Use of Corporate Partner Stock and Options to Compensate Service Partners -- Part 1

by: Sheldon I. Banoff

Many corporations conduct subsidiary business operations or joint ventures through general or limited partnerships or LLCs. Key executives ("service partners") who receive ownership interests in and provide services to such partnerships (rather than the corporation) also may receive, as part of their compensation package, restricted and unrestricted stock, nonqualified stock options (NQSOs), and stock appreciation rights (SARs) in the corporation. Relevant tax consequences to the service partner, the corporation, and other members of the partnership with respect to such equity-based compensation include:

- The timing and amount of income recognition by the service partner.
- The service partner's ability to obtain favorable capital gains treatment on appreciation in value of the equity-based compensation.
- The timing, amount, and allocation of the partnership's compensation deduction.
- The potential recognition of gain by the corporation (with respect to the stock or options used to compensate the service partner).
- The potential recognition of gain (or loss) by the other partners.

Two unrelated IRS rulings -- TAM 9822002 and Ltr. Rul. 9822012 -- previously discussed in THE JOURNAL signal a solution to the potential "zero basis" problem that arises in compensating employees of a partnership with stock of a corporation that is a member of the partnership. Those rulings also provide guidance in compensating service partners with such a corporation's stock. Ltr. Rul. 9822012 also provides insight as to the tax treatment of NQSOs and SARs based on the corporate partner's stock that are issued to service partners. Recently issued Prop. Regs. 1.83-6(d) and 1.1032-3 (REG-106221-98, 9/22/99), if finalized as proposed, also may affect the zero basis problem for service partners (and employees) receiving such stock or NQSOs. Taken together, the two rulings and Proposed Regulations should expand the use of stock-based compensation of such partners and thereby facilitate the realignment of corporate executives as partners (typically limited partners) in those partnerships or as members of LLCs in certain situations. Nevertheless, the partners' various tax consequences with respect to equity-based compensation have not been fully resolved.

INCENTIVE COMPENSATION ISSUES

NQSOs, SARs, and restricted and unrestricted stock plans can provide a corporation's key employees with equity-based incentive compensation. The employees earn an ownership stake in the employer while the corporation obtains valuable tax deductions, generally (except for SARs) without an expenditure of cash.

Service partners, like employees of a partnership, also may be "incentivized" by receiving additional ownership interests or options to acquire additional ownership interests in their partnerships. Unlike shares of stock, however, partnership interests are rarely publicly traded or liquid. Accordingly, some service partners will not view those interests or options as being as desirable as stock, particularly...
publicly traded stock. Moreover, the tax treatment of receiving such ownership interests or options remains uncertain. 4

A better way to incentivize service partners may be to provide them with NQSOs and SARs in, and stock of, a corporation whose value is materially affected by the operations of the partnership in which the corporation owns a substantial interest. By the same token, employees of the corporate partner may resist becoming partners in a subsidiary partnership unless they are also provided with a compensation package at least comparable to that provided by their corporate employer -- including NQSOs and SARs in, and stock of, the corporation. Finally, the corporate partner may prefer to increase the number of outstanding shares of its stock and/or prefer not to further increase the service partner's ownership interest in the partnership (which would dilute the corporation's ownership interest therein). A corporate stock compensation package can meet all these objectives.

There long has existed some uncertainty as to whether the tax consequences of compensating service partners with a corporate partner's stock, NQSOs, or SARs are less favorable (or, in some circumstances, actually burdensome) to the corporation and, in certain situations, to the other partners. Moreover, there is uncertainty as to whether the tax consequences to the partnership and its partners are governed by Section 83 (dealing with transfers of property to employees and independent contractors), Section 707(a)(1) (relating to payments to partners not acting in their capacity as partners), Section 707(c) (involving guaranteed payments to partners for services) or some combination thereof. The tax consequences to the partnership and its partners may differ, depending upon which Code provisions apply. The nine examples in this two-part article illustrate the potential problems -- and the impact of the new guidance provided by TAM 9822002, Ltr. Rul. 9822012, and Prop. Regs. 1.83-6(d) and 1.1032-3 -- with respect to such equity-based compensation.

USING CORPORATE PARTNER’S STOCK
The most straightforward approach to providing incentive compensation to service partners involves the stock of a corporate partner.

EXAMPLE 1: Individual X is a service partner of ABX, an accrual-method, calendar-year entity taxable as a partnership. ABX's equal partners are A Co., B and X. ABX does not currently have surplus cash. X wishes to receive $100,000 of additional compensation (in connection with services X rendered in 1998 to ABX) on a net after-tax basis, and will accept either cash or 1,000 shares of A Co. common stock (currently worth $100 per share). 5 X's effective combined federal and state marginal tax bracket is 50%. To meet X's objective and to maintain parity among the partners, the following occurs on 12/1/98: (1) A Co. directly transfers 1,000 shares (FMV $100,000) of its stock to X; (2) B and X each contribute $100,000 cash to ABX, and (3) ABX pays the $200,000 cash compensation to X. 6 The A Co. stock is not subject to a substantial risk of forfeiture.

POTENTIAL CHARACTERIZATIONS.
In absence of authority directly on point, there are at least six ways to characterize the transactions in Example 1:

1. A direct transfer of stock by A Co. to X;
2. A deemed transfer by A Co. of its stock to ABX, followed by a deemed transfer by ABX of the A Co. stock to X (the "deemed transfer"), characterized as a transfer of property governed by Section 83;
3. A deemed A Co.-to ABX-to X stock transfer, governed by Section 707(a)(1);
4. A deemed transfer, to which both Sections 83 and 707(a)(1) apply;
5. A deemed transfer, governed by Section 707(c); and
6. A deemed transfer, to which both Sections 83 and 707(c) apply.

These different characterizations can generate differing tax consequences to ABX and its partners. In all cases, X will recognize taxable compensation income on receipt of the A Co. stock, which is not subject to a substantial risk of forfeiture. For ease of analysis, we will first determine for each of the six alternatives their legal support and the primary tax consequences (other than potential gain recognition by ABX) that arise under Example 1. Next, we will analyze ABX's potential gain recognition (and the appropriate allocation of any recognized gain among ABX's partners) in using A Co. stock that, in the Service's view, may have a zero basis in ABX's hands.

Our initial analysis relates to the potential gain recognition by A Co. on its stock transfer, the timing of ABX's compensation deduction, and X's recognition of income with respect to these six alternatives.

Direct transfer to X. Under the direct-to-X characterization, which is consistent with the form of the transaction, A Co. would be treated as having issued its stock directly to X in exchange for X's services to ABX. Section 1032(a) provides in relevant part that no gain or loss will be recognized by a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of the corporation. Reg. 1.1032-1(a) states that a transfer by a corporation of shares of its own stock "as compensation for services" is considered, for purposes of Section 1032(a), as a disposition by the corporation of such shares for money or other property. Thus, A Co. should be protected from income recognition under Section 1032.

Compensation deduction. It long has been recognized that a corporation obtains a deduction under Section 162(a) (presumably subject to capitalization, e.g., under Sections 263 or 263A) for the FMV of its stock distributed to its own employees as compensation. Thus, the compensatory transfer of a corporation's stock to its own employees results in no income recognition (per Section 1032) and a tax deduction (under Section 162) by the corporation -- just as though the corporation had paid cash compensation to the employee, who then purchased that stock from his corporate employer.

In Example 1, however, X renders services solely to ABX, not to A Co., and thus any compensation deduction technically would seem to belong to ABX, not A Co. But under the direct-to-X characterization of the arrangement, ABX has not "incurred" or "paid" anything to X and has no traceable ownership or cost basis in the A Co. stock that A Co. issued to X. Thus, absent some legal obligation on A Co. to transfer its stock to X, apparently neither A Co. nor ABX would obtain a tax deduction for the property (i.e., the A Co. stock) paid to X. Since X will recognize compensation income in 1998, the result would be a tax whipsaw in favor of the IRS. Although such a result is theoretically possible, no one suggests that it is an appropriate or likely result, and in light of the more appropriate characterizations (discussed below) the IRS almost certainly will not take this position for advance ruling purposes or on audit.

