Fixing the Double Deduction From Carried Interest

By Calvin H. Johnson

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Commonly and appropriately, a service partner is taxed on the value of a partnership interest transferred as compensation. When the value of the interest exceeds its tax book value (capital account), the partnership seems to be allowed a double deduction, akin to deduction of both the accrual and the payment of the expense. The partnership gets a deduction for the fair market value of the partnership interest that the service partner includes in income and the other non-service partners later allocate partnership income over to the service partner, which is functionally equivalent to a second deduction for the same item.

The Shelf Project proposal would limit the partnership's deduction to the basis or capital account transferred to the service partner. The proposal also would tax sale of an income interest in the partnership as immediate ordinary income. The proposal would also apply to S corporation stock, where the problem is the same.

The proposal is equivalent to treating the partnership as if it had sold ordinary assets to pay the partnership interest. The discussion rejects the argument that the transfer of the partnership interest fits under section 721 for nonrecognition, and rejects an analogy between section 1032 (nonrecognition by a corporation in issuing stock) and section 721. It rejects the argument that the partnership should be treated as selling a fractional share of all its assets. A partnership can sometimes achieve a result better than the proposal by a real sale of assets, but the real sale would solve valuation difficulties and sometimes prevent the inappropriate accounting.

The proposal is made as a part of the Shelf Project, which is a collaboration among tax professionals to develop proposals to raise revenue in the ongoing revenue crisis by defending the tax base. It is intended to raise revenue without a VAT or a rate increase in ways that will improve the fairness, efficiency, and rationality of the tax system. The hard work needs to be done now to develop viable proposals. Shelf projects are intended to foreclose both 85 percent income tax rates and 60 percent federal sales taxes.

Shelf Project proposals follow the format of a congressional tax committee report in explaining current law, what is wrong with it, and how to fix it.

A. Summary of the Proposal

The Shelf Project collects proposals to raise revenue without raising rates. The project especially targets tax shelters, loopholes, and the like, whereby the tax system gives away revenue rather than collecting it. This proposal would limit the partnership's deduction for a transfer of a compensatory partnership interest to the capital account transferred to the partner. The proposal is equivalent to saying the partnership has a constructive sale, realizing ordinary income for the value of the interest that exceeds its basis, and then pays out the proceeds as compensation. Use of partnership interest as compensation would never be considered to be a nonrecognition event to the partnership if the partner includes the interest in income. The proposal would apply to compensatory transfers of S corporation stock as well.

A service partner is sometimes appropriately taxed on the value of a partnership interest when the interest is transferred. If the service partner is taxed, then section 83(h) gives the partnership a deduction (or a capital expenditure) for the amount included in the service provider's income. If the partnership's basis in the transferred interest is less than the fair market value, the partnership is getting a deduction for amounts never included in tax. The subsequent allocation of partnership income to the service partner away from other partners is like a deduction to the other partners and is sufficient accounting for the other partners' cost. A deduction allowed earlier on the transfer of the partnership interest that is in excess of the partnership's basis is a double deduction, much like allowing a deduction for both the accrual and the payment of a single expense.

The double deduction available for transfers of partnership interests means that the partnership will come out of a compensatory transaction with a shelter that will prevent tax on unrelated cash income. Those tax shelters should not happen.[1]

This proposal would not set when a partner is taxable on transfer of a partnership interest, but it assumes that taxation of value in excess of basis is commonly justified and does occur. Limiting the partnership's initial deduction on transfer of the interest is a technical cleanup that would allow a more reasonable set of rules for taxing the partner on receipt of compensatory transfers.

B. Current Law: The Problem Illustrated

To illustrate the double deduction, assume that a baseball team headquartered in New York is organized as a partnership and decides to compensate Barak Jedi, a star in his final years in baseball, by giving him a partnership interest worth a fraction of the income or the gate of the team for as long as he can play. He will withdraw from the partnership when he retires. The fractional interest is expected to be worth $18 million a year. Jedi immediately sells the interest for $50 million, which establishes its worth and property-like characteristics. Jedi includes the $50 million in income as compensation, and under the assumption, the partnership is entitled to a compensation deduction for $50 million to match the compensation income.[2] Assume that Jedi plays for three more seasons and then retires. Section 704 allocates $18 million of income of the partnership per year away from the other partners and onto the Jedi interest, so that no other partner pays tax on the Jedi share of the income.

The section 704 allocations away from the nonservice partners sufficiently describe the partnership's cost. If the partnership also deducts $50 million when and because Jedi includes the $50 million in income as compensation, that would be a windfall to the partnership. The New York team partnership would come out of the transaction with an extra $50 million deduction, which would shelter unrelated partnership income from tax. Cash gate receipts of $50 million, for example, are profit available to the partnership for any use, but would not be taxed. The appropriate deduction to the partnership on the taxable transfer of the partnership interest is zero — that is, the amount of partnership's tax basis in the interest it has transferred, although Jedi includes the value in income as compensation.[3] A $50 million shelter on the basis of an accounting error for the partnership interest is not a trivial error. The error also arises routinely under subchapter K, albeit not routinely at the $50 million level.[4]

The $50 million double deduction by the New York partnership might eventually be offset by gain to partners. The $50 million cash exempted by the double deduction will not have basis on the partner level. Once the partners have used up their partnership basis from other sources, a distribution of the sheltered cash will create partner level gain.[5] The partnership can defer the gain to the partners by retaining the sheltered income for its needs, although eventually every partnership must liquidate and distribute the untaxed cash. The gain presumptively will be capital gain, although the $50 million double deduction would have sheltered ordinary income. Section 1014, moreover, will step up the basis of partnership interests in the hands of heirs after the original partners die, and the step-up will eventually wipe out the partner level gain by increasing the partner's basis to include the retained,

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[1]Earlier analyses of the problem includes Mark Gergen, "Why a Partnership Should Recognize Gain on an Exchange of a Partnership Interest for Services," *Tax Notes*, June 18, 1990, p. 1487; and Martin J. McMahon Jr., "Recognition of Gain by a Partnership Issuing an Equity Interest for Services: The Proposed Regulations Get It Wrong," *Tax Notes*, Nov. 28, 2005, p. 1161, *Doc 2005-23275*, or *2005 TNT 228-18*, both of which recommend realization of gain on partnership assets in lieu of limitation of the deduction to basis. For a partnership with a bundle of assets, some ordinary, some capital, some short term and some long, some with built-in loss and some with gain, realization by the partnership with respect to all its assets requires a doomsday recording of all it has, which can be a nightmare.

