Pooling or Exchange: The Taxation of Joint Ventures Between Labor and Capital

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I. Introduction

Two people join in a venture in which one invests labor and the other capital. Depending on the structure of the venture, they may be taxed in several different ways. If a capitalist gives a laborer an interest in a venture's capital, directly or in the form of a partnership interest, the transaction is taxed as an exchange. The laborer has income on receipt equal to the value of the interest, and the capitalist has an expense in the same amount and income due to any gain she may have on the transferred capital. If the venture is in oil and gas, it is taxed as a pooling arrangement. Neither party is taxed upon the initial exchange; rather, they are taxed on their share of the venture's income as it is earned.

If a laborer is given an interest in only the profits of a partnership, the transaction technically is taxed as an exchange, but a profits interest is valued in a way that has the same result as a pooling approach. Finally, if the venture is conducted through a preexisting subchapter S corporation and the laborer is paid with stock, he has income on receipt of the stock while the capitalist is taxed on her gain from the venture as the income is actually earned. This is a hybrid of a pooling and an exchange approach.

This article proposes to systematize these various approaches to ensure as much parity as possible within the current income tax.[1] It argues that

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[1] This article considers an exchange of labor for an interest in a venture and not an exchange involving only capital. Property contributions generally are not taxed. IRC §§ 351, 721. Contributions of property are often difficult to distinguish from contributions of labor. Some labor-based rights are considered property. Receivables (rights to payment for prior services) are property for purposes of §§ 351 and 721. Roberts Co. v. Commissioner, 5 T.C. 1 (1945); Rev. Rul. 80-198, 1980-2 C.B. 113. Assets created by personal efforts are property. United States v. Stafford, 727 F.2d 1043, 1052-53 (11th Cir. 1984). And, even human earning potential may be property, if it can be cast as goodwill. A contribution of a going concern with goodwill to a corporation for stock has been held a nontaxable exchange of property. See Rev. Rul. 79-288, 1979-2 C.B. 139; Rev. Rul. 70-45, 1970-1 C.B. 17; 1 W. McKee, W. Nelson & R.

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a pooling approach effectively exempts from tax the return from the investment of labor and low-basis assets in a venture in a way that violates income tax norms. Thus, it proposes a general rule which would tax laborers on the receipt of an interest in a venture for services when the services are completed. At the same time, an exchange would be a taxable event for capitalists except in the situation where the interest exchanged has the character of a carved-out income interest. (This would include some exchanges involving profits interests.) The proposal requires a number of changes in current law, including repeal of the pool of capital doctrine. Also needed is modification of the current valuation rule to ensure that a service partner is taxed on an exchange of a partnership profits interest for services, certain partnership rules, including treatment of flip-flops as taxable exchanges, the subchapter S rules to bring them into conformity with the partnership rules, and § 83 and its regulations to ensure that an exchange of an interest for services is taxed when the services are completed.

II. Alternative Approaches

A. *Pooling Approach Versus Exchange Approach*

The difference between a pooling and an exchange approach can be illustrated with a simple example: *A* owns a dilapidated building in which she has no remaining basis. Unrepaired, the building is worth $10,000. *B* is a contracter, who normally would charge $10,000 to repair the building. Once repaired, the building is worth $20,000 and will produce $2,000 rent, net of expenses, per year forever.[2] Rather than hire *B*, *A* agrees to give him a half interest in the building in return for repairing it. This is done and the repairs are completed in 1989. They begin to rent out the building in 1990.

If the venture were an oil and gas well, the pool of capital doctrine would apply. That doctrine provides that owners of mineral rights and service providers (such as drillers and geologists) do not report gain at the time they join in the exploration or development of a well agreeing that each will take a share of production. They are taxed, instead, on income from the well as it is earned. The theory underlying the doctrine is that people who join in a venture contributing their capital and services for a share of a venture's profits give up and receive nothing. Instead,

Whitmire, Federal Taxation of Partnerships and Partners ¶ 4.02[1] n.18 (1977). I will not consider these line-drawing problems. However, if the proposals here are adopted, an effort would have to be made to prevent avoidance of taxation on an exchange of services for an interest in a venture by characterizing services as property.

[2] Thus, the building is not depreciable. If it were, the analysis would not change because the return would be greater to reflect the decline in the value of the asset.

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they pool their resources and keep a corresponding share of profits.[3] Although this doctrine has recently come under fire from the Treasury and the courts,[4] and its scope has been somewhat restricted,[5] it still stands,[6] and it has much support in the bar and the academy.[7] Applying this approach to the example, neither *A* nor *B* would have taxable income in 1989. Each earns $1,000 per year, pays $400 tax, and has $600 after tax.[8] When the building is sold, each nets $6,000 after tax.

[3] See G.C.M. 22730, 1941-1 C.B. 214, 221 (person granting the profits interest "has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person").

[4] See Background Information Note to Rev. Rul. 83-46 (Dec. 16, 1982), reported in Schwidetzky, The Pool of Capital Doctrine: A Peace Proposal, 61 Tul. L. Rev. 519, 546-47 (1987). The note quotes James A. Lewis Eng'g Inc. v. Commissioner, 339 F.2d 706, 709 (5th Cir. 1964) ("Unless a careful analysis of the reasons underlying the issuing of GCM 22730 compelled it, the Court would have great difficulty accepting a construction of the Code that would fly in the face of the general provisions of the tax laws to the effect that compensation for services must be returned as a part of gross income."). Zuhone v. Commissioner, 883 F.2d 1317 (7th Cir. 1989), may represent the death knell of the doctrine. Zuhone received an overriding royalty interest in mineral properties for services performed for two corporations (in which he was the sole shareholder) which developed and promised to operate the properties, sold interests in the venture to the public, and owned the mineral leases. The court of appeals rejected Zuhone's argument that he was not taxable on receipt of the interest under the pool of capital doctrine. The decision seems to hold that the doctrine will apply only when the service provider's sole compensation is from future profits and they are speculative. Id. at 1322. The court reasoned that Zuhone could not avail himself of the doctrine because the public sale of interests ensured that his corporations would profit even in the event of a dry well, because he received a salary as well as the royalty interest as compensation for his services, and because some of the wells were in production at the time he received the interest. Id. at 1323. The court of appeals decision suggests that the pool of capital doctrine may not apply to persons whose actual expenses are compensated by other investors and for whom the interest in profits is pure profit. Parts of the Tax Court decision, 57 T.C.M. (P-H) ¶ 88,142 (1988), suggest the same limitation on the doctrine, though taxpayers may find more solace in other parts of that decision which suggest that Zuhone lost for reasons that are more unusual or that can be avoided with careful planning. These include a failure to have a prior written agreement providing that the interest would be given in return for services, the fact that the services were unnecessary to bring some of the properties into production (since they already were producing), and the fact that Zuhone had worked for the corporations in a general capacity and could not establish a "specific" and "definite and demonstrable" contribution to the properties.

[5] *Lewis*, note 4, held the doctrine inapplicable to the exchange of an interest in secondary production for services to increase the production of an operating well (a waterflood program). Revenue Ruling 77-176, 1977-1 C.B. 77, held the doctrine inapplicable when an interest in a well other than that developed by the services was exchanged for services. And, without even mentioning the doctrine, Revenue Ruling 83-46, 1983-1 C.B. 17, held that the exchange of an overriding royalty interest in return for syndication services, title examination services, and services in obtaining financing for a leaseholder was currently subject to tax. *Zuhone*, note 4, makes further inroads on the doctrine.

[6] The validity of the doctrine was conceded in Revenue Ruling 77-176, 1977-1 C.B. 77. While questioning the doctrine, the preamble to the Background Information Note to Revenue Ruling 83-46 stated: "[I]n view of the length of time . . . Rev. Rul. 77-176 [has] been outstanding, it would not be feasible to revoke [it]." See Schwidetzky, note 4, at 546.

[7] See Linden, Income Realization in Mineral Sharing Transactions: The Pool of Capital Doctrine, 33 Tax Law. 115 (1979); Schwidetzky, note 4.

[8] Throughout this article, the tax rate is 40%.

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An exchange approach taxes such an arrangement as if there is an exchange of a share in the assets of the venture for the services. The consequences to the service provider are fairly straightforward. In the example, if we assume the exchange takes place after *B* completes the repairs in 1989, he has $10,000 income in 1989 (the value of half the repaired building) and owes $4,000 tax. In-kind compensation generally is taxed on receipt at its fair market value.[9] If *B* borrows at 10% to pay the 1989 tax[10] the after-tax cost of interest is $240 per year.[11] If *B* carries the loan until it can be repaid with proceeds from the sale of the building, he will end up with $360 income each year ($1,000 minus $400 taxes minus $240 after-tax interest on the loan) from the project. If *B* pays the 1989 tax with his own funds, the result is the same, for that will reduce his after-tax income in future years by $240. When the building is sold, *B* receives $10,000 tax free (he has a $10,000 basis in the building), repays the $4,000 debt, and is left with $6,000.

The consequences to a capitalist are a little more complicated. Generally, when a person transfers appreciated property in exchange for services, she has gain equal to the excess of the value of what she receives on the exchange over her basis in the property and a deductible expense (assuming the transaction is not personal) equal to the value of the property.[12] In the example, *A* could not deduct the $10,000 compensation paid *B* in 1989. Instead, she would capitalize the expense, and apply half

[9] Reg. § 1.61-2(d)(1).

[10] Throughout this article, the interest rate is 10%.

[11] This assumes interest is deductible. Under the temporary and proposed regulations on personal interest, interest on a deferred tax liability is not deductible. Temp. Reg. § 1.163-9T(b)(2)(i)(A). The analysis here suggests that denying the deduction of interest on such a liability is an error because it increases the effective cost of the tax above the amount that would have been paid without deferral.

As noted in the text, the same result would follow if *B* used $4,000 of other assets to pay the 1989 tax, since that would reduce his after-tax income in future years by $240 until the $4,000 was restored after sale of the building. If there is an argument for denying a deduction for interest on a tax debt, it is that the savings are used for consumption and not for investment. For example, *B* might reduce his consumption by $4,000 in 1989 to pay the tax, rather than liquidate a $4,000 investment. Assuming consumer interest should not be deductible, then interest on a tax debt which freed up resources for consumption should not be deductible.

[12] See International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); Walls v. Commissioner, 60 F.2d 347 (10th Cir. 1932). McDougal v. Commissioner, 62 T.C. 720 (1974), illustrates these consequences. The McDougals owned a race horse they had purchased for $10,000. When the horse was worth $60,000, they transferred a half interest in it to the horse's trainer as compensation for his services. The McDougals were held to have $25,000 (to make the example simpler, the numbers are rounded up and the depreciation of the horse is disregarded) gain on the exchange (the value of a half interest in the horse ($30,000) less half the basis in the horse ($5,000)) and a $30,000 expense (the value of a half interest in the horse). There was one mistake in *McDougal*. The $30,000 expense for the compensation paid in the form of a half interest in the horse should have been capitalized and included in the basis of the horse. Thus, the McDougals' basis in a half interest would be $20,000 ($5,000 + half of $30,000). They would have had $10,000 gain on the exchange and no deduction, and they would have had a $20,000 basis in the remaining half interest in the horse.

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the amount to the portion of the property given to *B* to determine gain. Thus, she would have $5,000 gain in 1989.

The different outcomes for labor and capital are not inevitable. If we treat *A* as exchanging her whole interest in the property for a half interest in the joint enterprise, we might tax her on $10,000 gain in 1989. This would be the result if *A* and *B* formed a corporation in 1989 to which *A* contributed property and *B* contributed services.[13] Or if we treat *B* as exchanging his services for a half interest in the property before improvement, he would have only $5,000 income in 1989. This would be the result under current law if *B* elected under § 83 to be taxed when he received the property and before he completed the work.[14] The outcome in each case depends on how we characterize what is exchanged (the whole property or half of it) and when the exchange takes place (before or after the improvements). The better result is to tax both parties on $10,000 gain. The other result leaves them with $5,000 unrealized appreciation at the end of 1989, a result which is generally undesirable and does not have to be tolerated here because there is an exchange which makes possible calculation of the entire amount of gain.[15]

Putting aside the third variation under which *A* has $5,000 gain in 1989, because the transaction is treated as a partial exchange of assets for services, a pooling approach increases *A*'s and *B*'s return from the project by $240 per year. Under a pooling approach, each venturer nets $600 a year.[16] Under an exchange approach, each nets $360 a year.

[13] Section 351's control requirement is not met since *B* receives an interest in more than 20% of the stock on the exchange for services. IRC §§ 351(d)(1), 368(c). Thus, it is a taxable exchange to *A*. James v. Commissioner, 53 T.C. 63 (1969). This outcome may be avoided. If *B* contributes more than de minimis property, his entire interest will be counted for purposes of the control requirement. Reg. § 1.351-1(a)(2) Ex. 3. Or, if *A* creates the corporation and later transfers stock to *B* for services, the second transaction will not affect the qualification of the first for nonrecognition so long as the two are not clearly connected. Culligan Water Conditioning of Tri-Cities v. United States, 567 F.2d 867 (9th Cir. 1978); American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948).

[14] IRC § 83(b). Property is valued on an election "without regard to any restriction other than a restriction which by its terms will never lapse" (IRC § 83(b)(1)(A)), but this probably does not mean that the property must be valued on the assumption the services will be successfully completed. The restrictions referred to are those in § 83(d), which concerns restrictions on such things as the resale of the property. See Reg. § 1.83-3(h) (defining a restriction as a "limitation on the transferability of property"). This would not include value resulting from the performance of the services.

[15] As for *B*, the § 83(b) election makes the increase in the value of the house due to his labor seem like self-constructed property, the value of which is not taxed as income. For a demonstration that the current approach undertaxes those who self construct property, see Cunningham & Schenk, How to Tax the House that Jack Built, 43 Tax L. Rev. 447, 451-56 (1988).

