economic interest in a partnership can be trifurcated into three distinct interests: (1) profit, (2) loss, and (3) capital. For example, if A and B form a general partnership by contributing $100 to form the partnership, they will each have a capital interest of 50 percent, but they can agree that 70 percent of the profits and losses will be allocated to A and the remainder to B. This makes an interest in a partnership interest unique compared with stock certificates. Stock certificate rights cannot be trifurcated. If a subchapter S stockholder owns 50 percent of the stock, his profit, loss, and capital interests must also be 50 percent.

When an interest in a partnership is exchanged or otherwise transferred, the partnership does not issue additional partnership interests to the newly admitted partner unless the partnership agreement requires such a transfer. The new partner must be admitted to the partnership through an amendment to the partnership agreement. The new partner must sign the partnership agreement, and his rights and obligations are delineated in the partnership agreement.

Compensatory Partnership Interests

In 2005 the Treasury Department promulgated proposed regulations and an accompanying draft notice[43] that addresses the tax consequences of exchanging a partnership interest for services rendered to the partnership. The proposed regulations did not address the tax consequences of exchanging a partnership interest for services rendered to the partners of an existing partnership. For discussion purposes, the former is referred to as a compensatory partnership interest and the latter is referred to as a noncompensatory partnership interest.[44]

[36] *See* Jackel, *supra* note 21.

[37] Reg. section 1.6031(a)-1.

[38] Section 702.

[39] IRS, "Tax Information for Partnerships" (updated Oct. 22, 2020).

[40] *See* section 706 (a); reg. section 1.6031(a)-1; *see also* section 702.

[41] *See, e.g.*, Fla. Stat. section 620.8101(7); UPA (2013) section 202.

[42] *See* David J. Hoare, "Tenancy in Partnership," Businessecon.org, Sept. 10, 2017.

[43] Notice 2005-43, 2005-24 IRB 1221.

[44] *Id.*, Prop. reg. section 1.721-1(b)(2), which states that "no gain or loss is recognized by a partnership upon . . . the transfer of a . . . compensatory partnership interest." *See also* Reg. section 1.704-1(b)(2)(iv)(*b*)(*1*) provides that "a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership."

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Under the proposed regulations, the FMV of a vested compensatory partnership interest that is exchanged for services is taxed to the service provider and the partnership is entitled to a deduction for an equivalent amount.[45] Also, neither the partnership nor its partners are required to recognize income on the transaction.[46] This makes the tax treatment of compensatory partnership interests and corporate stock options consistent.

Note that the nonrecognition treatment for the partnership and its partners does not apply to situations described in the *McDougal* case.[47] On January 1, 1968, F.C. McDougal purchased a racehorse named Iron Card for $10,000. At the time of the purchase, McDougal promised his horse trainer that he would give him half-interest in the horse once McDougal had recovered the costs and expenses of the acquisition of Iron Card. Iron Card became a successful racehorse and by October 4, 1968, McDougal had recovered the costs of acquiring Iron Card. That day, McDougal transferred a half-interest in the horse to the trainer. On November 1, 1968, McDougal and the trainer entered into a partnership agreement. Under the agreement, profits were to be shared equally by McDougal and the trainer, while losses were to be allocated to McDougal. The court held that the transfer of October 4, 1968, gave rise to a joint venture to which McDougal had to recognize gain or loss. The *McDougal* court stated that:

> When on the formation of a joint venture a party [McDougal] contributing appreciated assets satisfies an obligation by granting his obligee [the trainer] a capital interest in the venture, he [McDougal] is deemed first to have transferred to the obligee [the trainer] an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He [McDougal] and the obligee [the trainer] are deemed thereafter and in concert to have contributed those assets to the joint venture.[48]

Accordingly, if a capital partner has a preexisting obligation to a service partner, the capital partner is deemed to sell a portion of the assets to the service partner to satisfy the obligation and thereafter, the assets are then deemed to be contributed by the capital partner and the service partner to the partnership.

Before the issuance of the proposed regulations, there was a debate over whether a partnership and its partners had to recognize income from the transfer of a partnership interest in exchange for services. The debate centered on the interpretation of the partnership tax law (section 721) and the application of the aggregate theory to the transaction. The proposed regulations address this issue by stating that:

> Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. . . . The Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 — to defer recognition of gain and loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or

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[45] *See* Reg. section 1.83-1: Property transferred in connection with the performance of services.

(a) Inclusion in gross income — (1) General rule. "Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in section 1.83-3(a)) to such person and become substantially vested (as defined in section 1.83-3(b)) in such person." *See also* Notice 2005-43, 2005-24 IRB 1221, Prop. reg. section 1.83-3(e). Property. "Property includes partnership interest."