Deemed transfer - Section 83. Under Section 83(a), if property is transferred in exchange for services, the excess of the FMV of the property at the lapse of any substantial risks of forfeiture over any amounts paid for the property will be taxable compensation at the time of the lapse. If the transfer is not subject to any substantial risks of forfeiture, the service provider recognizes income under its method of accounting (i.e., upon receipt, for cash-method service providers). When an employer transfers appreciated or depreciated property to an employee or independent contractor in a transaction taxable under Section 83, the transaction generally will trigger taxable gain or loss to the
employer, pursuant to Reg. 1.83-6(b). The employer obtains a compensation deduction under Section 83(h), equal to the income recognized by the service provider.

Some courts have applied Section 83 to transfers of partnership profits interests and capital interests to taxpayers who were not yet partners, in exchange for services rendered. Although there are no cases or rulings on point, some commentators have presumed that the Section 83 rules also apply to property transfers to partners, but others would disagree. Nothing in the statute limits its application so as to exclude partnership property transfers to service partners.

If Section 83 applies, can the direct stock transfer from A Co. to X in Example 1 be characterized as successive deemed transfers from A Co. to ABX and from ABX to X? Reg. 1.83-6(d)(1) and Ltr. Rul. 9822012 support a deemed capital contribution to the partnership for transfers of property to a service provider.

If only Section 83 applies, the transaction should be characterized as a deemed transfer by A Co. of its stock to ABX and a deemed transfer by ABX of the A Co. stock to X, both on 12/1/98. Under this view, neither A Co. nor ABX would recognize gain or loss on the deemed transfer of A Co.'s stock to ABX, pursuant to Section 721. On the deemed transfer from ABX to X, by operation of Section 83 X will recognize $100,000 of ordinary compensation income on 12/1/98 with respect to the A Co. stock she receives. Pursuant to Section 83(h), ABX will obtain a $100,000 deduction for 1998, i.e., in ABX's tax year in which or with which ends X's (1998) tax year wherein the amount is included in X's gross income.

Deemed transfer - Section 707(a)(1). A strong argument exists that Section 83 cannot technically apply to the transfers in Example 1, because X is already a partner at the time of the stock transfer.

Section 83 was enacted in 1969 primarily to deal with vested and non-vested stock options received for services. Although Section 83(a) on its face is applicable to property transferred "to any person" in connection with the performance of services, Reg. 1.83-1(a)(1) effectively limits the application of Section 83 as providing rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. No known cases or rulings apply Section 83 to property transfers in connection with services rendered by one who is an existing partner. Neither Section 83 nor its legislative history hint of applicability to services rendered by partners. Moreover, in those cases in which the courts have held Section 83 to be applicable to transfers of partnership profits and capital interests, the service provider had not been a partner for tax purposes prior to the receipt of the interest in question; at such time the service provider was arguably an independent contractor or employee receiving such property (i.e., the partnership interest) in exchange for services rendered as an independent contractor or employee. Finally, as a matter of policy Section 83 should not be extended in Subchapter K transactions.

If Section 83 does not apply, Section 707(a)(1) may apply to the A Co. stock transfer - if X rendered her services to ABX "other than in her capacity as a partner" and is deemed to receive a payment from ABX. Can the direct stock transfer from A Co. to X in Example 1 be characterized as successive deemed transfers from A Co. to ABX and from ABX to X, if Section 707(a)(1) applies but Section 83
does not? Nothing in the statute, its legislative history, or Reg. 1.707-1(a) contemplates such deemed
transfers. Nevertheless, a deemed transfer should be found in Example 1, where each partner in ABX
is obligated to contribute $100,000 to ABX to maintain its respective equal ownership interest. B and X
are contributing $100,000 cash to ABX, which is earmarked for immediate payment by ABX to X as
cash compensation. A Co., by issuing its stock directly to X while being credited for a $100,000
capital contribution as though it was first paid to ABX, effectively is acting on behalf of ABX in making
the stock transfer directly to X. Even if Section 83 and Reg. 1.83-6(d) do not apply, the stock transfer
clearly should be viewed as a deemed A Co.-to-ABX-to X stock transfer.23 Indeed, in Ltr. Rul. 8049037
the IRS applied a deemed transfer approach to a service provider in a transaction technically outside
the scope of Section 83, thereby confirming that bifurcation is not limited to transfers to which Section
83 applies.24

A partner who renders services to the partnership other than in a partner capacity is treated as
not a member of the partnership with respect to that transaction, under Reg. 1.707-1(a). Under Section
707(a)(1) (in conjunction with Section 61), the service partner is taxable on the full value of the
payment for the services rendered because they are considered to be rendered to the partnership as an
entity separate and distinct from its partners. If the partner renders services not in his capacity as a
partner, the timing of the deduction would be determined by the service partner's reporting of the
income, pursuant to Sections 267(a)(2) and 267(c). Thus, where the partnership uses the accrual
method and the service provider uses the cash method, the deduction would be deferred until the
recipient receives the property.

If only Section 707(a)(1) applies in Example 1, the transaction should be characterized, first,
as a deemed transfer by A Co. of its stock to ABX whereby neither one would recognize gain or loss,
pursuant to Section 721, and, second, as a deemed transfer from ABX to X in which, by operation of
Section 707(a)(1), X will recognize $100,000 of ordinary compensation income as of 12/1/98 on receipt
of the stock. Since X renders the services in 1998, ABX would accrue a $100,000 ordinary deduction
for the payment of compensation as of 12/1/98.25

Deemed transfer - Sections 83 and 707(a)(1). Where X has rendered services other than in her
capacity as a partner, it appears that both Sections 83 and 707(a)(1) should apply to property payments
received for services.

Under Reg. 1.707-1(a), the transaction is treated as one between a partnership and a partner not
acting in his capacity as a partner. It is likely that the partner would be treated by the IRS as acting as
an independent contractor (but not as an employee) with respect to such services. In Rev. Rul. 69-184,
1969-1 CB 256, the Service ruled that bona fide members of a partnership are not employees of the
partnership for FICA, FUTA, or income tax withholding purposes. The Service reasoned that a
partner who devotes his time and energies in the conduct of his partnership's trade or business, or in
providing services to the partnership as an independent contractor, is, in either event, a self-employed
individual rather than an employee.26 Nevertheless, given its acknowledgment that a partner can be
viewed as an independent contractor -- at least for certain tax purposes -- the IRS most likely would
apply Section 83 to property transferred for services in a transaction governed by Section 707(a)(1), as
Reg. 1.83-1(a)(1) states that Section 83 is applicable to property transferred to an independent
contractor.

The dual application of Sections 83 and 707(a)(1) in Example 1 does not appear to have
unanticipated tax consequences. Pursuant to the principles of Reg. 1.83-6(d), A Co.’s direct stock
transfer to X should be characterized as successive deemed stock transfers from A Co. to ABX and

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from ABX to X on 12/1/98. Under that characterization, neither A Co. nor ABX would recognize gain or loss on the deemed capital contribution from A Co. to ABX, pursuant to Section 721. X will recognize $100,000 of ordinary compensation income on 12/1/98 with respect to the A Co. stock she receives, under either Section 83(a) or 707(a)(1) (in conjunction with Section 61). ABX will obtain a 1998 compensation deduction of $100,000 under either Section 83(h) (if Section 83 applies) or Reg. 1.707-1(a) (if Section 707(a)(1) applies). Thus, there is no conflict between the timing rules of Sections 83 and 707(a)(1), as both rely on the partner's method of accounting to determine the proper years of inclusion.

Deemed transfer - Section 707(c). Where X has rendered services in her capacity as a partner, Section 707(c) should apply to X's receipt of A Co. stock.