[16] It is interesting that if *A* hires *B* and pays him for his work on a deferred basis, the results sometimes will be the same to both as under a pooling approach: as a cash method taxpayer, *B* is not taxed on the compensation until it is paid. Reg. § 1.446-1(c)(1)(i); Rev. Rul. 60-31, 1960-1 C.B. 174, modified by Rev. Rul. 70-435, 1970-2 C.B. 100. Assume *A* agrees to pay *B* for his work in 1990 from the rents for that year and the proceeds on the sale of the building.

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Conceptually, the advantage of a pooling approach is that it effectively exempts from taxation returns from the pooling of labor and zero-basis assets in a venture.[17] One way to see this is to consider *B*'s position if he earns $10,000 in 1989 and invests the $6,000 left after tax. He will earn $600 and retain $340 after tax each year, the same result as under an exchange approach. Under a pooling approach, by taking payment in future rents from the building, in essence investing his labor in the project, *B* increases his return to $600, the amount he would have if he could invest the $6,000 earned after tax in 1989 at a tax-free 10% return. This result is consistent with the thesis that, under certain conditions, immediate deduction of the cost of an investment with a future return is equivalent to an exemption of that return from tax.[18] Exclusion from tax

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She should agree to pay *B* $11,000 and his after-tax income will be $6,600. *A* will receive $22,000 in 1990 ($20,000 sale proceeds + $2,000 rent), and she will deduct the $11,000 paid *B*, leaving her with $11,000 taxable income and $6,600 after-tax income.

This result is interesting because it is thought that deferring payments generally does not affect the after-tax return since the payor will pay tax on the return from investment of deferred amounts. Warren, The Timing of Taxes, 39 Nat'l Tax J. 499 (1986); Halperin, Interest in Disguise: Taxing the "Time Value of Money," 95 Yale L.J. 506, 519-24 (1986). Consider:

> *ABC* Corporation employs *D*. *ABC* earns $10,000 from *D*'s work in 1989 and is willing to pay her that amount. *D* doesn't need the money until 1990. If *ABC* keeps the $10,000 and invests it at an after-tax return of 6%, it will grow to $10,600 in 1990, and, after *D* pays tax in 1990 on the payment, she will have $6,360. This is the amount *D* will have if she receives $10,000 in 1989 and invests the $6,000 after tax at an after-tax return of 6%.

The two assumptions considered essential to this result—that the employer's after-tax return on investments equal the employee's and that the employee have the same tax rate in the years of earning and payment—are met in our example.

Deferral affects after-tax return in the original example because the expense of the salary paid *B* ordinarily would be capitalized by *A*, since it is associated with the sale of the building in 1990. This is an important limitation on substitute taxation: It works only when the deferred payment is a current, and not a capital, expense.

To cure this, either the service provider must be required to include compensation in income as it is earned, or the payor must be required to capitalize an amount equal to the present value of the deferred payment calculated using as a discount rate her after-tax rate of return. Furthermore, a deduction for the interest element of the deferred payment must be denied the payor. For an explanation of the equivalence of matching an expense and providing a deduction by discounting at an after-tax rate while disallowing the interest deduction, see Halperin, Time Value of Money and Insurance Reserves—The Case for "Post-Tax Discounting," 1986 Nat'l Tax Ass'n—Tax Inst. Am. 171.

[17] The pool of capital doctrine is even more advantageous in a world with percentage depletion. Under percentage depletion, investments in an oil well are not recoverable through depreciation or amortization. Instead, a fixed percentage (now 15% (IRC §§ 613, 613A)) of gross income is deducted each year, without regard to the cost of the well (its basis). Without the pool of capital doctrine, leaseholders, drillers, and others involved in an exchange of an interest in an oil well for services would have gain on the exchange (or when the services are completed), but they would obtain no tax benefit from this capitalized cost if the well is successful because percentage depletion makes the investment in services irrelevant to determining taxable income.

[18] See Brown, Business-Income Taxation and Investment Incentives, in Income, Employment and Public Policy: Essays in Honor of Alvin E. Hansen 300 (1948). For an explanation

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of the gain from the pooling of labor and capital is equivalent to a deduction of such gain.

B. *Profits Interest in a Partnership*

If a venture is conducted through a partnership, either an exchange or a pooling approach may apply, depending upon whether a service provider is compensated with a capital or a profits interest in the partnership. If a service provider is given a capital interest, the transaction apparently is taxed as an exchange.[19] Generally, a service partner has income equal to the value of the partnership interest received and the other partners have an expenditure for compensation (which may be deducted or capitalized, depending on the nature of the services) in the same amount plus gain to the extent the value of the services exceeds their basis in the service partner's acquired share in partnership assets.

> *Example:* *C* is given a one-third interest in *AB Partnership* in return for legal services. This is, in effect, a one-third interest in *AB*'s only asset, a building worth $30,000 in which *AB* has a $24,000 basis. *C* has $10,000 income on receipt of the interest. The original partners (*A* and *B*) each have $1,000 gain ($10,000 value of *C*'s service minus $8,000 basis in a one-third interest in the building). *A* and *B* also have a $10,000 expense that may be deducted or capitalized.

The exchange for a partnership interest affects the analysis in one respect. Normally, a transferee takes a basis equal to the value of property received for services, and, in our example, *C* takes a basis in her partnership interest equal to its value. Here the partnership also steps up its basis in the property it owns to reflect the gain taxed. It is as if the service provider receives an interest in partnership assets on the exchange and recontributes those assets to the partnership in return for an interest.

> *Example:* Continuing with the preceding example, *C* is treated as if she receives a one-third interest in *AB*'s building. Her income and basis in the building is $10,000. She transfers that

of the thesis and its scope conditions, see M. Graetz, Federal Income Taxation 385-90 (2d ed. 1988).

[19] See generally W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.03. For a case taxing a service provider on receipt of a partnership interest, see Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939 (1980), aff'd, 703 F.2d 485 (10th Cir. 1983). There is no case taxing the other partners upon such an exchange, though in McDougal v. Commissioner, 62 T.C. 720 (1974), the owners of a race horse were taxed on a transfer of a half interest in the horse to its trainer for services. The transfer occurred immediately prior to the formation of a partnership by the owners and the trainer.

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> interest in the building to the partnership and takes a $10,000 basis in her partnership interest. The partnership takes a $10,000 basis in *C*'s part of the building, and a total basis in the building of $26,000 ($10,000 plus the $16,000 basis in the remaining two-thirds of the building).

If, however, a service partner is compensated with a *profits* interest, the result is much the same as under the pool of capital doctrine. For a long time, it was thought that when a service partner took an interest in future profits of a partnership as compensation, neither she nor the other partners were taxed on the exchange.[20] This is a straightforward pooling approach. But, in a well-known case, *Diamond v. Commissioner*,[21] the Tax Court and the Seventh Circuit held that receipt of a profits interest for services is taxed in the same way as receipt of a capital interest.[22] Section 83, which was enacted before *Diamond* was decided, but after the transaction at issue, reinforces this result because a profits interest in a partnership probably is property under that section which requires taxing

[20] This is what the regulations seem to say. They provide, in part: "[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 [which makes contributions of capital to a partnership nontaxable] does not apply." Reg. § 1.721-1(b)(1). This is also what the early case law said. Hale v. Commissioner, 24 T.C.M. (CCH) 1497, 1502 n.3 (1965). It also seems that was the intent of those who drafted the partnership rules. See Cowan, Receipt of an Interest in Partnership Profits in Consideration for Services: The *Diamond* Case, 27 Tax. L. Rev. 161, 178-83 (1972).

[21] 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974). The Tax Court recently followed *Diamond* in Campbell v. Commissioner, 59 T.C.M. (CCH) 236 (1990). It held that a person who helped form and find financing for tax shelter partnerships had income on the receipt of a profits interest in those partnerships as compensation for his services.

[22] Sol Diamond helped Philip Kargman arrange financing for a building on which Kargman held an option. In return, Kargman gave Diamond a 60% share of profits or losses from the venture once Kargman recovered his capital contribution. Diamond sold his interest for $40,000 three weeks later. He took the position that this was capital gain on the sale of his partnership interest. The courts held that it was ordinary income on the receipt of the interest since the value of the interest was compensation to Diamond. The courts assumed that Diamond's interest truly was a profits interest because the value of the building at the time the partnership was formed (and he received the interest) was no greater than the outstanding liability plus Kargman's contribution. That is, they assumed Diamond received no interest in then existing partnership capital.

If one thinks an exchange of a profits interest for services should not be taxed (as many do), it is tempting to explain the holding of *Diamond* as a mistake forced by an infelicitous assumption. Given that Diamond sold his interest for $40,000 three weeks after he got it, the building must have been worth more than the amount of the loan outstanding plus Kargman's contribution when Diamond received his interest. In other words, Diamond got an interest in then existing partnership capital. See Cowan, note 20, at 192-95. The Service took this position in a General Counsel's Memorandum in 1977, reasoning that the interest in *Diamond* was a capital interest and that receipt of a profits interest should not be taxed. G.C.M. 36346 (July 23, 1975). Nothing ever came of this.

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property received for services.[23] The *Diamond* decision has been criticized by the bar and the academy, which generally advocate a pooling approach.[24]

Ironically, *Diamond* has had little impact because a profits interest has in some cases been valued on the basis of what a service partner would receive if a partnership was liquidated at the moment she receives her interest.[25] In the example involving the repair of a building, for instance,

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[23] Property, under § 83, is defined as anything more than an "unfunded and unsecured promise to pay money or property in the future." Reg. § 1.83-3(e). A profits interest is probably more than a naked promise to pay money in the future because it carries rights and obligations of ownership in a partnership, including a right to participate in the management of the partnership and a duty to share in partnership losses. See 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.06[1][b]; 1 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation § 46.08 (4th ed. 1989). A profits interest has been held § 83 property in two cases. St. John v. United States, 84-1 U.S.T.C. ¶ 9158 (C.D. Ill. 1984); *Campbell*, note 23. Cf. Rev. Rul. 83-46, 1983-1 C.B. 16 (holding that receipt of an overriding royalty interest in oil and gas properties is taxable under § 83). However, this issue was reserved when the § 83 regulations were promulgated.

[24] The American Law Institute (ALI) has proposed taxing only an exchange of a profits interest for services rendered to a capital intensive partnership where the interest represents a small share of total interests in the partnership. ALI Fed. Income Tax Project, Subchapter K 155-56 (1984). The American Bar Association Section of Taxation has proposed that an exchange of a profits interest for services be nontaxable unless the services are rendered in a nonpartnership capacity. ABA Section of Taxation, Committee on Partnerships, Proposal to Amend the Regulations under the Internal Revenue Code of 1986 to Define a Partnership Capital Interest and a Partnership Profits Interest, and to Clarify the Tax Treatment of Compensatory Transfers of Both Forms of Partnership Interests (April 17, 1987), reported in Tax Notes, Highlights & Documents, Doc. 87-2837 (May 12, 1987). Both proposals would tax an exchange of a profits interest for services only where the service provider is more like an employee than a partner. The ALI merely takes a more limited view of who is a partner. The ABA would treat anyone who satisfies the standards of § 707(a)(2) as a partner; the ALI would not treat a laborer with a small interest in a capital intensive partnership as a partner, regardless of that standard.

Criticism of *Diamond* includes A. Willis, J. Pennell & P. Postlewaite, note 23, at §§ 46.03-43.06; Banoff, Conversions of Services Into Property Interests: Choice of Form of Business, 61 Taxes 844 (1983); Cowan, note 20, at 189-92; Lane, *Sol Diamond*: The Tax Court Upsets the Service Partner, 46 S. Cal. L. Rev. 239 (1973); Robinson, *Diamond*'s Legacy—A New Perspective on the *Sol Diamond* Decision, 61 Taxes 259 (1983).

Proponents of taxing an exchange of a profits interest for services include Hortenstine & Ford, Receipt of a Partnership Interest for Services: A Controversy That Will Not Die, 65 Taxes 880 (1987)(arguing that a profits interest with intrinsic value should be taxed, but not an interest with contingent value); Comment, Receipt of a Partnership Profits Interest for Services: *St. John v. United States* and a Suggested Solution, 5 Va. Tax Rev. 127 (1985).

[25] *St. John v. United States*, note 23; see Kenroy, Inc. v. Commissioner, 47 T.C.M. (CCH) 1749 (1984). In *Campbell*, note 23, interests in tax shelter partnerships were valued on the basis of their fair market value measured by the amount investors paid for similar interests and by the discounted present value of tax benefits and cash distributions from the interests. United States v. Stafford, 727 F.2d 1043 (11th Cir. 1984), also suggests a less lenient measure of value. The major issue in the case was whether a real estate developer contributed services or property to a partnership when he contributed his nonbinding commitment to acquire property. The Eleventh Circuit held the commitment was property, but it remanded the case so that the trial court could determine whether part of the interest the developer received on the exchange was compensation for future services which should be taxed. As the issue was posed,

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if *B* receives an interest in rents from the project and nothing else, his interest would be valued at zero, because if the partnership liquidated in 1989 before rents were earned, *B* would get nothing. Because a profits interest is *defined* as an interest that would receive nothing upon an immediate liquidation of a partnership,[26] this measure of value ensures that a profits interest can never have taxable value. This rule does not really define an interest's value; instead it defines its book value, which is zero if the value of an interest depends on future earnings or appreciation in the value of partnership property. Consequentially, there is no tax on an exchange of a profits interest for services and each partner is taxed on his share of profits as the profits are earned. This is the same result as under the pooling approach.