[2]Section 83(h) provides that a payer of compensation will take a deduction at the same time and in the same amount as the compensation is included in income. Reg. section 1.83-6(b) provides that the payer must recognize gain on the transferred property, but, as discussed in text accompanying *infra* notes 33-48, some have argued that the partnership interest is not an interest on which the partnership can recognize gain by reason of section 721 giving nonrecognition for contributions to a partnership.

[3]*See, e.g.*, Janet B. Korins, "Recent Developments in Partnership Compensation: the Interplay Between Section 409A and Subchapter K," Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 242-243 (PLI 2008) (pointing to double deduction at the partnership level in deduction on transfer of partnership interest and subsequent allocations of income to the service partner).

[4]For another case of double deduction improperly allowed, see, *e.g.*, Calvin H. Johnson, "Ain't Charity: Disallowing Deductions for Kept Resources," *Tax Notes*, Aug. 2, 2010, p. 545, *Doc 2010-15394*, or *2010 TNT 150-10* (proposing to limit the charitable deduction to basis of property contributed to prevent sheltering of unrelated money the donor has kept).

[5]Section 731.

but untaxed, $50 million. Because man is mortal, the partners need only hold on to their interest long enough, and indeed, the New York partnership has been going on longer than the life of any mortal. A liquidation remedy to the double deduction, if a remedy at all, also will be long delayed. Notwithstanding the preference of the fans of a Boston team, the New York partnership shows no signs of imminent liquidation. A long-delayed and iffy capital gain event does not fix the double deduction.

The double deduction to the partnership often has a mirror image in the double taxation of the service provider. Jedi was taxed on $50 million as the value of the compensatory interest, but that would not defend against taxation of his share of the team's partnership income. The governing analogy is to basis in corporate stock, which is neither amortizable nor usable as an offset to dividend income. Assuming Jedi did not sell and was allocated $18 million a year of team income or gate and retired after three years, Jedi would have $50 million + (3 x $18 million), or a total $104 million of ordinary income, when his cash receipt was only the 3 x $18 million, or $54 million. The $50 million tax on the transfer of the partnership interest would be a double tax on top of his tax on cash receipts, much like taxing a receivable both when accrued and when paid. In the hypothetical, Jedi avoided the double tax by selling his interest the same year it was transferred although his successor thereafter would have to pay tax on the $18 million share of annual partnership income. A sale or liquidation by Jedi in later years would also give Jedi an offsetting $50 million loss. For example, if the $18 million per year distributable share is distributed as soon as it is taxed to the partner each year, then Jedi would have a remaining $50 million basis in a partnership interest that had no future cash to give to him when he retires and liquidates his interest. When his interest in the partnership is sold or liquidated, that $50 million would be a loss from a sale or exchange, probably a capital loss. The loss would be delayed and probably be capital loss, not usable to offset $50 million of compensation gain.

The delay in ''fixing'' the double income on the partner level is likely to be less than the delay in fixing the partnership level double deduction for some partnerships, because partners usually leave before a partnership as a whole is liquidated. The New York team will continue even after Jedi retires. If, as is likely, the $50 million compensation is ordinary and the loss on liquidation is capital, then the offset would not fix the double deduction. A fix that is of the wrong character and is delayed is not a fix to either the partnership or the partner. Double taxation also is avoided by tax planning and therefore occurs less often. Jedi's early sale avoided the double tax.

It might well be that paying compensation with taxable partnership interests works best with a tax-indifferent taxpayer that is tax exempt or has excess losses. The double gain on the partner level would then be avoided and if the service partner is a tax-indifferent party or can sell quickly. By contrast, tax loopholes such as the double deduction are expanded by normal tax planning and explode in importance.

When Jedi has so few years until retirement, the appealing remedy is to allow amortization of his partnership interest against the allocation of subsequent income. Jedi was given (assuming he did not sell) not $50 million on liquidation (when he can use his basis under current law), but rather three $18 million payments. Jedi is taxed both on the right to receive the future income and the income itself. Partnership interests are assumed to be nondepreciable, and partner basis is allowed only against distributions, or by use of tax losses or on sale. Jedi, however, needs to be able to amortize the $50 million basis he achieves against the $18 million distributive share of partnership income, much as an accrual method taxpayer can use its basis in receivables achieved by taxation of the receivables so that the cash collection of the receivables is not a second tax. Interests that are amortizable must not have an infinitely or indefinitely long tax life. Thus, if a taxpayer buys land, he is plausibly just buying the rents and yet the cost of the land is not amortizable against the rents because after every rent, the taxpayer still owns the land. If the partnership interest is like land or corporate stock then no amortization is appropriate because at the end of the year after allocation of income, the partner still has the land-like or stock-like partnership interest. Still, Jedi's career years are numbered. In a law partnership or other service business, the tax life will expire on retirement or over life expectancy. The double taxation of Jedi is a problem that can be solved much more easily than the double deduction can. The proposal here is to deny the partnership the ability to take the first part of the double deduction on transfer of the partnership interest by limiting the compensation deduction to basis.

C. Taxability at Transfer?

The double deduction problem arises only if the partner is taxed on the value of partnership interest that is in excess of the capital account carried over by the interest.

1. Tax of distributive share only? Deferring the taxable event on Jedi's benefit until he becomes entitled to his distributive share of the partnership income would solve the double deduction problem and the double income problem. Jedi would then not have the initial $50 million compensation, and the partnership could not claim a $50 million deduction on the transfer of the interest. Jedi would be taxed on the $18 million distributive share of partnership income and the other partners would allocate that $18 million away from their taxable income, but there would be no compensation deduction. If the partnership makes only ordinary income, then the service provider would be taxed at ordinary rates, which is the appropriate character for compensation received in return for services.