A partnership's payments for services rendered by a partner are governed by Section 707(c) if the amount of the payments is determined without regard to partnership income. Section 707(c) applies to payments of property as well as cash. If Section 707(c) applies to X's receipt of A Co. stock, Section 707(a)(1) cannot apply.

Section 83 arguably does not apply to a Section 707(c) payment for services because the rules of Section 83 apply only to employees and independent contractors, as discussed above. Indeed, a stronger technical argument can be made that Section 83 is inapplicable in connection with Section 707(c) payments than those governed by Section 707(a)(1), because a partner rendering services to a partnership in his capacity as a partner is neither an employee nor an independent contractor of that partnership, and therefore not subject to Section 83. A partner cannot be an employee or independent contractor vis-a-vis his partnership unless the transaction falls within Section 707(a), whereby that partner is treated as a nonpartner with respect to the transaction. Thus, Section 83 arguably applies (if at all) only to partnership-to-partner transfers that are described in Section 707(a).

Since guaranteed payments for services are generally treated as merely a partner's profits share, it seems illogical to treat the service partner as also being an independent contractor (whereby Section 83 could then technically apply with respect to such payments). Therefore, since Section 83 arguably applies only to transfers to employees and independent contractors, the characterization of a transfer of property to a partner as a Section 707(c) payment should preclude Section 83 from applying.

Because Sections 83 and 707(c) prescribe specific timing rules as to deduction and income recognition that are mutually inconsistent, the sections cannot both apply to the same transfer of property. Therefore, applying Section 83's rules to in-kind payments that otherwise constitute Section 707(c) payments would effectively repeal the timing rule of Section 707(c) any time a guaranteed payment obligation is satisfied in "property," but would leave it intact if the obligation were satisfied in money. Section 83 should not be read to achieve such a partial repeal of Section 707(c), particularly without express congressional intent to do so.

Can the direct transfer from A Co. to X in Example 1 be characterized as successive deemed transfers if Section 83 (and thus Reg. 1.83-6(d)(1)) does not apply? Section 707(c) expressly relates to payments by a partnership to a partner, not from one partner to another. Section 707(c) and Reg. 1.707-1(c) contain no authority to impute a deemed transfer from A Co., the transferor partner, to ABX, the partnership. As discussed earlier, however, the IRS and the Tax Court have applied a deemed transfer approach to service providers in transactions technically outside the scope of Section 83. Moreover, Reg. 1.721-1(b), dealing with transfers of partnership capital interests for services, provides
implicit authority for supporting a deemed capital contribution in Example 1, so as to permit Section 707(c) to apply.\textsuperscript{32}

If only Section 707(c) applies to the deemed stock transfer, it should be characterized as, first, a deemed transfer by A Co. of its stock to ABX whereby neither A Co. nor ABX recognizes gain or loss, pursuant to Section 721, and second, from ABX to X, governed solely by Section 707(c), in which the timing of X's recognition of income is determined by the timing of ABX's deduction, pursuant to Reg. 1.707-1(c).\textsuperscript{33} Thus, where (as in Example 1) the partnership uses the accrual method and the service provider uses the cash method, the service provider will recognize ordinary income when the obligation to make payment accrues, i.e., when the services are rendered. Thus, if X renders services and ABX's liability becomes fixed in 1998, ABX will obtain its compensation deduction in 1998 and X will recognize income in 1998.\textsuperscript{34}

When appreciated property is used to make a guaranteed payment for services, the partnership may be entitled to a deduction equal to the property's FMV. Otherwise, the deduction would be limited to the basis of the property transferred (i.e., possibly zero in the case of A Co. stock, under the Service's view). The reference in Section 707(c) to the deduction provision of Section 162(a), however, should sanction a partnership deduction equal to the FMV of the property transferred.

Deemed transfer - Sections 83 and 707(c). Where X has rendered services and received a property payment to which Section 707(c) applies, it can be contended that Section 83 also applies to such a transaction.

Pursuant to Reg. 1.707-1(c), guaranteed payments made by a partnership to a partner for services "are considered as made to a person who is not a partner," for the purposes of Section 61(a) (relating to gross income) and Section 162(a) (relating to trade or business expenses). Section 83 was enacted in 1969 to determine the timing of income recognition under Section 61 and deductibility under Section 162 with respect to transfers of property as compensation for services, and to set guidelines for measuring the income the service provider is deemed to receive. Therefore, it can be contended that Section 83 applies to Section 707(c) in-kind guaranteed payments because the service partner who receives guaranteed payments for services is considered to be a person who is not a partner (e.g., is an independent contractor) for purposes of Sections 61 and 162.

No clear authority establishes the interaction between Sections 83 and 707(c) in connection with a partnership's guaranteed payments of property to a partner rendering services while acting in a partner capacity. Regardless of which section governs, in the first part of the deemed transfer - by A Co. of its stock to ABX - neither A Co. nor ABX should recognize gain or loss, pursuant to Section 721. With respect to the deemed transfer of A Co. stock from ABX to X, conflicts may arise as to whether Section 83 or 707(c) governs, and differing tax consequences potentially may result in certain situations, insofar as (1) timing of X's income inclusion, (2) the timing of ABX's expense deductibility, and (3) ABX's recognition of gain or loss.

\begin{itemize}
\item \textit{Timing of income inclusion.} If Section 83 applies, a property payment for services would be included in income as determined under the recipient partner's method of accounting. In contrast, Section 707(c), relies on the appropriate partnership year of deductibility (determined under the partnership's method of accounting) to determine the proper year for the service partner to report income.
\item \textit{Timing of expense deduction.} Section 83(h) requires that any partnership deduction resulting from a compensatory transfer of property be reflected on the transferor's return for the tax year "in
which or with which ends the taxable year in which such amount is included in the gross income of the person who performed the services. Under Section 707(c), the deduction is determined under the partnership's method of accounting.

- Timing of gain recognition. As discussed below, it is likely that the partnership must recognize gain or loss on the actual or deemed transfer of appreciated or depreciated property to the service partner. The same uncertainty as to timing (described above for the expense deduction) arises on this issue, because Reg. 1.83-6(b) provides that any gain recognized by the transferor partnership on the transfer of the property must be included on the same return as the partnership's deduction.

A forceful argument can be made that enactment of Section 83 trumps the application of Section 707(c), which provides by its terms that Section 61 governs the income inclusion of a guaranteed payment. Reg. 1.61-2(d)(6)(i) provides that if a payment is made after 1969 and is considered a transfer of property for services, the transfer is governed by Section 83. The latter provision therefore arguably should govern the timing and amount of income inclusion and deduction. Although the timing rules of Section 83 and those under Reg. 1.707-1(c) are mutually inconsistent, if Section 83 applies it presumably should take precedence over a Regulation issued under another statute.

Nonetheless, it has been suggested (and this author concurs) that the Section 707(c) rules should preempt the Section 83 rules, but only as to the timing of income and deductions. Where general and specific provisions appear in the same statute in seeming contradiction, a specific clause, which qualifies or excepts a general clause, should control. This general rule of statutory construction applies without regard to the order of enactment of the statutes involved. Clearly, Section 707(c) is more specific, in its application to partnership transactions, than Section 83, in its more sweeping application to all compensatory transfers of property.

The reconciliation approach. It would seem preferable to leave the timing of income recognition from the receipt of property by one who is already a partner within the ambit of Section 707. The operative effect would be to allow the partnership year to control the timing of (1) the recipient's income recognition, (2) the partnership's deduction and (3) the partnership's recognition of gain from unrealized appreciation in the property. Under this approach (the "Section 83/707(c) reconciliation approach"), all other rules of Section 83, including the provision regarding the status of the service provider as a non-owner of the property for tax purposes during the vesting period, would continue to apply.