At first, it is not clear why a profits interest and a capital interest should be treated differently. The apparent difference in the two is that a capital interest would receive something upon an immediate liquidation of a partnership. Thus, an interest in the future earnings or in the future appreciation in the value of partnership assets is a profits interest.[27] The idea that existing wealth is different from future income—that trees are different from fruit, if you will—is fairly common in tax law, but that idea bears little scrutiny. Current investment wealth consists only of the right to future income. Trees are of value to investors because they bear fruit. For example, a partnership compensates its lawyer (who is a partner) by giving him a profits interest that equals the interest paid on a 30-year bond it holds. One might say that bond principal is capital while interest is profits, but, in reality, the bond is no more than a right to 31 future payments (30 denominated interest and one denominated principal). The interest is the greater part of the present value of the bond. Similarly, if what is exchanged is a right to share in rents from property, that profits interest may include a significant part of the present value of the property. If what is exchanged is a right to share in future appreciation of property, that, too, will constitute some of its present value. Buyers will pay less for the property if it is stripped of that right.[28]

that compensatory interest had to be a profits interest, for the developer would have received nothing other than the commitment back had the partnership dissolved at the time he received a partnership interest. Id. at 1055 n.17. On a hypothetical dissolution, the interest would be valueless.

[26] Reg. § 1.721-1(b)(1).

[27] 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.05[1]; A. Willis, J. Pennell & P. Postlewaite, note 23, at § 46.02; see G.C.M. 36346 (July 23, 1975). Cf. Reg. § 1.704-1(e)(1)(v)(defining a mere right to participate in earnings and profits as not being a capital interest for purposes of family partnership rules).

[28] Even an interest in future earnings in a service partnership might be treated as an interest in capital. In professional sports, player contracts are treated as assets. E.g., Laird v. United States, 556 F.2d 1224 (5th Cir. 1977), cert. denied, 434 U.S. 1014 (1978) (portion of purchase price of football team allocable to player contracts is amortizable). If some of the value of a firm is in the form of goodwill, that would normally be considered a capital asset, at least upon

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One would think that if there is any substantive difference between the two interests, it lies in the risk to a profits interest from a near-term liquidation or in the benefit to a capital interest of current access to partnership assets. This is relevant to value (and the ease of valuation),[29] but it does not mean that profits interests are necessarily valueless or even less valuable than capital interests. That depends on such variables as the likelihood of a near-term liquidation and the liquidity of partnership assets. Moreover, the two types of interests can be manipulated to eliminate any difference. A profits interest may be protected from the risk of a near-term liquidation by a covenant barring liquidation of a partnership or distribution of its assets. A capital interest may be stripped of the benefit of access to capital by a covenant barring withdrawals from a partnership or sale of its assets.

However, there is one difference between a capital interest and certain profits interests that may justify not taxing capitalists on an exchange of a profits interest for services in at least some cases. If a profits interest is in the nature of a carved-out income interest to which no basis is assigned, capitalists may be better taxed under a pooling approach than under an exchange approach. Examples of such carve outs include an exchange of an interest in rental profits for services by an owner of a building, or an exchange of an interest in oil well production for services by an owner of oil-bearing property.

Taxing an exchange of a carved-out interest without apportioning basis to the interest results in overtaxation of the transferor. For example, *D* owns land that earns $10,000 rent per year, providing her with $6,000 income after tax. Rather than renting the land on an annual basis, *D* exchanges a three-year lease for an annuity worth $24,868 that pays $10,000 for three years.[30] (In an exchange of a profits interest for services, income expected from the services would take the place of the annuity.) Because no basis is allocated to the carved-out interest,[31] if *D* is

a sale of a partnership interest. IRC § 741. Upon liquidation of a partnership, payments with respect to goodwill may be treated either as capital or ordinary in character, at the election of the partnership. See IRC § 736. Early on, the Service attempted to argue that value resulting from personal ability could not be goodwill (Rev. Rul. 57-480, 1957-2 C.B. 47), but it eventually abandoned that position (Rev. Rul. 70-45, 1970-1 C.B. 17). On the other hand, there is much authority that a right to future compensation for one's own services cannot be a capital asset. See, e.g., Foote v. Commissioner, 81 T.C. 930 (1983)(ordinary income on relinquishment of tenure); McFall v. Commissioner, 34 B.T.A. 108 (1936)(ordinary income on assignment of employment contract). Cf. Rev. Rul. 65-261, 1965-2 C.B. 281 (ordinary income on sale of right to use individual's name).

[29] See note 65 and accompanying text.

[30] This is the discounted present value at 10% of three year's rents. It is also the amount that a person would be willing to pay for the three-year lease if his basis in the lease was recovered under a system of economic amortization. This price ensures a 10% pretax and a 6% after-tax rate of return.

[31] Hort v. Commissioner, 313 U.S. 28 (1941).

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taxed on the exchange, she will have $24,868 gain and pay $9,947 tax. The annuity pays $2,487 interest in year one, $1,735 in year two, and $909 in year three, which is also taxed.[32] The rest of each payment is untaxed principal. Thus, *D*'s after-tax income (principal plus 60% of the interest) in the three years would be $9,005, $9,306, and $9,636, respectively. *D*'s after-tax income under the two options looks like this:

Leasing the Land for Three Years

Year 0	Year 1	Year 2	Year 3
	$6,000	$6,000	$6,000

Exchanging Three-Year Lease for Annuity

Year 0	Year 1	Year 2	Year 3
($9,947)	$9,005	$9,306	$9,636

The net present value of the after-tax income if she holds on to the land and collects rents is $16,038 (using an after-tax 6% discount rate). The net present value of her after-tax income if she exchanges a three-year lease for an annuity is $14,921. The loss results because *D* is allocated no basis in the carved-out leasehold interest. If *D*'s basis in the land is $100,000 (that is, it equals the value of the land), she should have no gain on the exchange of a three-year lease for an annuity. She is merely swapping one asset worth $24,868 for another.[33]

Ideally, we should tax carve-outs by assigning basis to the carved-out interest and then taxing the increase in the value of the remainder. Thus, in the example, we would assign a basis of $24,868 to the carved-out interest in rents and the annuity it buys, and tax the increase in the value of the remainder over the three years. If *D* is allowed to apportion basis between the carved-out interest and the remainder, she should be taxed on the appreciation of the remainder as the carved-out interest expires. Otherwise, she would be permitted to deduct a cost (basis recovered as the annuity purchased with the carved-out interest diminishes in value) without including in income the corresponding amount of gain (the increase in the value of the remainder).[34]

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[32] This assumes economic amortization rather than straight line recovery of basis.

[33] The problem is related to that of prepayments. If *D* is paid $24,868 cash up front for a three-year lease, instead of an annuity, the issue would be seen as one of prepayment. The point made here is another example that current law overtaxes parties to prepayments when the payee is taxed on receipt and the payor defers a deduction until accrual. See Halperin, note 16, at 517-18; Gunn, Matching of Costs and Revenues as a Goal of Tax Accounting, 4 Va. Tax Rev. 1, 24, 41-42 (1984). In the example, this cost is borne entirely by the payee (*D*) because the payment is set at an amount that ensures the payor a 10% pretax and a 6% after-tax return.

[34] This basic point was recognized in the enactment of the recent legislation denying depreciation or amortization deductions for term interests purchased in conjunction with remainder interests held by a related person. IRC § 167(r). See H.R. Rep. No. 247, 101st Cong., 1st Sess. 1362 (1989).

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In the example, not taxing *D* on the exchange, but taxing interest and principal on the annuity is equivalent to taxing interest and the increase in the value of the remainder. This is because the principal paid on the annuity equals the increase in value of the remainder (the remainder increases in value $7,513 in year one, $8,265 in year two, and $9,091 in year three). The result is obviously equivalent to the result if *D* keeps the land and rents it out, because in both cases she has $10,000 income per year. Thus, in this case, a pooling approach that does not tax an exchange of a carved-out interest for an asset, but fully taxes income from the asset, is equivalent to the ideal approach.

This demonstrates that a pooling approach produces the correct result for capitalists in some exchanges involving a carved-out profits interest. A pooling approach, however, matches the ideal only if an asset received on an exchange (the annuity in the example) has an income stream of the same duration and shape as the carved-out income stream. Shape refers to the distribution of income within the stream. In the example, the shapes are identical because *D* exchanges a right to three years of rents of $10,000 each for an annuity paying $10,000 each year for three years. If *D* instead exchanges a three-year lease for a three-year bond worth $24,868 and paying 10% interest, a pooling approach undertaxes her. Under a pooling approach, taxing interest and principal, her after-tax income from the bond looks like this:

Year 0	Year 1	Year 2	Year 3
	$1,492	$1,492	$1,492 + $14,921

The net present value of this is $16,516, which exceeds the $16,038 net present value of the rents. Under the ideal approach, taxing interest and the increase in the value of the remainder in the land each year, *D*'s after-tax income looks like this:

Year 0	Year 1	Year 2	Year 3
	($1,513)	($1,814)	$22,724

The net present value of this is $16,038, which is the proper result. The discrepancy results from the different shape of the income stream under the bond where most of the income is bunched at the end. The reason *D* does better under a pooling approach is that she is not taxed on the return from deferring income in years one and two to year three. The discrepancy becomes greater if an acquired asset is longer lived than a carved-out interest. For example, if *D* purchases a five-year $24,868 bond paying $2,487 interest each year, the net present value of her after-tax income under a pooling approach increases to $17,435.

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A pooling approach also diverges from the ideal if an exchange involves a carve out from an appreciated asset, with a basis below its value. To this point, we have assumed that *D*'s basis in the land is $100,000, its value. If *D*'s basis instead is $50,000, she should have taxable gain on an exchange of a three-year lease for an asset worth $24,868, because her basis in the carved-out interest would be only $12,434.

It would be better to tax an exchange of a profits interest for services and to modify the rules regarding carve outs to correctly apportion basis to carved-out interests. This would, however, also require taxing the increase in the value of a remainder interest, which entails a radical change in the treatment of unrealized appreciation; this is unlikely. In the absence of such reform, taxing capitalists under a pooling approach—not taxing an exchange of a profits interest for services, but fully taxing income from the services—is probably better than the alternative of taxing an exchange of a profits interest for services without allocating basis to a carved-out interest. A pooling approach is closer to the ideal in most cases. For example, if *D* is taxed on the exchange of a three-year lease for a three-year bond worth $24,868 and paying $2,487 interest, her after-tax income looks like this:

Exchanging Three-Year Lease for Bond

Year 0	Year 1	Year 2	Year 3
($9,947)	$1,492	$1,492	$1,492 + $24,868

The net present value of this is $14,920, which is worse than the $16,038 net present value of retaining the land. In this case, an exchange approach without allocation of basis misses the mark by more than a pooling approach: a $478 error versus a $1,118 error. This pattern will hold unless an asset acquired on an exchange is of a significantly longer life than a carved-out interest or unless its income is bunched disproportionately at the end.[35]

In many exchanges of a profits interest for services, the services will provide an income stream of comparable duration and shape to the carved-out interest. This is the case if *A* gives *B* an interest in the profits from a building *B* repairs for a period that equals the life expectancy of

[35] If *D* exchanges a right to three year's rents for a five-year bond, the discrepancy in net present value between a pooling approach and the ideal increases to $1,397 ($17,435 minus $16,038). The discrepancy in net present value between an exchange approach without allocation of basis and the ideal approach remains at $1,118. If *D* exchanges a right to the rents for a zero coupon bond worth $24,868 that pays $40,050 in five years, the discrepency grows to $1,920 ($17,958 minus $16,038). The figure $17,958 is $24,032 earned after tax in year five discounted at a 6% rate. In this case, the discrepancy under an exchange approach is $595 ($16,038 minus $15,443). The figure $15,443 is the net present value of an outlay of $9,947 at time zero and income of $33,977 in year five ($24,868 untaxed principal plus $9,109 after-tax interest).

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B's repairs. It is also the case if an owner of oil-bearing lands gives a driller an interest in profits for the life of a well. More generally, it will be the case when an interest given a laborer conforms in value and life to his contribution. We would expect this generally to be so.

However, we may want to restrict a pooling approach to exchanges involving interests carved out from assets with a basis near their value. As noted, a pooling approach fails to tax gain when services are acquired with carve outs from low-basis assets. Thus, we might tax exchanges involving carve outs from types of assets that generally have a low basis. Exchanges of carved-out interests from oil and gas wells for services might be taxed, for example, because expensing of intangible drilling costs[36] depresses the basis. Alternatively, we might establish a threshold ratio of basis to value (such as 50%) below which an exchange of a carved-out interest would be taxed.

Two broader points about the scope of this analysis are worth stressing. While this analysis may justify not taxing a transferor (an owner of capital) on an exchange of a carved-out income interest for services, it cannot justify not taxing a transferee (a laborer) on such an exchange. A transferee can have no basis in his labor and should be taxed. Thus, this analysis cannot justify not taxing the service partner, such as in *Diamond*, on the receipt of a profits interest for services. It also cannot justify not taxing a driller or other service provider in an oil and gas venture.

Moreover, this analysis applies only if a profits interest has the character of a carved-out income interest which is inappropriately denied basis. Thus, it cannot justify nonrecognition of gain by a mineral lease owner who exchanges an interest in her lease for services since basis can be allocated to that interest.[37] This reasoning might not justify not taxing the owner who gives an interest in future appreciation on the sale of the property in return for services. This is what Kargman gave Diamond. Arguably, this interest should be allocated no basis because it is of value only after Kargman's investment in the project is fully recovered.[38] The

[36] IRC § 263(c).

[37] If a mineral lease holder carves out an interest with a duration equal to her interest, she should be able to apportion basis to the carved-out interest. Cf. Bell's Estate v. Commissioner, 137 F.2d 454 (8th Cir. 1943)(capital gain is realized on sale of a life interest); Estate of Nickel v. Commissioner, 21 T.C.M. (CCH) 300, 305 (1962)(capital gain realized on transfer of part of life estate in settlement of claim). Amounts received on carve outs of lesser interests are defined as production payments and are treated as loans to the owner of the leasehold interest under § 636.

[38] The rules regarding options, which are analogous to interests in the future appreciation of property, are inconsistent with this. Amounts received on sale of an option are not taxed until exercise or lapse of the option. Hunter v. Commissioner, 140 F.2d 954 (5th Cir. 1944). Cf. Law Op. 988, 2 C.B. 84 (1920) (suggesting that payments in excess of basis are income when received). A transaction is treated as open until the option is resolved.