Sometimes taxing the service provider only on his distributive share is a reasonable model of taxation. If three lawyers form a partnership, it may well be that their partnership is expected to enhance the income of each when they become partners because their expertise fits together so well. Each lawyer gets more in return for his work by reason of receipt of membership in the partnership. The partnership interest is an enhancement of wealth to each of them. Wealth is just the discounted present value of future income, and the extra wealth must be compensation because each lawyer is putting in only services. Still, while the transfer of an interest to each partner might well be an increase in their wealth, the lawyers have not yet performed any work or earned any fees, and we do not know by how much they have increased their wealth. The only reasonable way to describe their compensation is to wait and see. Under the normal sub-K format, the partnership will recognize the compensation income and allocate it as the partners agree to split the earnings,[6] and each partner will be taxed on what he makes. While the normal section 704 allocations may act as a deduction equivalent to prevent other partners from being taxed on the share of one partner, there is no earlier taxable event on the transfer of the partnership interest and no double deduction by the other non-service partners.

2. Treating distributive shares as compensation. Sometimes, however, taxing a service provider only on distributive share mischaracterizes the compensation. If, for instance, a service partner is compensated by a transfer of an interest in future tax-exempt income from municipal bonds, future capital gain, or by a valuable tax shelter, the normal subchapter K template would not find compensation when the interest is transferred nor when the benefits are realized.

Compensation for services is ordinary income under a number of parallel, overlapping rationales.[7] Giving compensation the benefit of exemption or capital gain is ''clearly inappropriate.''[8] Capital gain applies to something else — appreciation of investment over time — and not to the compensatory return to labor. Another Shelf Project has recommended that we clean compensation out of capital gain, at least, by taxing the compensation embedded in carried interests as ordinary income.[9] Determining the character of the service partners' compensation by the character of the income to the partnership is a fundamental error.[10]

It would be possible and appropriate to reach compensation and avoid the double deduction and double income problem by characterizing allocations of distributive share distributions as compensation to the service provider without regard to the character on the partnership level.[11] Compensation to a service provider is ordinary income even when measured by clients' capital gains.[12] By analogy, a partner has compensation even when other partners pay him by reference to assets held by the partnership.

Other partners have given up some of their share of the tax-exempt income or capital gain; to account for their position, it is only necessary to reduce their tax-free or tax-favored revenue by the amount allocated to the service partner. No compensation deduction is necessary or appropriate on top of the allocation to the service partner.[13]

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[6]Sections 701, 702, 703, and 704.

[7]Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 47.9.4 (2010) (showing courts use diversity of grounds to prevent compensation from being treated as capital gain).

[8]*Id.*

[9]Johnson, ''Cleaning Compensation for Services Out of Capital Gain,'' *Tax Notes*, Jan. 11, 2010, p. 233, *Doc 2009-27878*, *2010 TNT 9-5*.

[10]The Obama administration proposed rules to make the service partner's interest ordinary income and subject to the employment tax. Treasury, ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals'' (May 11, 2009), at 23, *Doc 2009-10664*, *2009 TNT 89-44*. Able advocates for reaching compensation embedded in carried interest by taxing partnership allocations as ordinary income include Victor Fleischer, ''Two and Twenty: Taxing Partnership Profits in Private Equity Funds,'' 83 *NYU L. Rev*. 1 (2008); and Mark P. Gergen, ''Reforming Subchapter K: Compensating Service Partners,'' 48 *Tax L. Rev*. 69 (1992).

[11]*Id.* at 238-240.

[12]*See, e.g.*, *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967) (real estate broker); *Estate of Smith v. Commissioner*, 313 F.2d 724 (8th Cir. 1963) (investment adviser).

[13]*Cf.* section 265(a) (disallowing deduction of expenses of tax-exempt income).

If a service partner provides capital (or lets prior compensation stay in the partnership), then the service partner should get capital gain or tax-exempt money on invested capital, measured by the capital account, but only for the return on the capital at a rate no better than what other capital partners were getting.[14] If the service partner gets better than pro rata rates, he is getting compensation. A partnership trying to compensate a partner does not deal with the partner at arm's length because the partnership can share in the value of tax-favored compensation given to service providers, such that departures from pro rata capital returns cannot be presumed to be explained by noncompensation.

The open transaction doctrine has been used to make distributive shares taxable as compensation, but the doctrine is too crude a tool to identify the compensation. Regulations under section 83 sometimes defer the taxation of compensation under an open transaction approach on the logic that the early measurement of the compensation is premature. Thus, for example, the section 83 regulations prevent the transfer of an option for services from being the measurement of compensation unless the option is traded on an established market, so as to prevent the service provider from getting capital gain after taxation of only a minimal amount of compensation. The ordinary compensation character of the option is kept open until the option is exercised.[15] Similarly, the regulations keep the compensatory nature of the transaction open if the service provider is protected from loss on property transferred.[16]

The open transaction doctrine, however, is an imperfect remedy.[17] Apparently, the compensatory aspects of the transaction must be closed if the taxpayer is to be taxed on *any* capital value received upfront. The service provider then becomes a partner, entitled to share in partnership level capital gain or tax-exempt capital income, even if the partner continues to provide services that cause the partnership level income. The open transaction remedy puts the law into a quandary, sometimes taxing an inadequate amount of the compensation early by taxing speculative property and letting the gain become capital, and sometimes deferring taxation of investment values that within the norms of ordinary tax should be taxed immediately.

A better remedy is to allocate subsequent yields between capital and ordinary compensation. Thus, amounts taxed as compensation need to be treated as capital accounts that earn capital gains, but if the partner receives returns from the partnership on the capital accounts greater than pro rata with other capital, then the partner is getting compensation. Treating the service partner as taxable on a partnership interest when transferred should not be a block to taxing disproportionate subsequent returns as further compensation.

3. Appropriate immediate tax on transfer. The tax law sometimes needs to tax the value of the transfer of partnership interests when the service partner receives it. As a matter of principle, compensation is ordinary income when realized; and within the framework of an income tax, service providers make investments only after the investable amount has been taxed. Indeed, the ability to make an investment with untaxed amounts is a privilege with an expected value equal to paying no tax on the subsequent profit.[18] Section 83 provides that the service provider is taxed on the FMV of transferred property when it is non-forfeitable, ignoring sale restrictions and other restrictions that lapse. A partnership interest is just a folder covering for a fractional interest in the underlying partnership assets. Subchapter K is an accounting framework that needs to adapt to the substantive rules set, for

[14]Johnson, *supra* note 10, at 240, argued that partner debt to the partnership should not count in the capital account because the debt did not help create the capital gain or tax-exempt capital income. *Cf.* section 465(b)(3) (excluding borrowing from a person with an interest in the property from being considered an amount at risk in the property). Cash borrowed from a bank or other third party, by contrast, would be part of partner capital.