Applying the Section 83/707(c) reconciliation approach to Example 1, pursuant to the principles of Reg. 1.83-6(d) A Co.'s direct stock transfer to X would be characterized as successive deemed stock transfers from A Co. to ABX and from ABX to X on 12/1/98. As a result, neither A Co. nor ABX would recognize gain or loss on the deemed capital contribution from A Co. to ABX, pursuant to Section 721. X will recognize $100,000 of ordinary compensation income, under either Section 83(a) or 707(c). ABX's partnership year would control the timing of the deduction, pursuant to Reg. 1.707-1(c); thus, ABX, being on the accrual method, would obtain the deduction in 1998 (the year X rendered her services to ABX) and X would report $100,000 of compensation income in 1998. If ABX were required to recognize gain of $100,000 on the deemed transfer of the A Co. stock to X (assuming a zero basis for the stock), such gain must be included by ABX on the same return as ABX's deduction, i.e., 1998.

It should be recognized that in Example 1 the tax consequences would have been the same regardless of whether Section 707(c) or 83 (or some combination thereof) governed. Insofar as (1) the
stock was not subject to a substantial risk of forfeiture, (2) ABX, A Co., and X were calendar-year taxpayers, and (3) the A Co. stock was deemed transferred to ABX in the same year that X rendered her services to ABX, ABX’s deduction and gain recognition and X’s income recognition all would occur in 1998, regardless of the order in which Sections 707(c) and 83 were given effect in Example 1. If one or more of these factors were absent, differing tax results could occur (as other examples will illustrate).

**PARTNERSHIP'S GAIN - RECOGNITION AND ALLOCATION**

The remaining analysis with respect to Example 1 focuses on the consequences to ABX and its partners relating to the following issues:

- Does ABX simultaneously recognize gain or loss on its deemed transfer of A Co. stock to X?
- If so, how is the gain allocated among ABX's partners?

To date, these questions have not been definitively answered by the IRS or the courts. At least three approaches conceptually could be applied to determine whether ABX recognizes gain or loss in this scenario: (1) ABX has a zero basis in the A Co. stock, with partnership gain recognition; (2) ABX has a zero basis but there is no partnership gain recognition; and (3) ABX is deemed to have a cost (FMV) basis, with partnership gain recognition of zero.39

Zero basis/partnership gain recognition. Under this approach, ABX is viewed as having a zero basis in the A Co. stock, and recognizes gain equal to the full value of the stock on the date it was transferred to X,40 all of which is allocable to A Co. ABX takes a carryover basis in the A Co. stock on its deemed contribution from A Co., pursuant to Section 723.

In Rev. Rul. 74-503, 1974-2 CB 117, the IRS took the position, in an analogous situation involving the tax-free transfer of corporation P's own stock to its wholly owned subsidiary (S) pursuant to Section 351, that the carryover basis rules (under Section 362(a)) required the transferee to take a zero basis in the P stock.41 On subsequent disposition of the P stock, S presumably would recognize a short-term capital gain equal to the current value of the P stock.

Thus, under the zero basis/partnership gain recognition approach, at the partnership level ABX's compensation deduction relating to the A Co. stock transferred to X effectively would be offset by the short-term capital gain ABX would recognize under Section 1001,42 equal to the difference between the value of X's services (in Example 1, presumably $100,000, i.e., equal to the assumed value of the A Co. stock on the date of transfer) and ABX's basis in the A Co. stock (presumably zero).

If gain is recognized by ABX under the zero basis approach, what are the consequences to the partners - A Co., B, and X? The answer may turn on whether the aggregate or entity approach applies. Partnership taxation is a mixture of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under the aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which the partners have no direct interest in partnership assets and operations.

If the entity approach applies to a partnership's taxable sale or exchange of its corporate partner's stock, A Co. will be taxed on the full value of its stock transferred to X. When a partnership sells property that was contributed with a built-in gain, the portion of the tax gain realized on the partnership's sale that is attributable to the built-in gain is allocated to the contributing partner under
Section 704(c). Thus, when ABX is deemed to transfer A Co. stock to X immediately after its deemed receipt by ABX, any gain that ABX realized on the deemed stock transfer to X would be allocated to A Co., the contributing partner, under Section 704(c). If the entity theory of partnership taxation is mechanically applied, the partnership's short-term capital gain would retain its status and characterization, and thus A Co. would recognize short-term capital gain. Subchapter K principles require the income to be characterized at the partnership (not partner) level, and under the entity theory the partner must report its allocable share (even if the partner would have recognized no income if the partner had realized the income directly).  

Fortunately, TAM 9822002 rejects application of the entity theory for purposes of the taxable sale of a corporate partner's stock by the partnership. There, the IRS held that a partnership is properly treated as an aggregate of its partners for purposes of applying Section 1032. Application of the aggregate approach in this zero basis/partnership gain recognition scenario results in ABX recognizing gain on the transfer of the stock but, on allocation of that gain to A Co. as mandated by Section 704(c), A Co. would not recognize any gain by reason of Section 1032. ABX and its partners still would obtain the full compensation deduction under Section 162.

Zero basis/no partnership gain recognition. Under this approach, despite ABX's assumed zero basis in the A Co. stock, ABX would not recognize gain at the partnership level (and therefore none of its partners would recognize gain) because Section 83 arguably applies to the transfer. The underlying assumption is that the transfer by A Co. to X is a capital contribution of the A Co. stock to ABX under Section 721(a), followed immediately thereafter by ABX's transfer of the A Co. stock to X.

Strong support for this approach can be found in Rev. Rul. 80-76, 1980-1 CB 15, wherein an individual owning stock in corporation P transferred stock to an employee of corporation S, a controlled subsidiary of P. In holding 4 of Rev. Rul. 80-76, the Service concluded that "because Section 83 applies to the transfer," S does not recognize gain or loss on the transfer of the P stock, but S is allowed the Section 83(h) deduction.

Ltr. Rul. 9822012 is the first known ruling to extend application of Rev. Rul. 80-76 to transfers of a corporate partner's stock to a service provider (employee) of the partnership. It contains six rulings relating to the NQSO plan - none explicitly holding that the partnership does not recognize gain or loss on the transfer of the stock of its corporate partner to the partnership's employees on exercise of their options. In its analysis of the law, however, Ltr. Rul. 9822012 discusses Rev. Rul. 80-76 and specifically refers to its holdings that (1) because Section 83 applies, S (the corporate employer) does not recognize gain or loss on the transfer of the P stock, and (2) S is allowed the Section 83(h) compensation deduction. Unfortunately, Ltr. Rul. 9822012 does not completely lay to rest the issue of whether a partnership (like a controlled corporate subsidiary) also avoids recognition of gain or loss on the direct transfer of a corporate partner's stock to the partnership's employee (or a service partner). Moreover, the ongoing vitality of Rev. Rul. 80-76 appears in doubt; in the Preamble to recent Proposed Regulations dealing with the zero basis problem, the IRS and Treasury indicated Rev. Rul. 80-76 will be rendered obsolete when the Regulations are finalized.

Cost basis/zero partnership gain recognition. The third method of analyzing the tax consequences of Example 1 is to provide ABX with a cost basis in the A Co. stock equal to its FMV on the date of transfer. As a result, on its deemed transfer of A Co. stock to X, ABX would recognize zero gain at the partnership level, and A Co. would recognize zero gain as well.
Support for the cost basis approach is found in Ltr. Rul. 7908021, involving a transfer of NQSOs from a parent corporation (P) to employees of its subsidiary (S), subject to a substantial risk of forfeiture. On exercise of the NQSOs, the employees recognized income, and S faced the zero basis problem (with potential recognition of gain on use of P's stock). Ltr. Rul. 7908021 characterizes the transfer of P stock to each S employee as "a contribution of cash by P to the subsidiary's capital, followed by a purchase of the stock by S from P for its full value and an immediate transfer of the stock by S to the employee." (Emphasis added.) Although the IRS did not explicitly hold that S recognized zero gain, that result logically would follow from S's deemed FMV (cost) basis in the P stock.48