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owner cannot complain that no basis is assigned to the interest.

C. *Subchapter S: A Hybrid Approach*

If a venture is conducted through a preexisting subchapter S corporation,[39] an exchange is taxed under a hybrid of a pooling approach and an exchange approach. A laborer is taxed on receipt of an interest while a capitalist is taxed on the income from the venture as it is earned. (An exchange of subchapter C corporation stock for services is not considered here because double taxation of C corporate income radically changes the outcome.[40] The taxation of an exchange of C corporate stock for services can be dealt with only in the context of an analysis of the problem of double taxation.) For a laborer, receipt of corporate stock for services is taxed as a payment in kind or in the form of a capital interest in a partnership. He includes the value of the stock in income when it is not subject to a condition of forfeiture.[41] A corporation (i.e., the capitalist) has no gain on an exchange and it may deduct or capitalize an expense equal to the value of the stock.[42]

These rules, in effect, tax laborers under an exchange approach and capitalists under a pooling approach. Consider the results in the original example if *A* owns the building through an S corporation and compensates *B* for his services by issuing him stock equal to her own. *B* has $10,000 income in 1989 and incurs a $4,000 tax debt on which he would pay $240 interest per year. After paying taxes and interest, *B* nets $360 per year from the venture ($1,000 − $400 tax − $240 interest). When

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[39] If an S corporation is formed with a capitalist and a laborer taking stock for their contributions, the capitalist will be taxed on the exchange of assets for stock unless she (or other capital contributors) receives 80% or more of the corporation's stock. If the laborer receives more than 20% of the stock, the exchange does not qualify for nonrecognition under § 351. See note 13.

[40] In the first example involving repairs to a building, consider how much *A* nets if she operates the building through a corporation and she pays *B* with stock worth $10,000 that provides *B* with $1,000 dividends per year plus $10,000 on the sale of the building and liquidation of the corporation (that is, holding the result to *B* constant). *B*'s return is the same as under an exchange approach. He has $360 after-tax income each year and $6,000 after the sale of the building. (*B* incurs a $4,000 tax liability in 1989, which if he pays the tax by borrowing, costs him $240 interest after tax each year. After deducting this interest and the tax on dividends, *B* has $360 each year ($1,000 minus $400 minus $240). When the building is sold, *B* receives $10,000, repays the $4,000 debt, and is left with $6,000.) Each year it rents the building out, the corporation has $2,000 income and no deductions. It pays $800 tax. Once the tax is paid and $1,000 is distributed to *B*, $200 is left to be distributed to *A*, who ends up with $120 after tax. If the corporation sells the building for $20,000, it will have $10,000 gain (the $10,000 compensation paid *B* in 1989 is deducted), and will pay $4,000 in tax. After $10,000 is distributed to *B*, only $6,000 is left for *A*, and after she pays tax on that distribution, she has $3,600. This is far worse for *A* than under an exchange approach.

[41] IRC § 83(a).

[42] IRC § 1032. See Reg. § 1.83-6(d)(1); B. Bittker & J. Eustice, Federal Taxation of Corporations and Shareholders ¶ 3.12 n.128 (5th ed. 1987).

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the building is sold, he has $5,000 gain (half the basis is allocated to him), but that gain is offset by a $5,000 loss when the corporation is liquidated because *B* receives $10,000 against a $15,000 basis in the corporation. Thus, *B* receives $10,000 after the sale and liquidation, and, once he pays the $4,000 tax debt from 1989, he has $6,000. This is the same result as under an exchange approach. *A*, on the other hand, earns $600 each year after taxes ($1,000 minus $400 tax). When the building is sold, she has $5,000 gain on which she pays $2,000 tax. She has an additional $5,000 gain (and pays $2,000 tax) when the corporation is liquidated for she receives $10,000 on a $5,000 basis. Thus, *A* has $6,000 left after tax. This is the same result as under a pooling approach.

A complicating factor in the subchapter S rules is that the entity-level expense for stock compensation is allocated to all shareholders when it should be allocated entirely to the service provider.[43] In the example, if the corporation did not liquidate in the year it sold the building, the gain on the sale would be split evenly between *A* and *B* although it should be *A*'s gain. *B* includes in income the value of his part of the building when he receives the stock. When the corporation eventually liquidates, *B* will have an offsetting loss and *A* a gain in the same amount, but, in the meantime, the tax burden is shifted from *A* to *B*. The same thing will happen if the basis in the building is recovered gradually through depreciation. In partnerships, this shifting of the tax burden is not tolerated when a partner contributes appreciated property to a partnership,[44] and it is generally required when a partner joins a partnership that owns appreciated property.[45] That the subchapter S rules sometimes result in such a shifting of the tax burden is troubling, although it may be justified by a desire for simplicity (the special allocations necessary to allocate the expense to the service provider can be quite complicated if depreciation is

[43] The value of stock given as compensation is an expense of the corporation. See Reg. § 1.83-6(d)(1). If rules like those in § 706(d) prohibiting retroactive allocations of partnership items applied to S corporations, then the expense, if current, would have to be allocated to the original shareholders. Subchapter S has nothing like § 706(d), and so, presumably, the expense would be allocated to all shareholders at the end of the year. If a shareholder's interest completely terminates at the time of the exchange, and all shareholders agree, a corporation may close its books at that date and make a separate allocation of the expense to the shareholders immediately prior to the exchange. IRC § 1377(a)(2). See J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations ¶ 7.06[7] (1985).

[44] IRC § 704(c).

[45] Under the § 704(b) regulations, when a person joins a partnership which has appreciated property, a special allocation of gain on sale of that property to the original partners is permitted, subject to the ceiling limitations. See Reg. § 1.704-1(b)(5) Ex. 14(iv). If capital accounts are adjusted on the admission of a partner, the § 704 regulations require that built-in gain be allocated to the original partners. Reg. § 1.704-1(b)(4)(i). Though there is nothing in the § 704 regulations that requires such an allocation if capital accounts are not adjusted on the admission of the partner, the § 704 regulations suggest that failure to make such an allocation might be challenged under other principles (Reg. § 1.704-1(b)(5) Ex.14(iv), citing Reg. § 1.704-1(b)(1)(iii) and (iv)), including, one suspects, assignment of income.

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involved)[46] or by a belief that shareholders in S corporations are likely to be in similar tax positions so there will be little lost revenue from the temporary shifting of tax burdens.[47]

That the expense of stock compensation should, in theory, be allocated to a service provider may seem odd. One might think that stock compensation is an expense of a corporation, that is, of the original shareholder. Does she not relinquish an interest in assets when she gives up stock in the corporation for services? But, so long as services produce an asset or income of at least equal value to the stock, the shareholder gives up nothing.[48] Allocating part or all of the expense of stock compensation to the original shareholder permits her to earn and to draw income from the corporation tax free, and sometimes to shelter other income from tax.

> *Example: A* owns *Blackacre*, which is worth $10,000, through an S corporation. *A* gives *B* stock equal to her own in return for services that earn the corporation $10,000 in the current year. Each receives a $5,000 distribution at the end of the year. If the income and deduction are split evenly between the two (as the law requires), neither has taxable income pass through from the corporation, and *A* is not taxed on the distribution until she exhausts her basis in the corporation. If the entire amount of the deduction is allocated to *A*, she could use it to shelter up to $5,000 other income from tax, assuming she had adequate basis in the corporation.

The only justification for giving a corporation an expense for stock exchanged for services, at least where a corporation is taxed as a pass-through entity under subchapter S, is as a mechanism to provide a laborer a basis in assets held by a corporation to match his basis in the corporation's stock. In partnerships, a laborer paid with a partnership interest is given a basis in his interest in the assets of a partnership (the inside basis) by treating an exchange of an interest for services as an exchange of assets that are recontributed to the partnership.[49] There is no similar mechanism for creating inside basis for a laborer paid with S corporate stock for services. People will resist recharacterizing an exchange of stock for services as an exchange of assets that are recontributed to the

[46] See Reg. § 1.704-1(c)(2)(i) Exs. 1-2.

[47] Corporations and nonresident aliens cannot be shareholders of S corporations. IRC §§ 1361(b)(1)(B), (C).

[48] The original shareholder is entitled to a deduction only if the expense is a loss. For example, *A* gives *B* stock equal to her own in a S corporation owning a building worth $10,000 in return for defending a law suit. *B* preserves the corporation's asset, but does not increase its value. If the basis in the building and her basis in the stock is $10,000, *A* should have a $5,000 deduction because the stock transferred to *B* diminishes her wealth by that much.

[49] See note 19 and accompanying text.

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corporation, because the corporation (that is, the original shareholder) would be taxed on the exchange of assets for services. Without such a tax on the original shareholders, the expense for the issuance of stock for services can properly belong only to a laborer.

A more basic question is whether the hybrid approach of subchapter S is desirable. Is there any reason to tax labor, but not capital on an exchange of an interest for services? There may be, and if the argument is persuasive, it also justifies not taxing capitalists on an exchange of a partnership interest for services. The argument for the hybrid approach is that capitalists can evade a rule requiring that they recognize gain on an exchange of stock or a partnership interest for services by exchanging stock or an interest for cash and then paying cash for the services. This is the circle of cash argument, which has been used to justify the rule in § 1032 not taxing a corporation on gain on exchanges of stock for services.[50] Indeed, if *A* is told she must recognize gain if she compensates *B* with stock, she will find someone willing to invest $10,000 cash in the venture which can be used to pay *B*. The exchange of stock for cash is not taxable under § 1032. A rule taxing a capitalist on an exchange of an interest in a venture for services may be fatally undermined by the rules permitting tax-free infusions of cash into corporations and partnerships.

Though the question is close, the current partnership approach probably is preferable. If nothing else were at stake, we might reject the partnership approach taxing capitalists on grounds of equity and efficiency, because it is little more than a trap for the unwary and because it discourages giving a laborer an interest in a venture though such an arrangement may be economically desirable. But there is another concern. As we will see in the next section, valuation is the major problem in taxing an exchange of an interest in a venture for services. By threatening to tax capitalists on an exchange of an interest in a venture for services, we encourage them to raise cash to pay for services from third parties. This solves the valuation problem, at least insofar as laborers are concerned. Thus, what may seem a hollow or wasteful gesture, taxing capitalists if they pay laborers in kind, is, in fact, a way to encourage capitalists to pay laborers in cash to ensure that at least laborers pay the proper amount of tax.[51]

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[50] Hudson Motor Car Co. v. United States, 3 F. Supp. 834, 846 (1933). Cf. Comment, The Zero Basis Dilemma in Nonqualifying Triangular Acquisitions, 41 U. Chi. L. Rev. 92, 109 (1973)(authored by Sheldon Banoff)(making similar argument about triangular mergers).

[51] It is essential that the cash come from someone other than the laborer. Otherwise, a fictitious price might be placed on an interest and the labor, and the laborer would borrow to raise that price to buy an interest and then repay the loan with the same money. Something like this was tried in Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939 (1980), aff'd, 703 F.2d 485 (10th Cir. 1983). A construction company was given an interest in a project in return for its services. But the transaction was structured as a contribution by the company of its fee to the partnership. I suspect this was done to protect the other partners from tax. This

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III. Requirements of an Income Tax

This section addresses the fundamental question: Which of the two approaches—pooling or exchange—is preferable? Ultimately, the answer to this question may well depend upon one's views on the relative desirability of a consumption tax over an income tax. A pooling approach is consistent with a cash-flow consumption tax.[52] Under a pooling approach, gain from labor or capital invested in an enterprise is not taxed. Instead, tax is imposed when cash is taken from an enterprise and used for consumption.[53] An income tax, by comparison, tries to tax all increases in wealth.[54] This is consistent with an exchange approach which taxes gains derived from exchanges of labor for capital. Further, an income tax is a double tax: both invested income and investment returns are taxed.[55] Thus, as we have seen, if someone earns $10,000 in 1989, pays tax, and invests the $6,000 she has left after tax, she will earn only $360 after tax in 1990 on her investment. This is an after-tax return of 3.6% on earnings of $10,000 in a world where the tax rate is 40% and the pre-tax return rate is 10%. The effective 64% tax rate seems like double taxation—a tax of 40% on a tax of 40%—of the return from investing the 1989 salary. As we have seen, this result is consistent with an exchange approach.

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sort of arrangement should be collapsed into what it really is, an exchange of services for an interest.

[52] See Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1115-16 (1974).

[53] Under a cash-flow consumption tax, profits would not be taxed if they were reinvested.

[54] This is part of the Haig-Simons definition of income. The entire definition of income is the change in wealth plus consumption in a tax period. See H. Simons, Personal Income Taxation 50 (1938). The definition is controversial. Some economists think the criteria of the theory of optimal taxation—which considers a tax better the less it influences resource allocation decisions—more relevant than the Haig-Simons definition of income. On optimal taxation generally, see The New Palgrave, A Dictionary of Economics 734-738 (1987). Others reject Haig-Simons because they think no abstract definition of income is plausible. But many accept Haig-Simons as an ideal defining what we should aspire to tax. See Goode, The Economic Definition of Income, in Comprehensive Income Taxation 1 (J. Pechman ed. 1977); Musgrave, In Defense of an Income Concept, 81 Harv. L. Rev. 44 (1967); Pechman, Comprehensive Income Taxation: A Comment, 81 Harv. L. Rev. 63, 64-65 (1967).

[55] Another way to express the same point is by considering the consequence of taxing an increase in the value of an asset plus the earnings from that increase. Assume a farmer grows 100 trees and pays a 40% tax on that increase in his wealth, giving 40 trees to the government. He also pays a 40% tax on his harvest, giving the fruit of 24 trees to the government each year. He will be left with the produce of 36 trees for his toil. The effective rate of tax on the farmer's endeavors is 64%. The example is from I. Fisher & H. Fisher, Constructive Income Taxation 56-57 (1942). See also Andrews, note 52, at 1124-25.