[15]Reg. section 1.83-7.

[16]Reg. section 1.83-3(a) extends the option rule by analogy, preventing compensatory property from being transferred if the employee is protected from loss on the property to prevent the employee from getting into a capital gain position until the employee is at risk as to capital.

I am of the opinion that protection against loss is an insufficient reason to deny capital gain. Purchase of real property with nonrecourse liability, for example, routinely gives the purchaser both protection against loss and capital gain. If there is some compensatory value to be taxed, deferral is inappropriate. Protection against loss is an added compensatory value, not a justification for the very valuable benefit of deferral.

[17]Johnson, "Tax Models for Nonrecourse Employee Liability," 32 *Tax L. Rev.* 359, 379-385 (1977).

[18]Thus, for example, Roth IRAs (which exempt return) ordinarily have no more value than regular IRAs (which exempt capital put into the plan). The equivalence of no tax on capital and no tax on return is a staple of tax economics. The seminal statement is Cary Brown, *Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin H. Hanson* 300 (1948).

instance, by section 83. Subchapter K should never give a service provider better tax treatment than would be available if comparable compensation were given by a corporation or individual payer.

The current partnership tax regulations tax the service provider when current partners give up part of their capital account in favor of the service partner.[19] A partner's capital account is his share of the ''equity'' of the partnership (assets less liabilities) when the partnership assets are stated at their tax book. Tax book assumes that the assets will be sold at exactly their adjusted basis and that after payment of debt, the proceeds will be distributed to partners. ''Capital account'' is a bit of a misnomer because it includes current and prior income of the partnership not yet distributed, but it is a balance sheet account. Capital account is a book balancing account and has nothing to do with real value. The real value of the assets is not usually reflected in partnership adjusted basis or in capital accounts.

If the partnership deducts (or capitalizes) only the capital account shifted to the service partner, there is no double deduction. The partners are getting a deduction for amounts on which they have previously paid tax and have lost in favor of the service partner. Jedi received no capital account in the continuing hypothetical because the future income in which he had a share had not been taxed to the partnership yet.

It is often appropriate however, to tax the service partner on receipt of the interest at a value in excess of the immediate capital account he receives. When the partnership interest is taxed at a value in excess of the book value or capital account, the problem of double deduction arises, whether the partnership interest is an income interest or a capital interests.

A profits interest is an interest in future, as-yet-unrecognized income of the partnership. There is no capital account and no share of balance sheet assets of the partnership. A partnership has no basis in income until it is taxable, so any tax on the transfer of a profits interest will generate the double deduction problem.

In Rev. Proc. 93-27, the IRS announced that it would not assert tax on a transfer of a profits interest to the service partner, unless:

1. the profits interest related to a ''substantially certain and predictable'' stream of income, such as income from a high-quality debt securities or a high-quality net lease;

2. the partner sold the profits interest within two years of receipt; or

3. the profits interest was a limited interest in a publicly traded partnership.[20]

Item (2) is supported by *Sol Diamond v. Commissioner*,[21] in which the taxpayer was taxed on receipt of a 60 percent interest in the profits and losses of a partnership venture. The taxpayer sold the interest within three weeks of receiving it, and the sale price was reliable proof of its value at receipt.[22]

The common theme of Rev. Proc. 93-27 is that partnership interests with readily ascertainable value are taxed at transfer. The ascertainable value rationale would imply that some income interests not listed should nonetheless have an easily ascertainable value to be taxed at transfer, because it is the underlying principle and not the illustrative examples that count. Plausibly, only open transactions for which valuation is impossible to ascertain would avoid taxation on transfer. In other contexts, the regulations take the position that sales amounts realized will be taxed whether or not they are equivalent to cash[23] and that open transaction is ''a rare and extraordinary case.''[24] Deferred gain in installment sales for a taxpayer with more than $2 million installments outstanding, moreover, now

[19]Reg. section 1.721-1(b)(1).

[20]Rev. Proc. 93-27, 1993-2 C.B. 343, *Doc 93-6562*, *93 TNT 123-7*. Publicly traded partnerships are defined in section 7704(b) as those that are readily traded on an established securities market, and reg. section 1.7704-1(c) defines ''readily traded'' as markets in which prices are quoted and sales can be completed with about the same speed as on a stock market.

[21]56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

[22]In a notice of a revenue procedure that will come into effect only if the 2005 proposed regulations ever come into effect, the IRS proposed to ease the two-year rule. Under the revenue procedure, transfer of a partnership income interest would be taxed according to its value if it was received in ''anticipation of a subsequent disposition.'' A transfer of a partnership interest would be presumed to be in anticipation of subsequent disposition if that disposition were made within two years, unless, for example, the disposition occurred by reason of disability. Notice 2005-43, 2005-1 C.B. 1221, section 3.02, *Doc 2005-11236*, *2005 TNT 98-37*. Plausibly, the rationale of the 1993 revenue procedure was that a sale within two years was good evidence of value, or that a sale within two years would ameliorate the double taxation of partnership interests, once on transfer and again by allocation under section 704 of the income from the interest. The rationale of Notice 2005-43 appears to be that the transaction will be collapsed as a step transaction unless the disposition had separate motive, or that evidence of value will be disregarded for hardship cases.

[23]Reg. section 15a.453-1(c)(2).

[24]Reg. section 15a.453-1(d)(2)(iii).

commonly requires an interest charge to compensate the government for its delay in revenue.[25] If the deferral in taxation of transferred partnership interests decreases government revenue, then the government should have ordinary income plus an interest charge when the amount or the partner's benefit can be ascertained.