The IRS never again issued rulings applying the "deemed cash purchase" rationale of Ltr. Rul. 7908021 to transfers of parent corporation stock or stock options to employees of its subsidiary. In the recent Proposed Regulations under Sections 83 and 1032, however, the IRS and Treasury resurrected the "deemed cash purchase" rationale with respect to certain transfers of stock and stock options received by a corporation's employee.49 It is unclear whether the IRS will apply the deemed cash purchase approach with respect to stock transferred to a partnership's employees or service partners, if the other requirements of Prop. Reg. 1.1032-3 are met; the Preamble to the Proposed Regulations states that no inference is intended regarding the applicability of the zero basis result to transactions outside of the scope of the proposals. There is no logical reason, however, why a similar rule should not apply in the partnership context (if the other requirements of Prop. Reg. 1.1032-3 are met50); indeed, Ltr. Rul. 9822012, by its explicit reference to the nonrecognition rule of Rev. Rul. 80-76, indicates that at least for advance ruling purposes the IRS would apply Section 83 (and the Regulations thereunder) to provide nonrecognition of gain by ABX under whatever the Service's then-current rationale may be to avoid the zero basis problem (i.e., Rev. Rul. 80-76 or the deemed cash purchase rationale of Prop. Reg. 1.1032-3).51

Impact of differing characterizations. Returning to Example 1, the question becomes, in light of TAM 9822002 and Ltr. Rul. 9822012, what are the tax consequences to ABX, A Co., B and X, with respect to gain recognition by ABX on ABX's deemed transfer of A Co. stock to X. As shown below, the answer does not depend on the transfer's characterization as a deemed transfer of the A Co. stock governed by Section 83, 707(a)(1), 707(c), or some combination.

Direct transfer. Under this characterization, which is consistent with the form of the transaction in Example 1, A Co. would be treated as having issued its stock directly to X (in exchange for X's services to ABX). Since ABX is not treated as a party to the transaction, the partnership (and its partners) would not recognize gain.

Deemed transfer - Section 83. If Section 83 applies to the transaction, Rev. Rul. 80-76 also should be applicable (given the Ruling's application in the somewhat analogous situation of a transfer to a partnership employee in Ltr. Rul. 9822012), so that A Co. is deemed to make a capital contribution of its stock to ABX (tax-free under Section 721(a)) and ABX is deemed to transfer the A Co. stock to X on 12/1/98. ABX should not recognize gain or loss on its deemed transfer of A Co. stock to X "because Section 83 applies" (i.e., the stated rationale for protecting the services recipient in Rev. Rul. 80-76). Alternatively, if the "deemed cash purchase" approach in Prop. Regs. 1.83-6(d) and 1.1032-3 is adopted, ABX again should not recognize gain or loss on its deemed disposition of the A Co. stock, because ABX will be deemed to have a basis equal to the FMV of the stock.

In the unlikely event that neither Rev. Rul. 80-76 nor the deemed cash purchase rationale of Prop. Reg. 1.1032-3 protects ABX, the IRS will take the position that ABX recognizes $100,000 of short-term capital gain under the zero basis approach. This $100,000 gain, however, will be specially
allocated under Section 704(c) to A Co., the deemed contributing partner, and pursuant to the aggregate approach to Section 1032 in TAM 9822002, A Co. will not recognize taxable gain but will take a $100,000 deduction in 1998 -- the same result that would arise had X been A Co.'s own employee receiving A Co. stock.

Deemed transfer - Section 707(a)(1). ABX's deemed stock transfer to X is governed by Section 707(a)(1), and if IRS refuses to apply Rev. Rul. 80-76 because Section 83 does not "apply" to the transaction, the partners of ABX still should not recognize taxable gain in Example 1. Assuming arguendo that ABX recognizes $100,000 of short-term capital gain under the zero basis approach on ABX's deemed transfer of A Co. stock to X, that entire gain should be specially allocated to A Co. pursuant to Section 704(c); none will be allocated to B or X. Since TAM 9822002 applies the aggregate theory of partnership taxation for this purpose, A Co.'s $100,000 gain will not be recognized by operation of Section 1032.

Deemed transfer - Sections 83 and 707(a)(1). The partners of ABX again should not recognize gain in Example 1 on the deemed stock transfer even if Sections 83 and 707(a)(1) both apply. If Section 83 governs, the partnership itself arguably will not recognize gain (per Rev. Rul. 80-76 or the deemed cash purchase rationale of Prop. Reg. 1.1032-3); if Section 707(a)(1) governs, A Co. will not report taxable income (even if ABX recognizes gain under the zero basis/partnership gain recognition approach) because the gain would be allocated solely to A Co. pursuant to Section 704(c), and Section 1032 applies to A Co. (per TAM 9822002). No gain will be allocated to B and X.

Deemed transfer - Section 707(c). If Section 707(c) governs instead of Section 83, and assuming arguendo that ABX recognizes $100,000 of gain under the zero basis approach, A Co. again will be allocated gain pursuant to Section 704(c) but will not report taxable income because Section 1032 applies to it (per TAM 9822002). B and X will not report gain.

STOCK TRANSFERRED TO PARTNERSHIP

The analysis changes if the corporate partner actually transfers its stock to the partnership and the partnership transfers the stock to the service partner.

EXAMPLE 2: The facts are the same as in Example 1, except that A Co. actually transfers its stock to ABX on 12/1/98, and ABX transfers the shares (and cash compensation) to X immediately thereafter.

The form of this transaction should be respected for tax purposes, as it best complies with the substance of the transaction. Thus, there would be no reason for IRS to recharacterize it as a direct transfer of stock from A Co. to X, with the attendant tax consequences described earlier. The same
uncertainty arises, however, as to which Code provisions govern the operative tax consequences of the transaction. Because the payments are most likely to arise in connection with a partner rendering services in his capacity as a partner under Section 707(c), the remainder of this article will disregard the consequences of transfers to X that would be classified as Section 707(a) payments.53

As to the operative issues relating to (1) potential recognition by A Co. on its stock transfer to ABX, (2) the timing of ABX's compensation deduction and (3) the timing of X's recognition of ordinary income with respect to ABX's stock transfer to X, the analysis in Example 2 is identical to that in Example 1. There is no analytical difference between deemed and actual stock transfers by ABX to X under the facts in Examples 1 and 2. Thus, regardless of whether Section 83 or Section 707(c) or some combination thereof governs the analysis, A Co. will not recognize gain on its actual transfer of its stock to ABX per Section 721; ABX will obtain a $100,000 compensation deduction and X will recognize $100,000 compensation income, both in 1998.

Similarly, in Example 2 none of the partners will report taxable gain arising from ABX's transfer of the A Co. stock to X. If Section 83 governs the transfer, ABX should not recognize gain "because Section 83 applies," pursuant to the rationale of Rev. Rul. 80-76. If the rationale of Rev. Rul. 80-76 does not apply because there has been an actual (not deemed) transfer of zero basis stock from A Co. to ABX,54 the entire $100,000 gain will be recognized by ABX and allocated to A Co. pursuant to Section 704(c); A Co. would not recognize income, however, because it is protected by Section 1032 (per TAM 9822002). If the "deemed cash purchase" model in Prop. Reg. 1.1032-3 is applicable, then gain or loss will not be recognized, regardless of whether the stock is transferred by A Co. first to ABX (and then X) or directly to X. Assuming (1) the deemed cash purchase rationale of Prop. Reg. 1.1032-3 is not (yet) applicable, (2) the $100,000 gain is recognized and (3) Section 707(c) governs, A Co. again would be allocated the gain but not recognize income under Section 1032. Because the A Co. stock was transferred by ABX (to X) immediately after its receipt by ABX, there should be no post-contribution gain or loss, with differing tax consequences (as occurs in Examples 4 and 5, discussed in Part 2 of this article).

EXAMPLE 3: The facts are the same as in Example 2 (i.e., A Co. transfers 1,000 shares of its stock, and B and X transfer cash, to ABX on 12/1/98), but before X renders her services to ABX it is agreed that ABX will not transfer the A Co. stock or cash to X until 12/1/99. (ABX will retain any dividends paid by A Co. during the interim; such dividends will not be subsequently turned over to X.55) When ABX actually transfers the 1,000 A Co. shares (and cash) to X on 12/1/99, the value of those shares is still $100,000.