The double taxation problem has perplexed tax theorists since at least John Stuart Mill. See V. J. Mill, Principles of Political Economy ch. 2, § 4. The best modern-day response to the double taxation argument is Warren, Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L. J. 1081, 1097-101 (1980). See also Gunn, The Case for an Income Tax, 46 U. Chi. L. Rev. 370, 373-78 (1979). For a response from an earlier generation that is very similar to these, see H. Groves, Tax Philosophers 108-09, 112-13, 117-18 (1974).

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This is not the place to debate the general merits of an income tax and a consumption tax. Ours is an income tax, and even advocates of a consumption tax probably would not want to see it implemented on a piecemeal and essentially surreptitious basis through the pool of capital doctrine and obscure rules in subchapters K and S. This section considers a more limited question, which is whether there are arguments justifying a pooling approach even under an income tax. It is useful to analyze two types of transactions separately: an exchange of an interest for past or current services and an exchange of an interest for a promise to perform future services.

A. Exchange for Past or Current Services

Apart from a preposterous subsidy argument,[56] the usual arguments for the pool of capital doctrine are that interests in oil and gas wells are too hard to value to feasibly be taxed and that it is unfair to tax participants in a well before they have cash from production to pay the tax.[57] Similar valuation and liquidity arguments are made for not taxing an exchange of a profits interest in a partnership for services (no one has been so bold as to defend that rule as a subsidy).[58] These arguments are similar to the arguments for not taxing unrealized gains,[59] but a crucial difference in the two problems is that, here, noncash wealth accrues in an exchange, which should generally solve the valuation problem. The problem is more akin to that of taxing installment sales than that of taxing unrealized appreciation.[60]

Theoretically, illiquidity need never prevent taxation of income. We may assess tax on noncash income when it is earned, but wait to collect

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[56] See Schwidetzky, note 4, at 553-54. The argument is preposterous because even if we wanted to subsidize oil and gas ventures through the Code, it is absurd to do that by not recognizing gains from exchanges of labor for capital. The preference assists only those laborers who take compensation in kind or those capitalists who invest in low-basis assets. Thus, it creates an incentive for in-kind compensation and a disincentive for normal equity financing, both of which are irrational. If we really wanted to encourage oil and gas ventures by exempting their returns from tax, this could be done better either by making such returns tax exempt or by providing a deduction for the cost of such investments, although it is far from clear why we would want to subsidize oil and gas through the Code.

[57] See id. at 560-61; Linden, note 7.

[58] ABA Proposal, note 24, at 13; ALI Fed. Income Tax Project, note 24, at 153-55.

[59] Andrews, note 52, at 1141-43. There are occasional proposals to tax unrealized appreciation in the value of assets, though usually such proposals include only publicly traded instruments and other assets which are highly liquid and have an easily ascertainable value. See Shakow, Taxation Without Realization: A Proposal for Accrual Taxation, 134 U. Pa. L. Rev. 1111 (1986); Slawson, Taxing As Ordinary Income the Appreciation of Publicly Held Stock, 76 Yale L.J. 623 (1967).

[60] For an argument for the repeal or restriction of the rules in § 453 deferring tax on gain on installment sales, see J. Dodge, The Logic of Tax 155 (1989); Cain, Installment Sales By Retailers: A Case for Repeal of § 453(a) of the Internal Revenue Code, 1978 Wis. L. Rev. 1; Cain, Taxation of Promises to Pay, 8 Georgia L. Rev. 125 (1973).

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the tax, plus an appropriate interest charge, until cash is actually received. For example, in the case of *A* and *B*'s venture, the government could assess a surcharge of $240 on their rental income each year as interest for the deferral of $4,000 tax. This would be on top of the normal $400 tax. When the building is sold, the government will recoup the $4,000 by applying the normal 40% rate to the full amount of the gain. There are several models for such an approach in the Code.[61] And there is a growing body of literature exploring intricacies in the design of such a system.[62]

Valuation may seem a more significant problem. If we do not know the value of an interest or services, we cannot determine gain or the appropriate interest charge. But, as argued earlier,[63] making a transfer by a capitalist a taxable exchange (using whatever method of valuation) goes a long way towards solving the valuation problem, insofar as laborers are concerned, for it encourages capitalists to raise cash from third parties in tax-free transactions to pay laborers. Valuation is not so difficult when a capitalist pays for services with an interest in a venture so as to make this threat hollow.

Many interests in ventures are not, in fact, that difficult to value. Interests in oil and gas wells are commonly valued for purposes of bankruptcy, administering estates, or sales on the basis of production history, reserve reports, or sales prices of comparable sites, and conventions exist for valuing even unproven properties.[64] Valuation of mineral interests seems to be impossible only when it works in favor of the government.

Sometimes, an interest in a venture may be valued on the basis of what others pay for similar interests. If anyone contributes cash or other property with a readily ascertainable value to a venture, and receives an interest similar to that given a service provider, the value of the capital

[61] Certain sellers of property on an installment method who defer recognizing gain on the sale until an installment note is paid must pay interest on the value of the tax deferral. IRC § 453A. Interest is charged on underpayments of tax resulting from mistaken estimates by taxpayers using the percentage of completion method for taxing gain on long-term contracts. IRC § 460(a)(2), (b)(2), (b)(3). Shareholders of a Domestic International Sales Corporation pay interest on deferred income. IRC § 995(f). Certain domestic shareholders who defer United States tax on the earnings of foreign corporations until the earnings are repatriated as dividends must pay tax plus interest for the period of deferral when the dividends are paid. IRC § 1291. For a good explanation of this system, see Isenbergh, Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations, 66 Taxes 1062, 1068-69 (1988).

[62] See Blum, New Role for the Treasury: Charging Interest on Tax Deferral Loans, 25 Harv. J. Legis. 1 (1988); Land, Contingent Payments and the Time Value of Money, 40 Tax Law. 237 (1987).

[63] See note 51 and accompanying text.

[64] See, e.g., Brown, Guidelines for Advisors: Valuation of Oil and Gas Interests, 33 Oil & Gas Tax Q. 67 (1984); Etheridge, Valuation of Oil and Gas Interests, 16 Colo. Law. 446 (1987).

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contribution should establish the value of the interest.[65] For example, if an inventor takes a 10% interest in a venture as compensation for her work, and others contribute $100,000 for 30% interests, her interest and work should be worth $33,000 if everyone acts rationally (though it might be discounted slightly because it is a minority interest). This is a distinction between capital interests and profits interests in a partnership. If an inventor takes a contingent interest in a venture—for example, an interest in profits once capital contributions are repaid—the value of her interest cannot readily be derived from the value of capital contributions. But since this difference only goes to one method of valuation, it is hardly dispositive.

Usually, services rendered for an interest may be valued on the basis of their market price. The best evidence of this is the price usually charged by a service provider for similar work.[66] Competitors' prices are also relevant, although, depending upon the uniqueness of the services or skills, the prices may not be strictly comparable.[67]

We need only know the value of the consideration on one side of an exchange to determine both parties' gain. Consideration should be of at least equal value to each of the parties; otherwise the exchange would be

[65] See Zuhone v. Commissioner, 883 F.2d 1317, 1324 (7th Cir. 1989) (valuing an interest in nonproducing wells on the basis of the amount paid by investors for similar interests). This is generally valid because a rational investor will insist that the value of the services equal the value of the interest she gives up to the service provider. Marr v. Commissioner, 1 T.C.M. (CCH) 178 (1942), provides a graphic illustration of capitalists bargaining over the dilution of their interests. Co-owners of an oil and gas property disagreed over whether to pay a driller in cash or with oil from production. To resolve the dispute, the owners who wanted to pay for drilling out of production sold a production interest to the other owners, in return for cash which was used to pay the driller. *Zuhone* actually illustrates some difficulties with this method. The service provider's interest was not strictly comparable with those the investors purchased because the service provider bore no share of the expenses, but also received more of the tax benefits for those expenses.

[66] See Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939, 954 (1980), aff'd, 703 F.2d 485, 488 (10th Cir. 1983)(pricing a firm's services on the basis of its usual fee). Cf. Temp. Reg. § 15A.453-1(d)(2)(iii)(amount received in sale for contingent price is assumed to be no less than the fair market value of the property sold).

[67] Some might think there is a theoretical flaw in looking at the prices usually charged by a service provider to determine the value of her services. Might not a service provider set her price on the basis of her marginal cost and not her average cost? For example, a lawyer may charge more than usual if additional work interferes with highly valued leisure time. Or she may charge less if her fixed costs (an office, secretary, and books) have been recovered. But this is not really a problem. Fixed prices should be the rule. Microeconomic theory predicts that price will be constant in an industry or a firm, it is just that that price is set at the marginal cost of the last unit produced. P. Samuelson, Economics 526 (11th ed. 1980). Indeed, a popular lawyer probably will not just charge her last client more; she will charge all her clients more. Thus, the Service should be able to presume that an interest in a venture taken as compensation for services is worth as much as the service provider or her competitors usually charge for the services, unless the taxpayer can establish that her prices or prices in her industry truly are variable.

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irrational.[68] This sets only a minimum value. It is possible, even likely, that people derive additional profit from an exchange. For example, a geologist may value an interest in a oil well higher than the market because she has special knowledge of its potential. An owner of a mineral lease may be willing to pay more than the going rate for a geologist's services if the geologist has unique knowledge of the area. We can, however, be certain that the geologist does not value an interest in an oil well she accepts as compensation at less than the market, for, otherwise, the interest would be sold to others and she would be paid in cash. Similarly, the mineral lease owner does not value the geologist's services at less than the market, for otherwise the owner would refuse to pay the market price and the geologist would go elsewhere for work.

The only situation where this cannot be presumed true is where there is no market for both the capital and the labor.[69] If there is a market for either the labor or the capital, its market price establishes the value of both contributions, for the person with the marketable contribution should insist that she receive something at least of equal value to her, and the other person should take the marketable good only if he values it as much as the cash it could command in the market. Cases where a market is lacking for both goods in an exchange are likely to be rare.

Of course, there is a risk of undervaluation. But even with significant undervaluation, an exchange approach is still better than a pooling approach because at least some of the return on investments of labor and low basis capital assets in oil and gas wells and other ventures will be taxed. Moreover, undervaluation may be deterred by penalties similar to those now imposed for overvaluing property.[70]

In the rare case where it is impossible to value either labor or capital involved in an exchange, it is still possible to estimate gain on an exchange, and to charge interest for the deferral of tax on that gain, by working backwards from the actual results.[71] In essence, actual profits may be discounted back to the time of the receipt of an interest in a venture to determine gain at that time and interest charged for the deferral of tax on that gain. There are proposals along these lines,[72] though they pose enormous design problems (for example, should the discount

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[68] This, of course, is the principle of United States v. Davis, 370 U.S. 65 (1962). Accord *Hensel Phelps Constr. Co.*, note 65 (holding that a capital interest in a partnership received for services should be valued at amount equal to what the service partner normally charges for services).

[69] Cf. Robinson, note 24, at 267 n.90 (provider of services may have been willing to risk its cost of services, but not their fair market value).

[70] IRC § 6659.

[71] This is impermissible under current law which requires that property be valued on the basis of information known at the time of receipt. Later information is irrelevant. Zuhone v. Commissioner, 883 F.2d 1317, 1324-25 (7th Cir. 1989).

[72] See Blum, note 62, at 48-52, 56-65, 71-74, 83.

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rate include a risk premium).[73] Moreover, if services are performed over several years, it becomes necessary to allocate the return to some year (or years), and that may be impossible when there is no market price for the services. Though even these cases might be dealt with through an arbitrary surcharge on income earned on an interest, the receipt of which is not taxed.

I mention this possible solution only to suggest that there may be ways to deal with even the hardest cases. The problem is, finally, one of will. Valuation is a technical matter that can be solved in virtually all cases if we are willing to make the effort. There is a lesson in the history of the open transaction doctrine. In a sale of property for contingent consideration, such as a sale of an interest in a mine with payments based on future production,[74] it is difficult to determine the amount of gain on the sale because of the contingency. This makes it difficult to determine how much of each payment is recovery of the taxpayer's basis in the property and how much is gain. This problem formerly was solved in a way that was strongly pro-taxpayer: Gain was taxed only after full recovery of basis. In 1980, Congress required that basis be apportioned across all payments by some reasonable method, at least where a taxpayer elects installment treatment.[75] Though the conventions for apportioning basis are imperfect,[76] they do not seem to have been unduly burdensome or

[73] Not setting a premium penalizes winners in risky ventures by overvaluing an interest. For example, assume an oil well has a one in ten chance of hitting and that a hit earns the driller $110,000 in the year after drilling. A driller should take an interest in a well in lieu of $10,000 for that is the value of one in ten chance at $110,000 in a year. But if the well hits and the value of an interest is determined by discounting the return by ordinary rates, the interest in the unproven well will be overvalued at $100,000. The surcharge is $2,400 instead of the appropriate $240.

This may not be objectionable. The extra tax paid by winners in risky ventures equals the tax saved by losers. This means that if people are repeat players and they have many such investments, their gains and losses should offset each other. In the case of the driller, for example, if he works on ten wells in a year and one hits, the method imposes exactly the right amount of tax. Moreover, the method should not affect behavior very significantly. Once the additional tax is discounted for risk, it is the same as the tax on investments at ordinary rates of return. A one in ten chance of paying $2,500 is equivalent to a one in one chance of paying $250. If people are risk neutral, this should have no impact. If they are risk adverse or risk prone, it will slightly affect their behavior by slightly reducing the cost of losing and the payoff for winning. One might object to the redistribution of wealth from winners in risky ventures to losers. This result may be defended as a modest form of social insurance for risk takers.

If a risk premium is set, the Treasury will lose because losers on risky ventures will not be taxed on the value of chances received as compensation. The value of a successful venture will be greatly discounted to account for the risk, but the value of an unsuccessful venture will not be taxed.

[74] Burnet v. Logan, 283 U.S. 404 (1931).

[75] Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247 (codified in scattered sections of 26 U.S.C.). The Act is implemented by Temp. Reg. § 15A.453-1(c), (d). A taxpayer may opt out of § 453 and still attempt to qualify for open transaction treatment.