[46] *See* prop. reg. section 1.721-1(b)(2).

[47] *McDougal v. Commissioner*, 62 T.C. 720 (1974).

[48] *See id.* at 726.

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substantial vesting of a compensatory partnership interest.[49]

In theory, the debate over whether the partnership should recognize income from the transfer of a compensatory partnership interest is open because the proposed regulations have not been finalized. Some argue that the nonrecognition treatment is inconsistent with the case law and prior government positions regarding service transactions.[50] Others contend that the nonrecognition treatment is consistent with the entity approach used by section 721.[51] It is beyond the scope of this article to explore the validity of those arguments, but the government's decision to grant nonrecognition for compensatory partnership interests is inconsistent with the positions that had been taken in the past by several scholars and the IRS. That should be not a surprise because theoretical inconsistencies are a consistent feature of partnership tax law.

The reality is that the issue whether the partnership should recognize income from the transfer of a compensatory partnership interest is settled. A practitioner or partner is unlikely to challenge the Treasury Department's conclusions in the proposed regulations because to do so would mean the partners would recognize a gain on the transfer of a compensatory partnership interest and thus pay more income tax. Few professionals take positions that make their clients pay more tax. Also, the policies for ensuring that partnerships can attract service capital with compensatory partnership interests may outweigh the theoretical inconsistencies noted earlier.

Consequently, one of the fundamental theories that formed the basis of the partnership tax laws, the aggregate theory, has been pushed aside to accommodate the transfer of a compensatory partnership interest. The absence of the aggregate theory in a service partner transaction can produce theoretical inconsistencies in the exchange of a noncompensatory partnership interest.

Noncompensatory Partnership Interest

As mentioned, a noncompensatory partnership interest is an interest in an existing partnership that is exchanged for services that have been provided to the partners, not the partnership. The proposed regulations did not address noncompensatory interest; however, some of the theories and methods postulated in those regulations will be used for consistency.[52]

To illustrate, consider the following example: X and Y are equal partners in the XY general partnership. The partnership has one asset, inventory, that has an FMV of $200 and a basis of $120. The partnership does not have any liabilities. Z renders services to the partners in exchange for 50 percent of the partnership interests. After the transaction is consummated, Z will have a 50 percent interest in the partnership. X and Y will each have a 25 percent interest in the partnership.

The income tax consequences to Z are straightforward: Z will be taxed on the FMV of the partnership interest, which is $100 (50 percent x $200).[53]

The income tax consequences to the partnership and the partners are unclear. In a compensatory partnership interest transaction, X and Y will not have a gain from the transaction.[54] Nonrecognition of the gain in a noncompensatory partnership interest transaction seems to violate

[49] Notice 2005-43, 2005-24 IRB 1221, at 9/20, "Application of Section 721 to a Partnership Transfer."

[50] *See* Martin J. McMahon Jr., "Recognition of Gain by a P'Ship Issuing an Equity Interest for Services: The Proposed Regulations Get It Wrong," *Tax Notes*, Nov. 28, 2005, p. 1161.

[51] *See* BNA Portfolio 711-2nd: Partnerships — Formation and Contribution Timing Valuing the Capital Interest. "Some assume that the grant of a capital interest in the partnership results in a recognition of a pro rata portion of any gain or loss inherent in partnership assets, relying on the absence of a specific reference in section 721 to services. They allocate any resulting deduction to existing partners, with corresponding adjustments of their capital accounts. This approach improperly treats the grant of the partnership interest under the aggregate approach when the general approach of section 721 is properly an entity one. Under the entity approach, what is "transferred" to the service partner is a partnership interest, not a pro rata interest in partnership assets, and the grant of an interest in an entity in consideration of property or services is not a transfer of property."

[52] *See* prop. reg. section 1.721-1(b)(2).

[53] Sections 61 and 83.

[54] Notice 2005-43, 2005-24 IRB 1221; *see also* section 1032 for the equivalent corporate provision.

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the spirit of the proposed regulations and the partnership tax law. The proposed regulations indicate that the policy for not recognizing a gain on the transfer of a compensatory partnership interest is "to defer recognition of gain and loss when persons join together to conduct a business."[55] In a noncompensatory partnership interest transfer, the parties are not putting their capital and services together to conduct a business; rather, the transfer of the partnership interest is nothing more than the consideration that the capital partners use to pay for the services rendered by the service provider. General income tax principles provide that a gain should be recognized when appreciated property is used to pay an obligation, and the partnership tax law provides that gain or loss must be recognized upon the sale or exchange of a partnership interest.[56] Therefore, the gain should be recognized when a partner exchanges a noncompensatory partnership interest for services. For discussion purposes, the partnership tax law (section 741) is used to analyze the recognition of the gain.