Neither A Co. nor ABX should recognize gain on A Co.'s 1998 transfer of its stock to ABX, pursuant to Section 721, regardless of which Code provisions govern the 1999 stock transfer by ABX to X. The timing of deductibility by ABX and income recognition by X, however, will depend on the operative Code provisions that govern the ABX-to-X stock transfer.

Transfer governed by Section 83. If Section 83 applies, X will recognize ordinary compensation income equal to the FMV of the A Co. stock (i.e., $100,000) when she receives it on 12/1/99. Pursuant to Section 83(h), ABX will be entitled to a corresponding $100,000 compensation deduction in 1999 in conformity with Sections 446 and 461.56

Is gain also recognized by ABX on 12/1/99 on ABX's transfer of the A Co. stock to X, and if so, how is it allocated? If the "zero basis/no partnership gain approach" applies, consistent with holding 4 of Rev. Rul. 80-76, then even assuming ABX is viewed as having a zero basis in the A Co.
shares, ABX would not recognize gain at the partnership level (and therefore none of its partners would recognize gain) "because Section 83 applies" to the transfer.

If the rationale of Rev. Rul. 80-76 does not apply because there has been an actual (not deemed) transfer of zero basis stock from A Co. to ABX, then the "zero basis/partnership gain recognition" approach should apply. ABX would have a zero basis in the A Co. stock on its receipt both on 12/1/98 and on 12/1/99 (barring any other transactions during the 12-month period that might increase its basis), and thus would recognize $100,000 of short-term capital gain on its transfer of the A Co. stock to X on 12/1/99. Under this approach, A Co. would be allocated all $100,000 of this gain pursuant to Section 704(c), i.e., the pre-contribution or "built-in" gain as of 12/1/98. If the entity theory of partnership taxation were applied, A Co.'s $100,000 compensation deduction effectively would be offset by A Co.'s taxable short-term capital gain of $100,000. Fortunately for A Co., application of the aggregate approach as used in TAM 9822002 would effectively eliminate A Co.'s gain, by operation of Section 1032. Thus, no partner of ABX should recognize gain under Example 3, if Section 83 applies.

Transfers governed by Section 707(c). Under Reg. 1.707-1(c), the timing of X's recognition of income is determined by the timing of ABX's deduction. Since ABX uses the accrual method and X rendered her services to ABX in 1998, ABX's $300,000 compensation deduction will be accrued in 1998, and X will recognize income in 1998 -- even though she does not receive payment (i.e., the A stock and cash) until 12/1/99.

It appears that ABX does not recognize gain in 1998 (as ABX does not transfer the assumed zero basis stock to X in 1998, but merely accrues the liability to X that year), but ABX does recognize a gain of $100,000 on 12/1/99 when it actually transfers the assumed zero basis stock to X. Since it is assumed that Section 83 does not apply if the transaction is governed by Section 707(c), the "zero basis/no partnership gain recognition" approach based on Rev. Rul. 80-76 cannot apply; similarly, since ABX does not "immediately" transfer the A Co. stock to X on its receipt on 12/1/98, the "cost basis/zero partnership gain recognition" approach based on Prop. Reg. 1.1032-3 cannot apply. Thus, by process of elimination the "zero basis/partnership gain recognition" approach would be applicable; $100,000 of gain would be recognized by ABX in 1998; it would be allocated solely to A Co. under Section 704(c), and A Co. would be protected by Section 1032 (per TAM 9822002).

Transfers governed by Sections 83 and 707(c). As reflected above, there is a conflict between the timing rules of Sections 83 and 707(c). Under the Section 83/707(c) reconciliation approach discussed in the analysis of Example 1, the partnership's year of accrual would control the timing of the recipient's income recognition and the partnership's deduction. Consistent therewith, in Example 3 ABX and X, respectively, would report the compensation deduction and income in 1998.

Will any of the partners report taxable gain arising from ABX's 1999 transfer of the A Co. stock to X, assuming it has a zero basis in ABX's hands? If Section 83 governs the transfer and the rationale of holding 4 of Rev. Rul. 80-76 applies, none of the partners of ABX will recognize gain; if the rationale of Rev. Rul. 80-76 does not apply, and gain is recognized, it would be allocated solely to A Co. under Section 704(c), and A Co. would again be protected by Section 1032 (per TAM 9822002). Because the A Co. stock has the same value ($100,000) when received by X on 12/1/99 as it had when contributed by A Co. to ABX on 12/1/98, there should be no post-contribution gain or loss.

SUMMARY

-14-
Compensating service partners with a corporate partner's stock, NQSOs, and SARs results in varying tax consequences to the service partner, the corporation and, in some cases, the other members of the partnership. Examples 1 and 2, involving the transfer of the corporate partner's stock to the service partner for services she previously rendered to the partnership, illustrate the tax advantages of using such compensation: deductibility by the partnership (subject to capitalization) without cash outlay, and no taxable gain being reported by any of the partners in using the (assumed zero basis) stock. Example 3, involving a transfer to the partnership of the corporation's stock with no change in the FMV of the stock before its subsequent transfer to the service partner, introduces the uncertainty as to the timing of the partnership's deduction and the service partner's income recognition that arises because of the doubts as to whether Section 707(c) or Section 83 (or both) governs the transaction. The results are summarized on Exhibit 1 on pages 352-53.

Part 2 of this Article, to be published in the next issue of THE JOURNAL, will involve more complex examples involving transfers of the corporate partner's stock, NQSOs, and SARs. In addition to issues involving the timing of the partnership's deduction and the service partner's income recognition, these additional examples will illustrate:

- The recognition of gain by the partners (including the service partner) other than the corporate partner.
- The impact of post-contribution gain and loss relating to the stock.
- The applicability of Section 704(c) (including the differing consequences of the traditional and remedial methods, respectively) with respect to changes in value of the corporation's stock.
- Differences that may arise from the issuance of unvested or restricted stock to the service partner.
- The uncertainty as to the availability of a Section 83(b) election by a service partner with respect to such stock, and the differing tax consequences to all the partners that turn on that question.
- Issues involving the proper tax treatment of NQSOs granted to the service partner, and the tax aspects of issuing corporate partner-based SARs to service partners.

Footnotes:

1. For purposes of this article, references to "service partners" includes members of LLCs as well as partners in both limited and general partnerships, and references to "partnerships" include LLCs and limited and general partnerships.

2. See Banoff, "New Rulings Expand Partnership Use of Corporate Partner Stock and Options as Compensation," 89 JTAX 92 (August 1998). That article predated the issuance of Prop. Regs. 1.83-6(d) and 1.032-3 (REG-106221-98, 9/22/98), and analysis of the use of corporate stock and stock options to compensate an employee of a partnership should take into consideration the discussion of these Proposed Regulations.


5. For valid reasons A Co., B and/or X do not want X to receive additional partnership interests in ABX.

6. The compensation deduction would be equally allocated among ABX's partners pursuant to Section 704(b). As a result, in Example 1 X will have net taxable income of $200,000, i.e., $300,000 compensation income minus a $100,000 deduction, which is X's allocable share (i.e., one-third of $300,000) of the total compensation deduction.
X will own A Co. stock worth $100,000 and will have cash in hand of $100,000 (i.e., $200,000 cash compensation from ABX minus X's $100,000 required cash capital contribution to ABX), which X will use to pay taxes (50% marginal tax rate) on her $200,000 of net taxable income.

7. Reg. 1.1032-1(a) does not expressly limit "services" to those rendered directly to the issuing corporation.

8. See, e.g., Rev. Rul. 62-217, 1962-2 CB 59, and Rev. Rul. 69-75, 1969-1 CB 52. For the remainder of this article it is assumed for ease of analysis that the compensation deduction is not subject to capitalization.

9. The transfer of stock to an employee as compensation is governed by Section 83. In general, the compensatory transfer of appreciated property to an employee results in recognition of gain or loss by the transferor. Reg. 1.83-6(b). An exception exists for transfers of the employer's own stock; Reg. 1.83-6(b) is explicitly made subject to Section 1032.