[76] Consideration in a contingent price sale is assumed to equal the value of the property sold. Temp. Reg. § 15A.453-1(d)(2)(iii). There are several alternative methods for apportion-

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unfair. With a similar effort, we might tax most, or even all, exchanges of labor for capital.

B. *Exchange for Future Services*

Up to this point, this article has considered whether an exchange of an interest in a venture for past or current services should be taxed. It next considers an exchange of an interest in a venture for a promise to perform future services. Both intuitively, and as a matter of positive law, this would seem a very different and easy problem. Probably, most assume no tax should be imposed on such an exchange. No one thinks, for example, that a person making partner in a law firm should pay tax at that time on the discounted present value of her future earnings. Indeed, one criticism of the *Diamond* decision is that taxing an exchange of a profits interest for services might result in such a tax.[77] The law is fairly clear that rights (other than cash) received for a promise to perform future services are not taxed until the services are performed. Under § 83, property received for services is not taxed until the services are performed.[78] Although cash prepayments for services are taxed,[79] there is little authority for taxing noncash prepayments.[80] A promise of future

ing basis when payments are based on production. The methods include forecasting income, assuming a maximum price set in the sale contract will be paid, recovering basis ratably over a set period for payment, or, if all else fails, using a straight-line, 15-year recovery schedule unless the taxpayer can prove that method is inappropriate. Temp. Reg. § 15A.453-1(c).

[77] Cowan, Receipt of a Partnership Interest for Services, 32 N.Y.U. Inst. Fed. Tax'n 1502, 1526-27 (1974); ALI Fed. Income Tax Project, note 24, at 152 (Ex. 6).

[78] Property received subject to a condition of forfeiture is not taxed (unless the employee elects otherwise). IRC § 83(a). A requirement that substantial future services be performed is such a condition. Reg. § 1.83-3(c)(1). Other recognized conditions of forfeiture include a no-competition condition (Reg. § 1.83-3(c)(4) Ex. 5), and a condition that an employee's children attend college to receive benefits under an educational trust (Reg. § 1. 83-3(c)(4) Ex. 2; cf. Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd, 570 F.2d 210 (7th Cir. 1978)(employee taxed on educational trust benefits when payments made to children in school)).

[79] Cases involving cash prepayments to cash method taxpayers for services include Gustafson v. Commissioner, 55 T.C.M. (CCH) 250 (1988); Huebner v. Commissioner, 25 T.C.M. (CCH) 406 (1966); Robinson v. Commissioner, 44 T.C. 20 (1965); Freeling v. Commissioner, 7 B.T.A. 1238 (1927). Cash prepayments are more properly treated as a loan from the payor to the service provider. See Halperin, Interest in Disguise, note 16, at 515-19.

[80] In Schlude v. Commissioner, 372 U.S. 128 (1963), notes given as prepayment for services were held taxable on receipt. But the notes were negotiable and could be discounted at a local bank and so were equivalent to cash. Generally, a note or other right is considered a cash equivalent if it is readily marketable at a price close to its face amount. See Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

A noncash prepayment was taxed in T.F.H. Publications, Inc. v. Commissioner, 72 T.C. 623 (1979), aff'd, 622 F.2d 579 (3d Cir.), cert. denied, 449 U.S. 921 (1980). The taxpayer acquired printing and publishing assets, giving the seller of the assets as part of the purchase price a 90% discount on the first $400,000 of advertising placed by the seller in the taxpayer's publications. In essence, the taxpayer promised the seller $360,000 of free advertising as part consideration in the purchase of a magazine. The prepayment was the assets given in return for the

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payment for future services is not even that.[81]

The question, however, is not disposed of that easily.[82] The problem is part of the larger problem of how to tax human capital or human earning potential. An interest in a law firm has value because of the earning potential of its members, and a lawyer is given a partnership interest because of her earning potential. If we are going to tax a new law partner, we may well want to tax other rights that define the value of a person's earning potential, such as long-term employment contracts or the tenure rights of federal judges or professors.

Few think that human capital should be taxed, even in a system (unlike ours) that generally taxes unrealized gain,[83] but why this is so has never been explained convincingly. Two reasons for not taxing human capital are problems of liquidity and valuation.[84] Human capital is highly illiquid. With rare exceptions,[85] future services cannot be sold and banks are reluctant to lend without security that is more tangible than a claim on future wages. But, as discussed earlier, the liquidity problem can be solved by assessing a tax on income, but deferring its collection, with an interest charge, until cash is received.[86]

Human capital is also difficult to value. The value of a partner's interest in a law firm depends, for example, on the firm's fortunes, plus the risk of events such as sickness, having children, or marriage to someone living far away that may take the lawyer from the firm. Sometimes, how-

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promise of future services. The Tax Court held that the value of the assets must be accrued as a prepayment of income. 72 T.C. at 641.

[81] A colleague has suggested, only partly in jest, that this might be described as a noncash nonprepayment. The implication is that there is nothing there to tax.

[82] Two arguments for not taxing exchanges of interests for future services deserve only brief mention. One is that such a tax falls, improperly, on imputed income. Hortenstine & Ford, note 24, at 900-01. See ALI Fed. Income Tax Project, note 24, at 151. A tax on making partner in a law firm seems like a tax on imputed income because the tax is on potential, and so it might be borne by the lawyer even if she ceases to work for pay and devotes her time to herself. Imputed income is the wealth or satisfaction people derive by devoting their resources to themselves and not by selling them in the market. M. Chirelstein, Federal Income Taxation 23 (5th ed. 1988). But it is a tax on imputed income (or a tax on leisure) only if the lawyer later quits and does not go through with the exchange. A tax on imputed income may be avoided by giving the lawyer a deduction for earning potential previously taxed in an amount sufficient to offset the earlier tax.

The second argument is that a promise of future payment for future services should not be taxed because the promise's value as an asset is offset by a liability in the form of an obligation to perform future services. 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.02[4] (1989 Cum. Supp. No. 2). This ignores the fact that the service partner has no basis in her future services. The promise is all gain.

[83] Some advocate treating human capital like other capital and so, if consistent, should support taxing increases in the value of human capital. See Stephan, Federal Income Taxation and Human Capital, 70 Va. L. Rev. 1357 (1984).

[84] Andrews, note 52, at 1145-46.

[85] For example, professional athletes may sign long-term contracts that have signing bonuses or other payments up front.

[86] See notes 61-62 and accompanying text.

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ever, earning potential can be valued. In some large, well-established law firms, future profits of the firm and a lawyer's share may be predicted with a fair degree of certainty,[87] and the risk of death or illness may be accounted for by normal actuarial methods. When an interest in a venture with more tangible assets is given for a promise to perform future services, it is possible to assign some value to those labors. For example, in a research venture where one person contributes capital and the other promises to do the work, and the two agree to share the profits from the venture evenly, we can assume that the researcher's expected contribution is worth an amount equal to half the capital. When a person enters into a long-term contract for a definite salary, valuation requires only discounting that salary to present value. Adjustment should be made for actuarial risk, but it will be slight if the contract is for only a few years. Problems of valuation cannot explain the complete failure to tax human capital.

Some think the reason for not taxing human capital has to do with fundamental principles regarding the status of humans. One argument is that a principle of human dignity bars treating human potential in the same way as other wealth which can be taxed and marketed.[88] Another argument is that taxing human potential violates libertarian principles because it requires people to sell themselves to pay a tax.[89] The appeal of such ontological arguments depends, of course, on whether one accepts their premises. Some may not.[90] Even if one accepts principles of human dignity or liberty as relevant at some level of the analysis, it is not clear that such principles can justify not taxing human capital in cases where people trade on their earning potential by contracting to sell their services for future payment.

Professor Joseph Dodge has suggested another reason for not taxing human capital as other forms of investment are. His argument is that the unrecoverability of investments in human capital—no deduction or basis is given for the costs of education or personal maintenance, for example—may make it unfair to subject the returns on human capital to a double tax regime, that is, taxing increased earning potential as an in-

[87] Some firms compensate partners on a lock-step basis, basing shares entirely on seniority. Gilson & Mnookin, Sharing Among Human Capitalists: An Economic Inquiry Into the Corporate Law Firm and How Partners Split Profit, 37 Stan. L. Rev. 313, 341-46 (1984) (description of lock-step seniority system).

[88] Warren, note 55, at 1114-17.

[89] Kelman, Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World, 31 Stan. L. Rev. 831, 839 n.23 (1979)(tax is not payable on earning capacity until realization). Cf. Gunn, note 55, at 382 (tax on earning capacity would lead to "an unacceptable restriction on freedom"). This will be the effect of a tax on human capital only if a full deduction (with a refund, if necessary) is not allowed for unused potential that has been taxed.

[90] See Stephan, note 83, at 1364-65.

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crease in wealth and taxing the earnings themselves.[91] It seems unfair, for example, to tax a law school graduate on the value of her degree as well as on her earnings when she has been given no basis for her investment in that degree.

There are problems with this argument. It may be that other rules which are favorable to an investment in human capital—such as the failure to tax income forgone while in school[92] or the ability to deduct the cost of continuing eduction[93]—compensate for treating some investments in human capital as personal. The aggregate effect of these various rules is, ultimately, an empirical issue that cannot readily be resolved.[94]

Furthermore, it is difficult, at least in theory, to justify one defect in the law on the basis of another. The effects of disallowing recovery of investments in human capital and of excluding human capital from the tax base are offsetting, but nonequivalent. For example, if the return from an investment in education (including forgone income) is equivalent to other investments, a student is better off under the ideal approach—where she recovers the cost of her degree, but is taxed on any value in excess of its cost—than she is under the current system. This is axiomatic. If the rate of return on education is at the market rate, the cost of an education should equal its value, so a student will have no income on earning the degree, and only part of her earnings will be taxed because of cost recovery.[95] One can imagine rates of return on an investment where the result under the current approach approximates the ideal (it requires a good, but not great, rate of return),[96] but there is no reason to expect

[91] J. Dodge, note 60. Professor Dodge defends the exclusion for recovery of lost wages from personal injuries on essentially this ground. His argument is considerably more powerful than the argument that most personal injury awards should be treated as nontaxable recoveries of capital (see Stephan, note 83, at 1387-93) for it explains why a personal injury award is not taxed, but the return on its investment is.

[92] See M. Chirelstein, note 82, at 110. Many do not consider this income. For a general challenge to the concept of imputed income, see Chancellor, Imputed Income and the Ideal Income Tax, 67 Ore. L. Rev. 561 (1988).

[93] See, e.g., Ruehmann v. Commissioner, 30 T.C.M. (CCH) 675 (1971)(cost of LL.M. may be deducted if taxpayer is practicing law at time he obtains degree).

[94] Cf. Stephan, note 83, at 1384-85 (arguing that it is not clear that tax preferences for human capital formation outweigh disadvantages).

[95] Compare the taxation of an investment in a bond. There is no gain on purchase of a bond because it is priced at cost and only interest is taxed on payout.

[96] If we assume a student invests $100,000 in a degree which will provide a level return for 35 years, and that the discount rate is 10%, the results under the ideal system and the current system approximate if the return on the investment is 14% ($14,108 per year for 35 years). The present value of the degree is $136,758. Under an ideal system, her gain on receipt of the degree is $36,758 and her tax is $14,703. In addition, she has $10,200 taxable income each year (assuming straight line recovery of her basis in the degree), pays $4,080 tax per year, which, discounted to present value, costs $39,348. The present value of her total lifetime tax is $54,051. Under the present system, she pays $5,643 tax each year which, discounted to present value, is $54,423. (The relation is similar for most tax rates. For example, at a 50% rate the lifetime tax burdens under the two approaches are $67,567 and $68,029. At a 10% rate,

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such a happy coincidence in reality.

These points do not prove Professor Dodge wrong. It is quite possible that the preferences for investments in human capital do not compensate for the disadvantages. Furthermore, that the current regime for taxing human capital falls short of the ideal may be irrelevant, if the ideal is unattainable. However human capital might be taxed ideally, there is some appeal to Dodge's argument that it is perverse to tax earning potential in the same way as other assets—taxing both the potential (the discounted value of future earnings) and the earnings themselves—when investments in earning potential are unrecoverable.

It bears noting that this concern cannot justify a pooling approach when an interest is received for past or current services. Most compensation is taxed when it is earned either directly[97] or indirectly,[98] and it is difficult to see how a general defect in the treatment of an investment in human capital can justify special treatment for one type of compensation. Further, once human sweat is turned into a more traditional form of capital by taking an interest in a venture as compensation for services, there are rules to ensure proper recovery of the taxpayer's basis in the investment.[99]

There is another reason for not taxing earning potential that suggests there may be a connection between the problems of double taxation and illiquidity. One objection to double taxation (and an argument for a consumption tax instead of an income tax) is its inequity. From one perspective,[100] an income tax discriminates against savers and in favor of consumers. For example, two people earn $1,000 in 1989. One consumes this amount and the other invests it for one year, at a 10% rate of

the same numbers are $13,578 and $13,512.) If the student has a rate of return above 14% on the investment, she does better under the current regime than under the ideal regime. At rates of return below 14%, she does worse.

[97] Cash is taxed on receipt. Property is taxed when earned under § 83 (unless it is subject to a substantial risk of forfeiture or is not transferable).

[98] Deferred compensation arrangements can defer the employee tax, but often the employer will bear the tax because its deduction is deferred. See Warren, note 16.

[99] An argument for not taxing an exchange of a profits interest for services is that there is no mechanism for recovering the service partner's basis in the future profits. See A. Willis, J. Pennell & P. Postlewaite, note 23, at § 46.04. But that can be cured, though the form of the cure is fairly complicated. See 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.07[3]; Hortenstine & Ford, note 24, at 902-03. Two adjustments need to be made. First, the service partner must be given a basis in her partnership interest equal to the gain taxed. And, second, the partnership must be given a basis in future earnings, in the same amount, which will be recovered as the profits are earned. These deductions should be allocated to the service partner. The second adjustment ensures that the service partner pays no tax on already taxed earnings at the partnership level. The first adjustment ensures that she pays no tax when the profits are distributed to her.