IRC section 741 states, in part, that:

> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as [a capital] gain or loss . . ., except as otherwise provided in IRC [section] 751.

IRC section 751 (a) states, in part, that:

> The amount of any **money, or the fair market value of any property**, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to unrealized receivables of the partnership, or inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset. [Emphasis added.]

IRC section 741 uses both the entity and aggregate theories to govern the tax consequences of the exchange of a partnership interest. Under section 741, the sale or exchange of an interest in a partnership will be taxed as a capital gain, unless the sale or exchange of the partnership assets would produce ordinary income. If the sale or exchange of the partnership assets produces ordinary income, then IRC section 751(a) applies. Under section 751(a), the partner is deemed to have exchanged his pro-rata share of the ordinary income assets for the consideration received by the partner, which is an aggregate theory.

If one reads these tax laws literally and abandons the aggregate theory, then IRC section 751(a) does not apply to the exchange of a noncompensatory partnership interest for services. Section 751(a) only applies to: "The amount of any **money, or the fair market value of any property**, received by a transferor partner in exchange for all or a part of his interest in the partnership." Since services are not mentioned in section 751, it follows that the section does not govern the transfer of a non-compensatory partnership interest exchanged for services. Based on this interpretation, X and Y will have a capital gain on the exchange of the partnership interest for services. To further support this analysis, X and Y could not be deemed to have exchanged the ordinary income assets of the partnership because a partnership interest is no longer considered an interest in the partnership property by most states. This analysis is not only consistent with the methods used in the proposed regulations mentioned earlier, but also brings the transaction in line with the state law and the entity theory.

Abandoning the aggregate theory ignores the spirit of the partnership tax law in this area. The intent behind IRC sections 741 and 751 is to prevent partners from converting untaxed ordinary income into capital gain income on the sale or exchange of a partnership interest. The aggregate theory is used to accomplish this objective because the partner is deemed to have exchanged his pro-rata share of the ordinary income assets in the partnership for the consideration received. In the previous example, this would mean that the partners did not

[55] *See Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) — when a taxpayer exchanges services for a partnership interest, he must include the fair market value of that interest in gross income. *See also* Notice 2005-43, 2005-24 IRB 1221, at 9/20.

[56] *See United States v. Davis*, 370 U.S. 65 (1962). *See also* section 741.

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exchange a partnership interest for the services — but rather they exchanged their pro-rata share of the partnership assets (for example, the inventory). This approach brings the transaction in line with the intent behind the partnership tax law provisions of section 751(a).[57]

Conclusion

Aggregate theory principles were traditionally used to interpret the laws that govern the tax consequences of exchanging a partnership interest for services. Thus, the partnership tax law was interpreted to provide that a gain or loss should be recognized by the partners when a partnership interest is exchanged for services. Also, the nature of the partnership assets was examined to determine the character of the gain or loss (that is, ordinary versus capital) to ensure that ordinary income was not converted into capital gain income.[58] Perhaps those who followed the aggregate theory tradition were guided by the spirit of the partnership tax law, because the tax conference committees said during the creation of the partnership tax laws that "no inference is intended . . . that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."[59]

In 2005 the Treasury Department promulgated proposed regulations that concluded that no gain or loss should be recognized to a partnership, nor to any of its partners, when a compensatory partnership interest is exchanged for services. The policies for ensuring that partnerships can attract human capital with compensatory partnership interests, and to defer recognition of gain and loss when persons join together to conduct a business, may outweigh the theoretical inconsistencies discussed here.

For now, the aggregate theory has been abandoned when it comes to analyzing the tax consequences of permitting a service partner to enjoy the privity relationship of a partnership. The abandonment of the aggregate theory in this area — along with literal interpretations of the partnership tax law — could lead to the conversion of ordinary income into capital gain income when the services are exchanged for a noncompensatory partnership interest, which seems to be inconsistent with the spirit of the partnership tax law. ■

[57] *See* section 754, which provides that the service partner will be deemed to have exchanged his services for the partnership assets if an election is made. This means that the service partner will be able to increase his share of the partnership assets to their FMV to avoid double taxation when the assets are later sold by the partnership.

[58] *See* William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Income Taxation of Partnerships and Partners* (1997). *See also* Arthur B. Willis, John S. Pennell, and Philip F. Postlewaite, *Partnership Taxation* (1999).

[59] *See* H.R. Conf. Rep. No. 2543, *supra* note 21.

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