10. Therefore, ABX will not meet the requirements of Section 162, and as a result will not be entitled to the compensation deduction absent recharacterization of the transaction. Cf. Ltr. Rul. 8025127, holding 5.

11. See Gevirtz, TC 1987-144 (partner not entitled to deduction for expenditure where taxpayer failed to prove the payment was expressly required under the partnership agreement or otherwise made pursuant to a routine partnership business practice under which such expenses were paid by the partner without reimbursement); Ltr. Ruls. 9316003, 9330004.

12. Perhaps a theoretical argument for deductibility could be based on the aggregate approach to partnerships, i.e., that in rendering her services to ABX, X should be deemed to constructively render a portion of her services to A Co., in accordance with A Co.'s proportionate ownership interest in ABX. There is no known authority for such a "services deemed rendered" argument.

13. See, e.g., St. John, 53 AFTR2d 84-718 (DC Ill., 1983); Campbell, 943 F.2d 815, 68 AFTR2d 91-5425 (CA-8, 1991), rev'd TCM 1990-162 (Tax Court applied Section 83; Eighth Circuit discussed its application, but did not come to a conclusion). See Banoff, supra note 4.


15. Starr, Walshe and Payne, supra note 4, at 17 fn. 32; Cunningham, "Taxing Partnership Interests Exchanged for Services," 47 Tax L. Rev. 247 (1991), at 264 (suggesting that the basic technical issue is whether Subchapter K is intended to supersede any possibly contrary provisions of the Code).

16. See Karch, "Equity Compensation by Partnership Operating Businesses," 74 Taxes 722 (December 1996), at 728, fn. 43.

17. Under Reg. 1.83-6(d)(1), a transfer of property by a shareholder of a corporation to an employee of that corporation or to an independent contractor as consideration for services performed for the corporation is considered to be (1) a contribution of the property to the capital of the corporation by the shareholder, immediately followed by (2) a transfer of such property by the corporation to the employee or independent contractor. Ltr. Rul. 9822012 apparently extends this logic (i.e., a deemed capital contribution by the transferor partner to the partnership) with respect to property transfers to partnership employees. See Banoff, supra note 2, at 96-98.

18. Consistent therewith, the heading of Section 83(h) is "Deduction by employer." Partnerships generally are not viewed as "employers" of their service partners. Titles and headings in Code sections are not binding, of course; see Section 7806. Also see Campbell, supra note 13, at fn. 7 (noting that the limitation in Reg. 1.83-1(a)(1) causes some question to exist as to the applicability of Section 83 to a service partner's receipt of a profits interest).

19. Also see Regs. 1.83-3(f), 1.83-5(b)(1), 1.83-7(a) and 1.83-8(b)(2), referring solely to employees and independent contractors. Compounding the uncertainty is the Service's 1971 issuance of Prop. Reg. 1.721-1(b)(1), which would apply Section 83 to a transfer of a partnership capital interest for services rendered to the partnership. One
commentator reads the Proposed Regulation as answering in the affirmative the question of whether a partner is "an employee or an independent contractor" within the meaning of Reg. 1.83-1(a). Weidner, "Pratt and Deductions for Payments to Partners," 12 Real Prop., Probate and Trust J. 811 (1977), at 840, fn. 134. The Proposed Regulation does not attempt to reconcile the apparent conflict with Reg. 1.83-1(a) and the other above-mentioned Regulations regarding the applicability of Section 83 to service partners. Moreover, this Proposed Regulation has never been finalized, and thus should have no force and effect at this time.

In Armstrong v. Phinney, 21 AFTR 2d 1260 (CA-5, 1968), the appellate court held that a partner was an employee of his partnership for purposes of Section 119. Contra: Wilson, 376 F.2d 280, 19 AFTR2d 1225 (Ct. Cl., 1967). The IRS has ruled that a partner cannot also be an employee of his partnership for federal employment tax or income tax purposes. Rev. Rul. 69-184, 1969-1 CB 256; Rev. Rul. 72-596, 1972-2 CB 395; Rev. Rul. 73-414, 1973-2 CB 144.

20. See notes 13 and 14, supra.

21. Based on the longstanding, specific rules relating to deductibility by the partnership and timing of income by the partner, as provided under Reg. 1.707-1, application of Section 83 should not be extended into Subchapter K. There is no indication that Congress's enactment of Section 83 in 1969 was intended to modify those Subchapter K rules established under the 1954 Code and implemented in regulations shortly thereafter.

22. Under Regs. 1.707-1(a) and (c), both Section 707(a)(1) and 707(c) include transactions involving the rendition of services by a partner to his partnership. The courts have wrestled with the difficulties in determining whether a resulting payment is properly governed by Section 707(a)(1) or Section 707(c). See, e.g., Pratt, 64 TC 203 (1975), aff'd in part and rev'd in part 550 F.2d 1023, 39 AFTR2d 77-1258 (CA-5, 1977). See also Rev. Rul. 81-300, 1981-2 CB 143; Rev. Rul. 81-301, 1981-2 CB 144; Postlewait and Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984," 40 Tax Lawyer 649 (1985).

23. A Co.'s transfer should be viewed as made on behalf of ABX, even if B and X had not made their equivalent cash contributions, if either (1) A Co. was expressly required under the partnership agreement to transfer its stock to X or (2) A Co.'s capital account in ABX is credited for such contribution (as though the contribution was first made to the partnership) and liquidating distributions are made in accordance with the partners' ending capital account balances.

24. Ltr. Rul. 8049037 involved the exercise of an SAR by an employee of a subsidiary corporation (S) and the payment of money directly to the employee by the parent corporation (P) as a result of the SAR exercise. IRS treated these events as a contribution to capital by P to S, followed by a deemed payment from S to the employee. Section 83 technically was not applicable because there was a transfer of money, not property. Also see Lopo, TCM 1961-126; TAM 8442001 (payments of a partnership's expenses by its corporate partners should be treated as additional capital contributions to the partnership, and the partnership should be treated as having paid these expenses).

25. ABX's deduction would be the FMV of the stock deemed transferred to X (i.e., $100,000), rather than the stock's basis in ABX's hands (a carryover basis from A Co., pursuant to Section 723; such basis presumably would be zero, under the Service's view).

26. Also see note 19, supra.


28. See the text accompanying notes 18-19, supra.

29. Pursuant to Reg. 1.707-1(c), guaranteed payments made by a partnership to a partner for services "are considered to be made to a person who is not a partner." If the Regulation went no further, this would suggest that the partner would be treated by the IRS as acting as an independent contractor or employee. Reg. 1.707-1(c) further provides, however, that Section 707(c) guaranteed payments are considered to be made to one who is not a member of a partnership only for purposes of Section 61(a) (relating to gross income) and Section 162(a) (relating to trade or business expenses); for purposes of other provisions of the Code, guaranteed payments are generally regarded as a partner's distributive share of partnership income and profits. Reg. 1.707-1(c) provides that Section
707(c) payments are not treated as partnership profits for purposes of Sections 706(b)(3), 707(b) and 708(b).

30. See Amici Brief filed with the Eighth Circuit in Campbell, supra note 13, by the American Film Marketing Ass’n., et al., 91 TNT 44-73, fn. 5.

Granting priority to the rules of Section 707(c) can also be supported by a review of regulatory developments since the enactment of Section 83 in 1969. See Hortenstine and Ford, "Receipt of a Partnership Interest for Services: A Controversy That Will Not Die," 65 Taxes 880 (December 1987), at 912.