[100] The criticism assumes that the equity of a tax should be assessed by seeing how it affects the relative positions of people when future cash flows are discounted to present value using pre-tax rates of return.

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return. At a 40% tax rate, the consumer has $600 to spend in year one. The saver has only $636 to spend in year two ($600 earns $36 after tax). At a 10% discount rate, the saver's $636 in 1990 is worth only $578 in 1989. Those concerned with double taxation think this is unfair to savers.

A decisive answer to this criticism, at least insofar as the problem is considered one of fairness, is that people will save only if the after-tax return on savings compensates them for the extra tax imposed. The saver would not save unless she thought $636 in 1990 was worth at least as much as $600 in 1989.[101] But this answer suffices only if the saver can choose whether to save or to consume her wealth. That is, it suffices only if the wealth is liquid. If the saver's income in 1989 is illiquid—perhaps the only compensation available to her is property that cannot be sold or pledged as security for a loan—we cannot assume that the $636 she eventually realizes after tax in 1990 is as good as $600 earned and spent in 1989. Thus, concern with the apparent inequity of double taxation may justify not taxing gain in the form of illiquid wealth, such as human capital. Of course, this only tells us that the saver does not necessarily derive as much satisfaction from consuming $636 in 1990 as she would derive from consuming $600 in 1989. For all we know, she may derive more.

An interesting implication of this argument is that it could apply to an exchange of an interest for past or current services as well, if the services and the interest are truly illiquid. For example, if a scientist receives an interest in a research venture in return for her labors, and her skills and the product are so unusual that there is a market for neither ex ante, it might be unfair to subject her to the normal double taxation regime for investments on her interest in the venture because the illiquidity of her services and the interest makes it doubtful that she can, like other investors, demand a return sufficient to compensate her for the double tax. This may be a reason not to tax the receipt of highly speculative interests retroactively by discounting the eventual earnings to determine their initial value.

I give this much attention to the issue of taxing human capital only to warn that the norms and arguments relied upon to justify taxing current compensation, in whatever form it takes, might be used to justify taxing earning potential. There are differences in the two problems. Human capital probably is harder to value than other assets. Taxing human capital may be troublesome because of concerns of human liberty or dignity, or because of the way investments in human capital are treated, or because of the illiquidity of human capital and the concern with double taxation. Nevertheless, the differences tend to be more those of degree

[101] Warren, note 55, at 1097-101.

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than of kind, or they rest on debatable premises. Differences in degree may be crucial, however. Perhaps we cross over a line where valuation or other problems are sufficiently difficult that wealth in the form of human capital cannot be taxed in most cases, and so, for the sake of equity, we choose to tax it in no cases. Whatever the reason, the reality is that we do not tax human capital, and, unless we want to radically change the tax, consistency requires that we not tax rights short of cash given in anticipation of future services. Thus, in trying to tax exchanges of interests in ventures for services, we must draw the line at taxing only exchanges of interests for past or current services. The question is how we go about doing that.

IV. Implementing the Proposal

Apart from the problem of valuation already discussed,[102] most of the problems in trying to tax an exchange of an interest in a venture for past or current services involve transactions where services spanning more than one year are provided. These problems include determining (1) when an exchange takes place for tax purposes and (2) how to tax the parties prior to that time. This section considers these problems as well as a few other issues that arise in changing the partnership and subchapter S rules in order to uniformly tax laborers and capitalists on an exchange of an interest in a venture for past or current services.

In most cases, when an interest in a venture is exchanged for services performed over more than one year, the exchange should be treated as occurring in the year when the interest is no longer subject to a risk of forfeiture should the laborer cease working.[103] This is generally the rule under § 83 today, though conditions not related to the continued performance of work are also considered sufficient to delay the recognition of gain. That broader rule is undesirable, for only work-related conditions are relevant to the issue of whether an interest is given for past or future services. For example, there is authority that amounts placed in an educational trust for the children of employees are not income to the employees until the children attend college and so have a right to draw

[102] See notes 64-76 and accompanying text.

[103] In Hensel Phelps Constr. Co. v. Commissioner, 74 T.C. 939 (1980), aff'd, 703 F.2d 485 (10th Cir. 1983), an interest was held not subject to a risk of forfeiture, though the taxpayer had not completed construction of the project, because the construction obligation was imposed by a contract separate from the partnership agreement and there was no express provision requiring forfeiture of the partnership interest if the taxpayer did not fulfill this obligation (74 T.C. at 953). As a matter of contract law, this decision is probably wrong. Since the interest was consideration for the work, the owners of the project in *Phelps* had the right to rescind the contract and recover the interest should the construction company breach in a substantial way. Rescission need not expressly be provided for. See Restatement (Second) of Contracts § 373.

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from the trust.[104] The condition that children attend college is considered a condition of forfeiture. This seems wrong. The condition is relevant to valuing an employee's interest in the trust, but that interest is fully earned once no further work is required for the benefit, and it should be taxed at that time. One might as well argue that amounts invested in an annuity for an employee which begins payment at retirement are subject to a condition of forfeiture because payment requires living to retirement age.

The problem with a standard that defines when an exchange occurs on the basis of the forfeitability of an interest is that people may try to delay tax by imposing negligible service requirements. In the *Diamond* case,[105] for example, it may have been possible to delay tax on the exchange by requiring Diamond to provide continuing advice to the partnership in addition to obtaining a loan to finance the project as a condition for retaining his interest. Section 83 suggests a partial solution to this problem: The future services must be substantial.[106] Thus, the regulations suggest, a requirement that future consulting services be performed may not suffice.[107] Moreover, future services should have to be substantial in relation to past services. For example, a requirement that a driller also manage an oil well should not be treated as a condition of forfeiture if the burden of management is slight in comparison to that of drilling. Requiring that future services be substantial in relation to past services will discourage evasion because people will be reluctant to risk significant amounts by undertaking onerous conditions of service.[108] The § 83 regulations need to be strengthened in this regard. On the other hand, the suggestion in the regulations that a requirement that work be performed is not a substantial risk of forfeiture if the employee controls a significant ownership interest, because he is unlikely to enforce the condition against himself,[109] should be disregarded. Otherwise, § 83 becomes a vehicle for taxing human capital when people promise to contribute services to closely held corporations.

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[104] Armantrout v. Commissioner, 67 T.C. 996, aff'd, 570 F.2d 210 (7th Cir. 1978); Reg. § 1.83-3(c)(4) Ex. 2.

[105] Diamond v. Commissioner, 56 T.C. 530 (1971) aff'd, 492 F. 2d 286 (7th Cir. 1972). For a discussion of the case, see note 22.

[106] Reg. § 1.83-3(c)(1).

[107] Reg. § 1.83-3(c)(2). If the sole consideration is that a retiring employee render consulting services upon his former employer's request, the risk of forfeiture is not considered substantial unless the retiree is in fact expected to perform substantial services.

[108] If a package of services that is often sold separately is involved, the government might also disaggregate the services and treat the transaction as involving several exchanges completed at different times. For example, if well drilling services are commonly sold separately from management services, the government might treat a contract packaging the two as two separate contracts, and tax the drilling part when the well is completed by valuing the consideration for that part on the basis of the market price.

[109] Reg. § 1.83-3(c)(3).

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Section 83 should also be amended to eliminate the possibility of electing to be taxed before satisfying a condition of forfeiture, or, if the election is to be preserved, the service provider should be required to value an interest on the assumption that his services will be successfully completed. As noted earlier, this seems not to be required under the current regulations.[110] This is necessary to prevent use of the election to avoid recognizing gain on the value of an interest that derives from a service provider's labor. In the original example involving *A* and *B*, for instance, by electing to be taxed upon receipt of an interest in the unimproved building, *B* was able to reduce his income from $10,000 to $5,000 in 1989, avoiding tax in 1989 on the $5,000 increase in the value of a half interest in the building that resulted from his services. This also prevents converting such returns from services into capital gain.

Two approaches have been suggested for taxing a laborer who holds an interest in a venture subject to a condition of forfeiture. Under § 83, the laborer is treated as an employee of the other owners of the venture until the condition of forfeiture is satisfied.[111] The leading authorities in partnership taxation oppose this approach, at least for partnerships. They would treat a service partner whose interest is subject to a condition of forfeiture as a partner.[112] The two approaches have different consequences in several important respects. If profits are earned, but are not distributed by a venture, the partnership approach taxes the profits to a service partner, while the § 83 approach taxes the profits to the other owners. If a venture has losses, the partnership approach permits a service partner to deduct a share of the loss (assuming he has basis from debt), while the § 83 approach allocates the loss to the other owners. If there are cash distributions while a venture operates at a loss, the § 83 approach treats the distributions as salary to a service provider which increases the loss to the other owners. The partnership approach treats them as tax-free distributions to a service partner, or, if he has no basis in his partnership interest, as capital gain. If profits are distributed to a service provider and his services are capital in nature, the partnership approach provides the other partners with what is, in essence, a deduc-

[110] See note 14 and accompanying text. However, in Campbell v. Commissioner, 59 T.C.M. 263 (CCH) (1990), the Tax Court rejected an argument that an interest in a partnership should be valued on receipt when the value of the interest depended upon the performance of future services by the taxpayer. The court characterized the initial interest as of only formal significance.

[111] Reg. § 1.83-1(a)(stock subject to a substantial condition of forfeiture is treated as owned by the employer and dividends with respect thereto are compensation to employee).

[112] See 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.08[3][b]. Cf. A. Willis, J. Pennell & P. Postlewaite, note 23, § 46.14 (criticizing § 83 more generally); J. Eustice & J. Kuntz, note 43, at ¶ 7.06[7] (questioning wisdom of § 83 approach with regard to S corporations); D. Schenk, Federal Taxation of S Corporations ¶ 11.04 (1989 Supp.) (suggesting stock subject to restriction can be treated as treasury stock and ignored).

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tion for the payments because they reduce their shares of current income. The § 83 approach requires that the payments be capitalized by the other owners as a salary expense.

These issues are not very difficult to resolve once we realize that a person who holds an interest subject to forfeiture is both an employee and an owner, and, rather than trying to classify him as one or the other, instead tailor specific tax consequences to suit his circumstances. For example, if a service provider is liable for debts of a venture even though his interest is forfeitable, he should be able to deduct his share of the venture's losses for he bears the economic risk of those losses.[113]

Whether undistributed earnings should be taxed to a service provider should depend on whether his right to the earnings is secure. Thus, undistributed earnings should be taxed to a service provider if they are nonforfeitable. Conversely, undistributed earnings should not be taxed to a service provider if the earnings cannot be distributed under the partnership agreement and if the earnings are subject to forfeiture (assuming the agreement will be enforced). There will be hard cases between these two extremes, but they can be resolved by asking whether there is a substantial risk that the service provider will never receive earnings credited to his account. For example, if an agreement permits, but does not require, distribution of earnings, and the service provider cannot compel distribution because he has a minority interest and undistributed earnings are forfeitable, the service provider might be taxed on undistributed earnings if his relation with the other partners makes it unlikely that they will use their power to deny him earnings credited to his account.[114]

If services are capital in nature, all payments to a service provider until his interest vests should be capitalized, just as the value of the interest is treated as a capital expense on the eventual exchange. Otherwise, it would be advantageous to compensate providers of capital services with precompletion distributions. Section 707(a)(2)(A) is not to the contrary. That section deals with the case where a partnership attempts to avoid capitalization requirements by giving a service provider a partnership interest as compensation.

> *Example: KLM Partnership* employs an architect to design a building. Rather than paying him a fee of $10,000, *KLM* gives the architect an interest in its gross profits in the current year of equal value. If this plan worked, *KLM* would reduce partnership income by $10,000 and avoid capitalizing the expense.

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[113] See 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 5.08[3][b] Ex. 1.

[114] Cf. Reg. § 1.83-3(c)(3).

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Section 707(a)(2)(A) recharacterizes distributions to a service provider as compensation—taxing the other partners on the service provider's share of profits and requiring them to capitalize the expense—when the interest of the service provider is not truly that of a partner. An interest is treated as disguised compensation if it is shortlived, or is out of gross profits, or involves no risk of losses. If a service provider is truly a partner—if he is there for the long haul and is subject to the fortunes of the partnership—the allocation of a share to him will be respected.

> *Example: KLM Partnership* gives its architect a 1% share in the future profits and losses from the building he designs. Section 707(a)(2)(A) does not apply.

There is nothing in § 707(a)(2)(A)'s legislative history that suggests that a determination that an interest is truly a partnership interest entails particular tax consequence for its exchange.[115]

People still can avoid capitalizing distributions by not requiring services from a partner who performs services that are capital in nature. If an architect has a share in profits and losses and is not required to perform future services, for example, he is a partner and § 707(a)(2)(A), at least by implication, supports taxing his share as a partnership distribution even though he performs services which are capital in nature. But people are unlikely to try to take advantage of this. To do so, they must forgo the legal right to compel a service provider to continue to work, a risk only families and other groups that trust each other a great deal would be willing to take.[116]

A related issue is how to tax a service provider who is allocated a share of profits and to whom a distribution is made before she has done any work.[117] For example, a partnership that owns a coal mine might give a reclamation company a share of its profits in return for a promise to

[115] Indeed, the Blue Book suggests that an exchange of a partnership interest for services is taxed if under the facts and circumstances it has the substantial economic effect of a direct payment. See Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 227 (Comm. Print 1984).

[116] If future services are essential to the value of an interest, it is unnecessary to formally require that services be performed and, so, capitalization may be avoided. But, this will be possible only where a venture has few assets. Then, it is unlikely that expenditures are capital in nature (otherwise there would be assets) and the revenue stakes are likely to be small.