Further, there are times when compensation can be reached *only* by taxing the value of transfer. In *Campbell v. Commissioner*,[26] for instance, the taxpayer was employed by a tax shelter promoter to help put together and sell tax shelters before the 1986 passive activity limitations dramatically restricted shelters. Campbell was compensated by a transfer of a fraction of the shelter he was working on. Outsiders were buying comparable fractional interests in the same shelter for large, known cash prices.[27] The shelter was aggressive enough that no partner should have expected to see cash back on top of the shelter he was buying.[28] Saving tax from a transaction is presumably not a taxable income event: Just as paying tax is not a deduction,[29] paying less tax presumably is not income. Assuming that the reportable tax losses were not themselves compensation (which is not free from doubt),[30] then the transfer of the interest to Campbell, at its FMV, would be the only opportunity to tax the compensation. If the transfer is the only chance to tax compensation, then the transfer is necessarily taxable.

Value in excess of partnership basis also arises in the transfer of capital interests. A capital interest is an interest in the *value* of existing partnership assets, which the partner would be able to claim at least on liquidation. A regulation proposed in 2005 but never finalized, would have allowed a partnership and its partners to elect to value a partnership interest that is transferred in connection with the performance of services as being equal to its liquidation value.[31] The liquidation value was defined, however, not as tax book equity (capital account), but as ''the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.''[32] Ongoing partnerships often have significant goodwill or going concern value. The New York baseball team, for example, has patrons with attachment to the team who will probably pay for tickets to future games at a level that will give value to the partnership above its basis in its tangible assets, net of debt.

A service partner's *capital interest*, taxable under the proposed regulations, is different from the service partner's *capital account* when the FMV of the partnership assets exceeds their book value. Capital account is the partner's share of the tax-account adjusted basis, or ''tax book,'' and it would not include the value of what would have been distributed on liquidation, except when the values had already been taxed to the partnership. A partnership income interest would not be taxed under the proposed regulations (unless it fit within the exceptions of a bond sold within two years or publicly traded), but the goodwill value of the business reflected in the capital interest would be taxed at transfer. Taxation of the value of *capital* interests is not limited to interests that, like bonds, are disposed of within two years or publicly traded (as income interests are).

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[25]Section 453A. There are exemptions from section 453A interest for farm property and an individual's personal use property. Obligations of less than $150,000 do not count toward the $2 million per taxpayer threshold.

[26]T.C. Memo. 1990-162, *rev'd*, 943 F.2d 815 (8th Cir. 1991).

[27]The pre-1986 shelters gave immediate tax deductions derived from IOU basis and then should have created offsetting phantom gain on sale or default on the debt. A shelter might give $1 million in tax deductions without cash cost, worth $500,000 at the pre-1986 rates, and then capital gain, taxed at 28 percent but deferred for 10 years. The net value for a $1 million tax loss would be $500,000 - $280,000/ (1+10 percent)^{10}, or about $390,000.

[28]The shelter claimed interest deduction under the Rule of 78s for a loan with compounding interest. The Rule of 78s allocates total interest as if the loan were going down on a straight line schedule by fixed amount each period and the total amount of interest to be paid over the term is fixed. If interest is compounding, however, and the loan is increasing each year, the rule overstates the interest in early years. The Rule of 78s, with compounding interest, can make the first-year interest deduction many times larger than the underlying capital.

[29]Section 275.

[30]If the shelter promoter partnership is considered to be a third party, then it is plausible that *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), would make the tax savings taxable. In *Old Colony*, the Supreme Court held that an employer's payment of the employee's income tax was itself income. Tax is imposed on gross pay that includes the tax and not just on the take-home pay after tax. If, as in *Campbell*, the service partner is not taxed on the value of the transferred interest, then it is *necessary* to find that *Old Colony* applies to the tax savings as they arise to tax the compensation. On the other hand, it was irresponsible for the *Campbell* court to give tax **(Footnote continued in next column.)** deferral to the receipt of the partnership interest without also settling that the shelter savings benefits were taxable to the employee.

[31]Prop. reg. section 1.83-3(e)(l).

[32]Preamble to prop. reg. section 1.83-3(e)(l). *Accord* Notice 2005-43, *supra* note 23, at section 4.02, offering a revenue procedure that would be published when the proposed regulations are published with the same language.

The distinction between limited taxation of pure income interests and FMV of capital interests is impossible to maintain in common circumstances or in theory. Goodwill value is nothing but the discounted present value of future income in excess of amounts allocated to things the accountants allow to be stated as balance sheet assets. There is neither a practical nor a theoretical line that can be drawn between the present value of untaxed future income and goodwill. Thus, if Jedi had been given some fractional interest in goodwill or existing value in his $50 million interest such that he received some liquidation value assuming immediate sale for real value including goodwill, then the interest would be taxable on transfer even without the quick sale. Jedi, however, had to work (or play) to get his interest and would get nothing if the partnership were liquidated immediately, and so has no capital account to value.

This Shelf Project proposal does not attempt to restate or revise the common-law rule or section 83 standard that a partnership interest would be taxable on transfer and only suggests that the ordinary rules of compensation, arising outside subchapter K, commonly require taxation in excess of capital account, and appropriately so.

D. Deduction Under the Circle of Cash

Section 83(h) gives a compensation deduction (or a capital expenditure) in the same amount and at the same time that the service provider includes compensation in income. When a taxpayer uses appreciated property to pay the compensation, there is also a constructive sale of the compensatory property.[33] The property transfer is translated into an equivalent cash transaction, as if there were a circle of cash. The employer is treated as paying from the employer the employee in cash, and the employee returns the cash to buy the property. Alternatively, the employee can be considered to buy the property using borrowed cash, and the employer uses the cash received for the sale to purchase the compensation property.[34] It does not matter whether the hypothetical circle of cash starts with the employer or the employee; the cash ends up where it started, and the employee ends up with the property.

As described in the next section, the constructive sale of an income interest or goodwill will create immediate ordinary income to the partnership. It is argued here first, however, that the partnership should not get nonrecognition even when the constructive sale is of a capital interest.