31. See notes 23-24, supra, and accompanying text.

32. A transfer of a partnership capital interest in favor of another partner as compensation for services is characterized under Reg. 1.721-1(b)(1) as an event whereby one or more partners gives up his right to be repaid his capital contributions. The thrust of the Regulation seems to be that the nonservice partners, and not the partnership, are the transferors of the property in question (i.e., the service partner's interest), as they are the ones relinquishing and transferring a portion of their capital interests to the service provider as payment for his services, even though the services are being rendered to the partnership. See Robinson, "The Tax Implications of Exchanging a Partnership Interest for Services: An Analysis," 51 JTAX 16 (July 1979), at 17. To the extent that the value of the capital interest is compensation for services rendered to the partnership, Reg. 1.721-1(b)(2)(i) characterizes the property transfer as a guaranteed payment for services under Section 707(c). Since Section 707(c) only applies to payments by the partnership, Reg. 1.721-1(b)(2)(i) implicitly must bifurcate the partners' relinquishment or transfer of portions of their capital interests into (1) a deemed capital contribution from the partners relinquishing their right to be repaid capital contributions, followed by (2) a transfer by the partnership to the service partner, governed by Section 707(c).

33. A partner must include such payments as ordinary income for his tax year within or with which ends the partnership tax year in which the partnership deducted such payments as paid or accrued under its method of accounting. Reg. 1.707-1(c).


35. If Section 707(c) controls the recipient's inclusion of income, an insoluble relationship appears to result in that the timing of the transferee-partner's income is controlled by the appropriate year of the partnership in which the deduction is available, while the transferor-partnership's deduction is available under Section 83(h) in the appropriate year of the partner in which the income must be included.

36. See Hortenstine and Ford, supra note 30, at 912.

37. See, e.g., Chester N. Weaver Co., 97 F.2d 31, 21 AFTR 310 (CA-9, 1938); Monarch Life Ins. Co., 38 BTA 801 (1938) (a particular enactment that otherwise encompasses the subject of the particular enactment).


39. These approaches, summarized below, are extensively discussed in the author's August 1998 article in THE JOURNAL. See Banoff, supra note 2, pages 94-96.

40. Gain or loss recognition derives from the longstanding rule that the use of appreciated or depreciated property to pay compensation is viewed as a taxable disposition of the property for its FMV, thereby producing gain or loss under Section 1001. See, e.g., Davis, 370 U.S. 65, 9 AFTR2d 1625 (1962).

41. See generally Banoff, "How IRS' New Zero-Basis Approach Will Affect Corporate Tax Planning," 42 JTAX 96 (February 1975). For purposes of this article, it is assumed that the zero basis approach of Rev. Rul. 74-503, 1974-2 CB 117, would be upheld as valid (notwithstanding the strong doubts of several commentators, including this author) and applied to any deemed or actual transfer by A Co. of its stock to ABX.
42. Reg. 1.83-6(b) states: "Except as provided in Section 1032, at the time of a transfer of property in connection with the performance of services, the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property." This language seems to indicate that ABX would recognize a gain (as Section 1032 does not apply to ABX's transfer of its corporate partner's stock). As to the reason the gain is short-term, see Banoff, supra note 2, at 94, fn. 12.

43. For an exhaustive look at the operation of Section 704(c), see Rubin and Macintosh, "Exploring the Outer Limits of the 704(c) Partnership Built-In Gain Rule (Parts 1-3)," 89 JTAX 177, 228, and 271 (September, October, and November 1998).


45. As to the underlying rationales for the Service's analysis in Rev. Rul. 80-76, 1980-1 CB 15, see GCM 38176, 11/26/79; Banoff, supra note 2, pages 95-96 and fns. 18-21. The IRS reportedly will not apply the rationale of Rev. Rul. 80-76 (at least for advance ruling purposes) if A Co. does not transfer its stock directly to X. See Prosperi, "Service Opposes Tax-Free Use of Parent Stock by Subsidiary's Rabbi Trust," 86 JTAX 96 (February 1997).

46. Indeed, the Service has never ruled in the partnership context as to whether the deemed capital contribution approach of Reg. 1.83-6(d)(1) applies; that Regulation is limited to the transfer of stock by a shareholder of a corporation to an employee of that corporation. No published or private ruling has explicitly extended relief from the zero basis problem for transfers to employees (or service partners) of a partnership.

47. See note 2, supra.

48. Cf. Rev. Rul. 80-189, 1980-2 CB 106, which confirms that "S, under Section 1012..., will have a basis in P's stock acquired in the transaction [i.e., S's purchase of P stock from a third party] equal to the amount paid therefor."

49. See note 2, supra. Prop. Reg. 1.83-6(d), dealing with transactions in which a corporate shareholder transfers its own stock to a person in consideration of services performed for another corporation (not partnership), states that the special rules in Prop. Reg. 1.1032-3 are applicable. Prop. Reg. 1.1032-3(b) states that such a transaction is treated as if, immediately before the acquiring corporation (S) disposes of the stock of the issuing corporation (P), the acquiring corporation (S) purchased the issuing corporation (P)'s stock from the issuing corporation (P) for FMV with cash contributed to the acquiring corporation (S) by the issuing corporation (P).

Prop. Reg. 1.1032-3 would apply only if, inter alia, the acquiring corporation (S) "immediately" transfers the stock of the issuing corporation to the service recipient; see Prop. Reg. 1.1032-3(c)(2). Thus, transfers of stock held for any period of time would not come within the ambit of Prop. Reg. 1.1032-3.

50. E.g., ABX would have to immediately retransfer to X any stock or NQSOs actually received from A Co. See note 49, supra.

51. One-third of $300,000. See note 6, supra.

52. For example, where computation of a partner's "interest in partnership profits" or the partnership's (recognized) gross income is relevant. See Banoff, supra note 2, page 94 and fns. 35-36.

53. If Section 707(a) governs, the tax consequences to ABX and its partners often will be the same as would arise if Section 83 were to govern.

54. The IRS reportedly has taken this position, at least for advance ruling purposes. See Prosperi, supra note 45.

55. Any dividend income received by ABX on A Co. stock and interest income earned by ABX on B's and X's cash contributions for the period 12/1/98 to 12/1/99 are disregarded for all purposes of this article.
56. Since the A Co. stock is substantially vested when it is transferred by ABX to X on 12/1/99, ABX will be allowed the deduction in accordance with its accrual method of accounting on 12/1/99, subject to Sections 446 and 461. Reg. 1.83-6(a)(3).

The $200,000 cash payment will be governed by Section 707(c); Section 83 does not apply to mere unfunded and unsecured promises to pay money. Reg. 1.83-3(e). Therefore, ABX will accrue the $200,000 deduction in 1998 and X will report that amount as income in 1998 per Reg. 1.707-1(c), even though X does not receive the cash compensation until 12/1/99.

57. A Co., B, and X each would be allocated $100,000 of ABX's $300,000 compensation deduction (i.e., its $100,000 deduction under Section 83(h) plus the $200,000 cash compensation paid to X).

58. ABX cannot literally offset the partners' respective compensation deductions and capital gains at the partnership level because capital gains must be separately stated from bottom-line income and losses on each partner's Schedule K-1. Section 702(a).

59. Despite the use of "payments" in both Section 707(c) and the Regulations thereunder, it is clear that no actual payment need be made; if the partnership deducts the amount under its method of accounting, the "recipient" partner must include the amount in income in the appropriate year. Gaines, TCM 1982-731; Pratt, supra note 22.

60. Rev. Rul. 80-76 may not apply because (1) there has been an actual (not deemed) transfer of zero basis stock from A Co. to ABX, or (2) the Ruling by then has been revoked as part of the finalization of Prop. Reg. 1.1032-3; in turn, the latter would not apply because ABX did not "immediately" transfer the A Co. stock to X on its receipt on 12/1/98. Prop. Reg. 1.1032-3(c)(2); see note 49, supra, or (3) Section 707(c) "governs" the transaction to the exclusion of Section 83; Rev. Rul. 80-76 was issued solely under Section 83.

61. This assumes that during the period 12/1/98 - 11/30/99, ABX does not utilize the remedial method under Section 704(c) to eliminate a portion of the difference between the value of the A Co. stock and its (assumed zero) basis in ABX's hands on 12/1/98. See generally Rubin and Macintosh, supra note 43.