[117] This is different from the issue of how to treat a distribution made to a partner who has not yet been allocated any profits. That issue arises, for example, when a law firm makes a distribution to a new partner upon her elevation. To avoid the anomaly of taxing such distributions as capital gains (the result under § 731 if the new partner has no basis in her partnership interest), such distributions are treated as advances and are accounted for at the close of the tax year by which time, presumably, the new partner will have a profits share from which the compensation can be deducted. See Reg. § 1.731-1(a)(1)(ii); 2 W. McKee, W. Nelson & R. Whitmire, note 1 at ¶ 19.03 [2]. This treats the distribution as a loan, though there is no mechanism for imputing interest.

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reclaim the mine once it ceases production. The profits distributed are really in the nature of a prepayment, and, in theory, should be treated as a loan by the other partners to the reclamation company.[118] However, current law generally does not tax prepayments in this fashion; usually they are treated as income to the payee. In most cases, this is unlikely to result in undertaxation because the payee will pay tax on the investment return.[119]

> *Example:* A distribution is made to a reclamation company by a mining partnership in 1989 in lieu of paying it $10,000 in 1990. The reclamation company will insist on being paid $9,434 in 1989, for it will have $5,660 after tax, which will grow in value to $6,000 in 1990, the same amount the reclamation company would have if paid $10,000 in 1990. For the partnership, a deduction of $9,434 in 1989 (a profits allocation has the same effect as a deduction) is equivalent to a deduction of $10,000 in 1990: the tax savings of $5,660 in 1989 grows to $6,000 in 1990, the amount that would have been saved on a $10,000 deduction in 1990.

This will be true so long as the payee pays tax at the same rate as the payor and the eventual expense would have been deductible.

Several changes need to be made in the treatment of an exchange of a profits interest in a partnership for services. These can be described briefly since they are explained above. First, a service partner should include in income the real value of an interest, and not the value of an interest upon a hypothetical liquidation.[120] An interest should be presumed to be worth what a service provider normally charges for his services. Second, a service partner should be given an inside basis in the profits to be recovered as the profits are earned. This deduction should be allocated entirely to the service partner.[121] If the profits are contingent, a recovery schedule can be derived from the § 453 regulations.[122] Third, the original partners should also be taxed on an exchange of a profits interest for services, except where a profits interest is in the nature of a carved-out income interest to which no basis is assigned (for example, an interest in rents), and, then, only if the income stream provided by the services is not of significantly longer duration than the carved-out interest and if it does not bunch income disproportionately at the end.[123]

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[118] See Halperin, Interest in Disguise, note 16, at 515-16.

[119] Id. at 517.

[120] See note 25 and accompanying text.

[121] See note 92.

[122] Temp. Reg. § 15A.453-1(c), (d).

[123] See notes 31-35 and accompanying text.

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What qualifies for nonrecognition treatment may be defined through general guidelines stated in this fashion or a more formal standard might be adopted. For example, a profits interest might be required to have a life 80% or more of the life of an asset produced by services. Nonrecognition might be also denied carve outs from assets with a basis significantly below their value.[124]

Other changes in the partnership rules may be necessary. At present, compensatory shifts of interests among partners are not taxed, even if a shift involves an interest in capital. The classic example of such a shift involves a flip-flop in a research and development partnership. A capitalist puts up the money for a venture, taking a 90% interest in profits and losses until he has earned a certain return on his capital. A researcher does the work for the venture, taking a 10% interest at the start. Once the capitalist gets her money out, profits and losses are split evenly between the two. If this was done through a corporation, with the capitalist giving the researcher stock as progress was made on the research, the researcher would be taxed on the receipt of the stock. Under the partnership rules, there are no tax consequences on the shift of interest, though it is clearly done to compensate the researcher for his work.[125]

There is no reason why an exchange of an interest in a venture for services should be taxed differently because a laborer is already a partner. Indeed, not taxing such shifts opens an enormous hole in the rule taxing an exchange of a partnership interest for services. To avoid or minimize tax on such exchanges, people need only minimize the size of a service partner's initial interest and then increase it later. An oil and gas venture looking for a way to get some tax benefit for payments for syndication services,[126] for example, could admit a promoter as a partner for a small capital contribution and then allocate her a greater share as the venture progresses. Any shift in interest that is related to the performance of services should be a taxable event.

There is also a question of how to tax a retiring partner who is promised future payments by a partnership. As the law now stands, a grant of a share of profits or a promise of guaranteed payments to a retiring partner is not a taxable event for the retiring partner or her ex-partners. Instead, if payments are guaranteed (that is, they are made without regard to profits), they are income to a retiring partner when made and are de-

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[124] See note 25 and accompanying text.

[125] Such an arrangement is not thought to implicate § 721 because it involves a shift of interests among partners and not the entry of a new partner. The arrangement passes muster as a special allocation. See Reg. § 1.704-1(b)(5) Ex. 3. Cf. Hamilton v. United States, 687 F.2d 408 (Ct. Cl. 1982)(upholding shift in allocations and rejecting argument that arrangement is a nonrecourse loan from capital partners to service partners).

[126] These are never recoverable. IRC § 709(a).

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ductible by the other partners at the same time.[127] If a retiring partner is given a profits share, she will be taxed on her share of profits and the other partners will benefit from what is in effect a deduction, whether or not profits are distributed.[128] This seems inconsistent with the proposal since these rights presumably are given as a reward for past services. Indeed, such arrangements are pension-like,[129] and, so, one might well argue they should be taxed as other nonqualified, deferred compensation arrangements are. This would mean that if the right to deferred payments was considered property under § 83, it would be taxed when granted;[130] otherwise, the payments would be taxed when received under cash method principles.[131] But this is not a satisfactory solution. Whether a promise of post-retirement payments should be a taxable event should not depend upon whether the right is property under § 83, which is defined as anything more than an unfunded and unsecured promise to pay money or property in the future.[132] This is largely a matter of formal characterization that has little to do with the value of the right.

Promises of post-retirement payments usually do not need to be taxed when the payments relate to past income. This can be seen by considering a case where payments are made out of a fund accumulated during a retiring partner's tenure at a law firm.

> *Example: Q, R,* and *S* are in a law partnership that earns a $30,000 fee in *S*'s last year of practice, 1989. If *S* takes her share of the fee ($10,000), and invests the amount left after tax ($6,000) for two years, she will have $6,742 in 1991 after tax. Instead, *S* asks for her share of the fee in 1991 as a guaranteed payment. The partnership (*Q* and *R*) should agree to pay $11,236 to *S* in 1990, and her after-tax return will remain $6,742. The easiest way to see this is to assume that *Q* and *R*

[127] IRC §§ 707(c), 736(a).

[128] IRC § 702. If a retiring partner has a basis in her partnership interest and the payments are for her interest in partnership goodwill, current law is even more generous to her. Such payments are treated as a recovery of basis first and only after basis is exhausted are they subject to tax. IRC §§ 731 and 732. This is akin to the rule for taxing open transactions in Burnet v. Logan, 283 U.S. 404 (1931), a privilege which generally is no longer available for sales of property. See Temp. Reg. § 15A.453-1(c), (d).

If a partner withdraws by selling her interest to the remaining partners in return for a promise of deferred payments, the results are different. Tax on the payments will be deferred if she elects installment treatment under § 453, but basis will be apportioned ratably across the payments and not recovered first. Interest may also be imputed under § 453 or § 1274.

[129] Cf. Gilson & Mnookin, note 87, at 345 (noting pension-like nature of lock-step compensation arrangements in partnerships).

[130] Cf. United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 821 (1950)(annuity given by employer is taxed on receipt).

[131] Rev. Rul. 60-31, 1960-1 C.B. 174.

[132] Reg. § 1.83-3(e).

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invest the $10,000 fee held for *S* in a fund in 1989 and borrow $4,000 to pay the tax on that income. In 1990, the fund grows to $10,600, after tax, and the liability grows to $4,240 (assuming the interest is deductible). In 1991, the fund grows to $11,236 and the liability grows to $4,494. The tax savings from deducting the payment of the fund to *S* in 1991 pays off the liability and the fund is distributed to *S*.

Deferring the tax on *S* until the guaranteed payment is made is acceptable because *Q* and *R* bear the tax on the return from the investment of that amount. This has been described as substitute taxation.[133] For this result to hold, *Q* and *R* must have the same after-tax rate of return as *S* and *S* must have the same tax rate in 1989 and 1991. Both conditions are likely to be met under the current rate structure since middle income and above taxpayers all pay tax at a 28% or 33% rate.

This result does not actually require the existence of a fund to make the retirement payments. In our example, for instance, if *Q* and *R* spend the earnings attributable to *S* in 1989, but repay her with a guaranteed payment in 1991, the transaction is, in essence, a loan from *S* to *Q* and *R*. The failure in 1989 to tax *S* on the income used to make the loan is made up by taxing *Q* and *R* on that income in 1989. The only possible advantage there might be in such an arrangement is that *Q* and *R*'s deduction in 1991 of the guaranteed payment provides what is, in essence, a deduction for the interest paid *S* on the loan, which is inappropriate under current law if *Q* and *R* use the loan for personal consumption.[134]

An argument can be made for taxing promises of post-retirement payments when the remaining partners make that promise to secure their own future income. For example, a name partner in a law firm who retires might be given a profits share so that the firm can continue to use her name to attract business or in exchange for a promise not to compete. In such a case, the remaining partners should be required, at least in theory, to capitalize the expense. As noted earlier in another context, substitute taxation does not work when a deferred expense should be capitalized.[135]

It is probably not worth the effort to tax such transactions. First, even if payments are for goodwill or a promise not to compete, it is not clear that we want to tax the transaction as a sale by the retiring partner and an investment by the other partners. We might reason that the retiring partner provides a continuing service by letting the firm use her name or by not competing. Ultimately, this is another aspect of the problem of

[133] See Halperin, Interest in Disguise, note 16, at 522-23.

[134] IRC § 163(h).

[135] See note 16.

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taxing human capital, though we may feel differently about the issue here because the earnings do not require actual labor. From the other partners' perspective, we may not want to treat the transaction as an investment because there is no mechanism to ensure appropriate recovery of the investment. If the investment is goodwill, it would be recovered only if the firm were sold. Moreover, one would expect that post-retirement payments usually are made because of a partner's past contributions to a firm. Few people have sufficient reputation that a firm will reap a continuing economic benefit from use of their name or their promise not to compete.

Several reforms are necessary in the subchapter S area. Most importantly, § 1032 should be changed so that the shareholders of a corporation that exchanges stock for services will be taxed on gain attributable to the share of a corporation's assets represented by the stock. The corporation also may deduct or capitalize the value of the stock, and it is necessary to increase the basis of assets in the hands of the corporation to account for the service provider's gain. All of these effects can be accounted for, as they are in the partnership area now, by treating an exchange of stock for services as an exchange by the corporation of an interest in its assets for services, and then a recontribution to the corporation of those assets by the service provider.[136]

In addition, a change needs to be made in the rules for discharge of debt to prevent avoidance of the tax on an exchange of subchapter S stock for services by undertaking a debt to pay for services and then converting that debt into stock. Currently, a corporation has gain when it issues stock to satisfy debt only if the amount of the debt exceeds the value of the stock.[137] Thus, a subchapter S corporation could avoid tax on an exchange of stock for services by undertaking a debt to pay for services and then converting that debt into stock of value equal to its face amount. To prevent this, the satisfaction with stock of debt incurred to pay for services should be treated as a taxable exchange of stock for services.[138]

[136] See note 19 and accompanying text.

[137] IRC § 108(e)(10). Prior to 1981, a corporation never recognized income on the issuance of stock for debt, even if the value of the stock was less than the amount of the debt. See Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 Tax L. Rev. 225, 238-40 (1959).

[138] It seems that a similar strategy may not be possible in the partnership area. Though there is no case law on the point, a leading partnership treatise suggests that exchange of a service-related debt for an interest in the partnership should not be considered a tax-free exchange of property for an interest under § 721. 1 W. McKee, W. Nelson & R. Whitmire, note 1, at ¶ 4.02[3].

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V. Conclusion

Perhaps at the conclusion it is worth restating some of the more important points made in this article. A pooling approach to taxing an exchange of labor for capital in a venture in effect exempts from tax the return from the investment of labor and zero-basis assets in a venture. It is not just a matter of timing. A pooling approach would be appropriate under a consumption tax; it is inappropriate under an income tax.

The current approach to taxing an exchange of a profits interest in a partnership for services, and the approaches favored by the ABA and ALI (which are very different from the current approach in form, but not in result) have the same effect as a pooling approach and should be rejected. However, not taxing the original partners on an exchange of a profits interest for services may be justified if a profits interest is in the nature of a carved-out income interest which is assigned no basis under the general principles regarding carve outs, though this approach approximates the ideal only if an asset produced by services has an income stream of similar duration and shape to a carved-out interest and only if an interest is carved out from an asset with a basis near its fair market value.

The subchapter S rules are a hybrid of an exchange and a pooling approach. The result to a laborer is the same as under an exchange approach and the result to a capitalist is the same as under a pooling approach (if the corporation exists prior to the exchange). Taxing labor, but not capital, might be justified by the circle of cash argument, but it is probably better to threaten a capitalist with tax when she compensates labor with an interest in a venture because that encourages her to raise cash from third parties to pay labor, and so solves the valuation problem at least insofar as taxing labor is concerned.

Problems of valuation may prevent taxing gain in a few cases, but these are likely to be rare because valuation is impossible only when there is no market for both the services and the capital involved in an exchange. Problems of liquidity should never prevent imposing the proper amount of tax.

Finally (ironically, I consider this part of the article one of the most interesting, though, from a practical point of view, it is surely the least important), an exchange of an interest in a venture for a promise to perform future services should not be taxed consistent with the general policy of not taxing human capital. It may be possible to justify this policy on the basis of concerns about valuation, human dignity, or because of the way investments in human capital are treated, though there are problems with each of these arguments. Ultimately, this part of the article may be of interest, not for its answers, but rather for the insights it

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provides on such fundamental issues in an income tax as the treatment of investments in human capital, double taxation, and the principle of realization.

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