1. Rejection of nonrecognition. Amendments to regulations proposed in 2005 under the Bush administration but never finalized would have prevented a partnership from recognizing any gain from a transfer of a partnership interest even when the service partner recognized taxable compensation on the transfer.[35] Pre-existing section 83 regulations provide that the transferor recognizes gains on a compensatory transfer of appreciated property "except as provided in section 1032." Section 1032 provides that a corporation recognizes no gain by issuing stock. Transfer of corporate stock as compensation thus gives the corporation both a deduction equal to the FMV included in the service provider's compensation (or a capital expenditure) but no offset by gain on the constructive sale. The 2005 proposed regulation would have extended that treatment to partnerships by adding "except as provided in section 721 and section 1032." Section 721 provides that neither a partner nor partnership recognizes gain upon the contribution of property in exchange for a partnership interest.[36] Under the proposal, the partnership would also deduct (or treat as capital expenditure) the FMV of a partnership interest transferred as compensation but would have no offsetting gain.

Compensatory transfers of corporate stock are different from transfers of partnership interests.[37] Compensatory transfers of partnership interests worth more than basis create double deductions, whereas compensatory transfers of stock do not. The subsequent distributions on stock, whether as dividends or in redemption of shares, are not deductible. For partnerships, by contrast, the section 704 allocations away from the non-service partners give partnerships the equivalent of a second deduction.

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[33]*See, e.g.*, *International Freighting Corp. v. Commissioner*, 150 F.2d 310 (2d Cir. 1943); *McDougal v. Commissioner,* 62 T.C. 720 (1974); reg. section 1.83-6(b).

[34]*See, e.g.*, Rodney P. Mock, "Beating the Dead Horse: Revisiting *McDougal* in Search of Substantial Authority," 63 *Tax Law.* 411, 426 (2010).

If need be, either the employer or the employee might borrow the necessary cash and repay at the end of the transaction. The loan term need only be long enough for the circle of cash to be completed.

[35]Prop. reg. section 1.83-6.

[36]Advocates of the 2005 proposed regulation approach include Terence F. Cuff, "New Partner in Professional Services Partnership Faces Unforeseen Tax Problems," 64 *J. Tax'n* 302 (1986); Alan Gunn, "Partnership Interest for Services: Partnership Gain or Loss?" *Tax Notes*, May 7, 1990, p. 699; and Henry Ordower, "Taxing Service Partners to Achieve Horizontal Equity," 46 *Tax Law.* 19, 32-33 (1992). Gunn calls on nonrecognition because the partnership could have sold the partnership interest for cash without tax.

[37]In "Exchanging Partnership Interests for Services Under Current Law," *Tax Notes*, July 23, 1990, p. 495, Alan Roy Hollander argues by analogy between sections 721 and 1032.

For stock (but for not partnership interests), the FMV at transfer needs to be deducted by the corporation (or counted as capital expenditure) to describe the employer's real income. Stock represents the net present value of the cash distributions that the corporation will pay in the future on the stock. Stock is a proxy for the cash the corporation must divest itself of (by dividends or redemption of the stock) to pay the service partner his compensation. Issuance represents an obligation to make future distributions. (Issuing stock cannot be gain to the issuing corporation because stock is not an asset the sale of which yields gain. Stock, like debt, is a claim on assets, listed on the right, or credit, side of the balance sheet.) The distributions on stock are not fixed as to time and amount, but all shareholders are entitled to share in distributions when made, and the "share" remedy is an effective enough remedy to persuade the market to give the stock its value. The value of stock is derived by discounting estimated future cash at a discount rate set by the market. Indeed, market-set stock value is highly adverse to the corporation because the discount rate used to compute present value of the future cash the corporation must pay is set by a risk-adverse market to be very high. The discount rate (unlike interest) also is not deductible.[38] Stock compensation is not a double deduction because the corporation will get no deduction for the subsequent distributions on the stock. For a partnership to be in the same situation, it would have to pay tax at the partnership level on amounts allocated to the service partner.

Compensatory transfers of S corporation stock are on the partnership side of the distinction between compensatory stock and compensatory partnership interests: Neither the S corporation nor the other non-service shareholders pay tax on the income of the S corporation that is paid over to the service partner. Therefore, an S corporation gets a double deduction when it deducts the FMV of stock when the service provider takes the stock value into income. The proposal would thus affect both S corporations and partnerships.

Section 721, under long-standing regulations, does not apply to the compensatory transfers. The nonrecognition rules of section 721 save contributions of appreciated property to a partnership from tax, but they do not save a service provider from being taxed on the receipt of the partnership interest.[39] Section 721 is written as a unitary statute for both sides so that it should not be applied asymmetrically — if it does not apply to the compensation recipient, as the regulations provide, it does not apply to the transferor, either.[40]

Subchapter K more generally should not give partnerships a better situation than would be available if the transferor were a single entity. When a single-entity employer, whether a corporation or an individual, transfers appreciated assets to pay compensation, that is a realization event that prevents the double deduction. Subchapter K needs to be a facilitating framework shaped to be compatible with the underlying substantive results set outside the subchapter's confines. A transferor should not avoid tax on the gain on the transferred property even if the transferor is a partnership rather than a corporation or a sole proprietorship.

The circle of cash argument is powerful, however, not because of a normative reading of the tax law, but because it relies on what the taxpayer could accomplish by tax planning. If the double deduction were not available by a straightforward transfer of a partnership interest, then the parties could do a real transfer of cash, in which the service partner pays for his partnership interest with cash and receives cash compensation. If sophisticated taxpayers could accomplish the same result with a real circle of cash, then denying the double deduction only affects the taxpayers without tax counsel who are sophisticated enough to tell them to use a real circle of cash.

There are some defenses even to a real circle of cash. If a quick circle of cash yields a bad policy result, then the step transaction doctrine will collapse the circle as if it had never happened — assuming the steps are identified as a part of a unitary plan.[41] Some planners might avoid the collapse of the steps under the doctrine by building a separate business justification for both the cash in and out of the partnership, even though that is a bad result. Still, the doctrine can at least stop the easy abuses.

[38]Johnson, "The Legitimacy of Basis from a Corporation's Own Stock," 9 *Am. J. of Tax Pol'y* 155 (1991).

[39]*See, e.g.*, reg. section 1.721-1(a)(2) (taxing transfers of partnership interest for services as if they were made to someone who is not a partner).

[40]McMahon, *supra* note 1.

[41]*See* Stephen S. Bowen, "The End Result Test," 72 *Taxes* 722, 724 (1994) ("The end result test is very much the order of the day."). *See also Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *King Enter. Inc. v. United States*, 418 F.2d 511 (Cl. Ct. 1969); *Penrod v. Commissioner*, 88 T.C. 1415 (1987).

The step transaction doctrine is a tool that should be used only to defeat an abusive result.[42] The shelter from the double deduction, however, is an abuse. The tax law should not generate $50 million in fake losses, as in the Jedi hypothetical. The double deduction and shelter is not consistent with reflection of income.[43] Indeed, the double deduction, certainly at the $50 million level, is a partnership abuse reached by both the partnership general antiabuse regulations[44] and by the new codification of substance over form.[45]

If limitation or repeal of the exemption for contributions is necessary to stop the double deduction, that is not too big a price to pay. Section 737, for example, creates an exception to the nonrecognition of pre-contribution appreciation on property when the partnership later distributes the appreciated property to another partner. Section 737 is not applicable here because the partnership issuing an interest is not literally redistributing any asset. There might be zero pre-appreciation gain on any assets and the double deduction from compensatory transfers would still be a problem. Even so, section 737 means that section 721 nonrecognition does not have an infinite penumbra, given that a subsequent distribution can cut it off. A tax exemption for the pooling does not necessarily mean we have to give tax exemption to the constructive sale.

Rodney Mock has aggressively argued that Treasury's failure to finalize regulations that would have disallowed recognition of gain means that there is no substantial authority — at the one-third chance of success level — for nonrecognition of appreciation, at least in connection with the formation of new partnerships.[46] Under the Mock position, tax professionals cannot advise their clients to report tax relying on nonrecognition.

2. Recognition of what? Under the assumption that section 721 nonrecognition is not available, what is the character of the gain in the constructive sale embedded in the compensatory transfer?[47]

a. Ordinary.

i. Profits interest. When, as in the Jedi hypothetical, the partnership transfers income or profits interest to pay the expense, the offsetting proceeds from the constructive sale should always be ordinary. A sale of income from property by any taxpayer is a prepaid sale of the income, and a prepaid sale is ordinary income.[48] Since income is fruit of the tree, a taxpayer cannot transfer the fruit as capital gain while retaining the capital or the tree that produced it. Both basis and the capital gain privilege reside in the capital account (the tree). The partnership has not yet earned the future income, but for income tax accounting, cash received as a prepayment for future cash is income immediately.[49] Moreover, when an interest that will terminate upon retirement is given to a partner like Jedi, the partner is not being given an infinite stream of income but only a three-year, chronological slice of the partnership's income. A sale of a chronological carveout is always ordinary income.[50]

The proposal would provide that sale of profits or income interest is taxable income to the partnership, both when there is real cash received and when there is a constructive sale. When a partner puts in cash in return for a profits interest, that is not a contribution to capital or a pooling; instead, it is a sale of the profit.

ii. Goodwill. Compensatory transfer of a capital interest should also be ordinary income to the extent the transfer shifts an interest in goodwill

[42]*See* Marvin A. Chirelstein and Benjamin B. Lopata, "Recent Developments in the Step-Transaction Doctrine," 60 *Taxes* 970, 974 (1982) (arguing that the step transaction doctrine is "not a rule of law to be applied whenever certain formal criteria are satisfied, but rather is an 'extremely useful judicial device' dependent for its application on underlying considerations of substantive tax policy or Code structure").

[43]*See* section 446(b).

[44]Reg. section 1.701-2.

[45]Section 7701(o).

[46]Mock, *supra* note 35, at 455.

[47]Monte A. Jackel, "Reprise of the Noncompensatory Option Regs," *Tax Notes*, Jan. 10, 2011, p. 221, *Doc 2010-25427*, *2011 TNT 7-7*. Jackel argues that issuance of partnership interest under service partner's exercise of a compensatory option to buy the interest should be viewed as a "discharge of an obligation." I am not convinced that that rationale leads to ordinary income in all cases or settles the issue. Discharge of an obligation in connection with the sale of property is considered to be capital gain (*Commissioner v. Tufts*, 461 U.S. 300 (1983)) and a discharge that would be recharacterized as a tax-exempt receipt of cash would itself be tax exempt (section 108(e)(5)(discharge considered reduction of purchase price), section 108(e)(8)(discharge considered contribution to capital)).

[48]*See, e.g.*, *Reggio v. United States*, 151 F. Supp. 740 (1957) (settlement received when interest coupons were reduced was in lieu of interest, hence ordinary income without use of basis); *Hort v. Commissioner*, 313 U.S. 28 (1941) (settlement received when tenant canceled lease was prepayment of rent and ordinary income without use of basis).

[49]Johnson, "The Illegitimate 'Earned' Requirement in Tax and Nontax Accounting," 50 *Tax L. Rev*. 373 (1995) both describes and justifies current law.

A taxpayer who sells future income from the property reduces the value of the property, but the income tax convention is that that basis resides in the capital interest and not in the income interest, so that no basis offset is allowed. The proposal leaves the law as it is without attempting to justify it. Insofar as the partnership is allowed to use basis in a constructive sale or shift the basis lost to the service partner from whatever source, the double deduction objection is inapposite. Using basis would also imply a greater system that treated expiration of discount as original interest discount.

[50]*See, e.g.*, Chirelstein, *Federal Income Taxation: A Student's Guide to the Leading Cases and Concepts*, 376-380 (2009).

generated within the partnership. Goodwill is the residual value of an ongoing enterprise that is in excess of the value of any separate identifiable assets that the accountants will allow to be stated on the balance sheet. Goodwill adheres to the business as a whole and cannot be sold apart from the sale of the business. There is no viable economic distinction, however, between goodwill value and the value of future income — the value of the business in excess of the value of its separate assets is just the extra present value of future receipts that the business will produce. If an income interest is ordinary when transferred, then there is no viable distinction for a transfer of an interest in goodwill.

Consistently, the regulations on capital expenditure treat expenses to develop goodwill as immediately expensable because the expenditures do not create a separate and distinct asset that can be sold apart from the business as a whole[51]; expenditures for goodwill are not chargeable to the capital account. If the expenditures creating the goodwill are not chargeable to the capital account (that is, capitalized), then the returns should be ordinary income and not gains from the capital account.

Consistently, another Shelf Project has proposed that sales of goodwill must always be treated as ordinary income: The combination of ordinary deduction of inputs into an investment and capital gain for the outputs creates its own subsidy or negative tax, such that, for instance, investments worth 10 percent in absence of tax become 25 percent returns after tax, and silly investments losing in absence of tax become privately profitable after tax.[52] Goodwill needs to be ordinary income in full when sold to keep the (internal-rate-of-return reducing) effective tax rate close to zero.

iii. Fragmentation into assets? When a taxpayer sells a whole business, the sales proceeds are allocated to separate assets of the business according to the relative FMV of the different assets.[53] For anything but a single-asset business, the allocation can be complicated. Some assets, including inventory and accounts receivable (and goodwill, under the proposal) are ordinary assets; some ordinary assets can produce gains, while others produce losses. Depreciable property involves recapture and then capital gain, but ordinary loss.[54] Depreciable real estate has its own 25 percent tax rate on recapture.[55] Land and corporate stock would be capital gain and loss. The gains and losses can be short term or long term. Internally developed goodwill is a capital asset under current law, but it should be an ordinary asset. For international partnerships, revenue from assets must be sourced to either the United States or some foreign location. For a complicated business, the doomsday accounting associated with a sale of business can be extraordinary work, and it would be required if transfer is a sale of a fraction of the assets.

Some commentators have argued that the constructive sale in the compensatory transfers of capital interests should be treated as a fractional sale of the business.[56] That means that every time some new partnership interest is transferred, there would have to be another doomsday accounting of all the partnership assets. The fractional interest might be small, even trivial, and there could be hundreds of transfers per year. The doomsday accounting of all the assets of the business would be required for them all.

The complicated construction of fractional sale of all assets, moreover, is also probably an inaccurate description of the economics. Compensation, for example, is a current liability, ordinarily paid out of current assets, including current cash revenue, accounts receivable, and inventory sales. Compensation might be paid by the coming to fruition of goodwill. The New York partnership will not sell Yankee Stadium and other fixed assets to pay a player. The service partner is not going to be around for liquidation of the partnership. Current assets are usually ordinary assets, or at least are more likely to be, and goodwill should be an ordinary asset. The compensation should therefore be understood as a recognition of ordinary income in the constructive sale.

This proposal rejects the requirement that a compensatory transfer of a capital interest be treated as a fragmented sale of a fraction of all the assets, primarily because of the related administrative burden but also because the fragmentary interest in all assets pro rata is not a good description of the transaction. The proposal instead recommends that the gain always be treated as ordinary.

The complicated doomsday accounting creates a bad accounting result when it leads to gain on capital assets. Allowing the partnership to get both capital gain and an ordinary deduction for the

[51]Reg. section 1.263(a)-4(b)(3). It should be noted that because expenditures for goodwill create a substantial future benefit, Treasury is authorized to identify goodwill expenditures as capital expenditures under future guidance but only prospectively from publication of the guidance. Reg. section 1.463(a)-4(b)(1)(v).

[52]Johnson, "Sale of Goodwill and Other Intangibles as Ordinary Income," *Tax Notes*, Jan. 14, 2008, p. 321, *Doc 2008-331*, *2008 TNT 10-31*.

[53]*Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

[54]Sections 1231, 1245, and 1250.

[55]Section 55A.1(h)(1)(O).

[56]Gergen, *supra* note 1; McMahon, *supra* note 1.

appreciation of assets creates a tax arbitrage under which the partners save the difference between the rates when nothing has actually happened. Thus, if there is $100 capital gain on an asset, the constructive (fictional) sale of the asset would generate 15 percent capital gain and 35 percent ordinary deduction to yield $20 in tax savings. The constructive sale is fictional, so that $20 in tax savings arises from nothing. The tax arbitrage is unfortunate.

The tax arbitrage of ordinary deductions and capital gains generally is available if a taxpayer or partnership actually sells some appreciated capital assets. The arbitrage is unfortunate, but at some point inevitable. If we treated capital gain sales and expenses as offsetting within a single tax year, taxpayers would just put the gains and expenses into different years or different subpartnerships. At some point, the combination of capital gain and ordinary deduction would be available.

Even if the mismatch between capital gain and ordinary expense is inevitably available, there is value in forcing the partnership to undertake a real sale to get the capital gain mismatch. First, in some cases, the partnership would want to keep, rather than sell, capital assets. A constructive sale for a bad result should not be implied when the partnership is not willing to undertake a sale. If the arbitrage is claimed to be inevitable, we should force the real sale, because in some cases the mismatch will be neither inevitable nor undertaken.

Constructive sales, moreover, require appraisals or guesstimates of what the asset would produce on sale. Appraisals of value are unreliable, especially with low audit rates and the strong temptation to overvalue favorable assets. If the taxpayer is going to get the accounting mismatch of capital gain and ordinary loss, the law should at least force a real sale that avoids the appraisals.[57]

E. Explanation of the Proposal

This proposal will allow a partnership or S corporation to deduct (or treat as capital expense) only the capital account transferred from other owners to the service provider. ''Service provider'' means both employees and independent contractors. The proposal is equivalent to requiring the entity to include ordinary income on the gain on the S stock or partnership interest. The partnership net deduction after ordinary gain would be limited to the basis or capital account transferred to the new partner. The function of the proposal is to prevent or at least impede shelters from double deductions.

The proposal also would provide that sale of profits or income interest is not a contribution to the capital of the partnership but rather a taxable sale of future income. The proposal would affect a real circle of cash, as well as the constructive circle of cash that might be found in the Jedi hypothetical. Sale of future income by the partnership is prepaid receipt of the income and it would always be ordinary income.

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[57]Johnson, *supra* note 5 (arguing for basis only deduction for charitable gifts, and forcing a taxpayer to sell capital assets to get a mismatch); Johnson, ''Tax Models for Nonprorata Shareholder Contributions,'' 3 *Va. Tax Rev*. 81, 121-122 (1983) (arguing to leave the taxpayer to his private remedy of an actual sale rather than undertaking the appraisals in a constructive sale).