A Win-Win Proposal for Analyzing Profits-Only Partnership Interests

Brad Borden
A Win-Win Proposal for Analyzing Profits-Only Partnership Interests

By Bradley T. Borden

Table of Contents

I. Introduction ........................................... 75
II. Partnerships and Partnership Interests .......... 77
   A. Types of Partnerships ........................... 77
   B. Types of Partnership Interests ................. 78
   C. Nature of Partnerships .......................... 79
III. Partnership Disaggregation ....................... 81
   A. Partner-Shareholder Comparisons ............... 81
   B. Contribution-Focused Analysis .................. 83
   C. Complexities of Mis-Taxing Interests .......... 83
IV. Partnership Disregard ................................ 84
   A. Hired Services vs. Hired Property ............... 85
   B. Partner-Nonpartner Capacity ..................... 86
   C. Investment Partnership Misconception .......... 87
V. Conclusion ........................................... 88

I. Introduction

The taxation of carried interests, which are a variation of profits-only partnership interests, has been the focus of the recent heated debate among academicians, practitioners, taxpayers, and lawmakers. One camp (the compensation proponents) argues that profits-only partnership interests are granted as compensation, at least in part, to a person who provides services to a partnership and should be taxed as such. Compensation proponents tend to be

1Although profits-only partnership interests have emerged recently in the debate of carried interests, the debate was spurred by various court decisions and rulings that have addressed the proper taxation of profits-only partnership interests. See Campbell v. Commissioner, 943 F.2d 815, 823 (8th Cir. 1991) (holding that a profits-only interest had only speculative, if any, value and therefore the grant of the interest is not taxable); Diamond v. Commissioner, 492 F.2d 286, 291 (7th Cir. 1974) (holding that the grant of a profits-only partnership interest with a determinable market value for past services is a taxable event); Rev. Proc. 2001-43, 2001-2 C.B. 191 (providing guidance on the tax treatment of nonvested profits-only interests); Rev. Proc. 93-27, 1993-2 C.B. 343 (providing for the tax-free treatment of the grant of most profits-only partnership interests). The House of Representatives passed H.R. 3996, the Temporary Tax Relief Act of 2007, on November 9, 2007, which would have added section 710 to the Internal Revenue Code and would have taxed income allocated to holders of some profits-only partnership interests as compensation income. The version of the bill that passed the House is available at http://thomas.gov/home/gpoxmlc110/h3996_eh.xml#HFEDCF81900D34B6A9416DD0226DF43DE3. This article will refer to the bill as proposed section 710. Treasury and the IRS have also recently proposed rules for taxing profits-only partnership interests, which would have allowed the tax-free grant of profits-only partnership interests and the character of partnership income to flow through from the partnership. See prop. reg. section 1.83-3(e), 36 Fed. Reg. 10787 (May 24, 2005) (providing that “property includes a partnership interest,” which would place the grant of a profits-only partnership interest under the section 83 income recognition timing rules); Notice 2005-43, 2005-1 C.B. 1221 (providing a proposed safe harbor that would allow a service provider to include the liquidation value (which should be zero) of a profits-only interest in income on the date of grant).

See, e.g., Victor Fleischer, “Two and Twenty: Taxing Partnership Profits in Private Equity Funds,” 83 NYU L. Rev. 1, 57-58 (2008) (recommending that at least a portion of the partnership profits allocated to holders of profits-only partnership interests be taxed as ordinary income); testimony of Darryll K. Jones (Footnote continued on next page.)
academics, who are concerned with distributive equity. At the core of the argument adopted by the compensation proponents is the apparent inequity that results when a service-providing partner is able to pay tax on significant amounts of allocated partnership profits at favorable long-term capital gain rates. The other camp (the proponents of partnership-level characterization) argues that any partnership profits allocated to a partner should retain the character determined at the partnership level. The proponents of partnership-level characterization tend to worry to a significant degree about the integrity and complexity of partnership tax law, found in subchapter K of the Internal Revenue Code.

This report suggests that the different positions may be attributable to the focus of analysis. The current focus is on disaggregating partnerships by changing the character of income as it flows from a partnership to a partner. The compensation proponents favor disaggregation because it treats a service-providing partner’s share of partnership profits as compensation. The proponents of partnership-level characterization don’t favor disaggregation because it violates long-standing partnership rules and has ripple effects that could adversely affect the application of other areas of tax law. This report suggests that if the analysis changes its focus from partnership disaggregation to partnership disregard, the two camps may find a harmonious solution to the problem carried interests pose.

All profits-only partnership interests present a significant conceptual challenge because partnerships can be very complex arrangements. The complexity makes properly identifying relationships among partners and partnerships difficult, which in turn makes tax legislation difficult. Partnerships are as old as private business and are a natural part of our economy, which adds to the importance of partnership tax lawmaking. The prevalence of partnerships and their scope — both in terms of the numbers of businesses adopting the form, and the form’s place in business society — add to their unique place among business arrangements. A partnership may be any of the following: a business arrangement between two unsuspecting entrepreneurs, a complicated investment arrangement, or a joint venture between multinational energy companies. The partnership form’s unique nature requires tax rules that are often significantly different from other tax rules. Because any partnership could grant one of its members a profits-only partnership interest, the tax law governing profits-only partnership interests should produce accurate and consistent tax results regardless of the type or size of partnership in

Comments”). All code and section references are to the Internal Revenue Code of 1986, as amended, unless stated otherwise.

This suggestion is in some respects a reminder of the instruction Congress gave to Treasury in 1984 to promulgate regulations that would “provide, when appropriate, that the purported partner performing services . . . is not a partner at all. Once it is determined that the service performer . . . is actually a partner, the committee believes the factors described below should be considered in determining whether the partner is receiving the putative allocation and distribution in his capacity as a partner.” S. Comm. on Fin., 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, 227 (Comm. Print 1984) (hereinafter Finance Committee) (see note 75).

question. The law should also be equitable and efficient. Partnership disaggregation does not accomplish those goals.

II. Partnerships and Partnership Interests

Before examining the concepts of partnership disaggregation and partnership disregard, the report presents a working definition of tax partnership and describes three types of partnerships and three types of partnership interests. The report also discusses the nature of partnerships, which is the key to analyzing partnership disaggregation. This discussion helps set the stage for the discussion of taxing profits-only partnership interests.

A. Types of Partnerships

A tax partnership exists when two or more persons combine services and share profits from the combined services or when two or more persons combine property and services and share the profits from the property-services combination. The tax partnership definition used in this report uses the term “combination” to imply the shared ownership and control of the property and services. Thus, a partnership requires the partners to share ownership and control of the partnership property and services. Although the definition is fraught with shortcomings when used for tax purposes, it remains a significant part of the federal definition of tax partnership. Partnerships can be one of three different types: services partnerships, property-services partnerships, or investment partnerships. Each type of partnership can grant profits-only partnership interests.

1. Services partnerships. A two-person law partnership is an example of a services partnership. For instance, on completing tax LL.Ms, Sarah and Joline decide to form a law firm. They form Jorah Law Firm and they agree to share the expenses of the firm equally and divide profits so that Sarah will receive 60 percent of the profits from work she originates and Joline will receive 60 percent of the profits from work she originates. They have no assets to contribute, so their combination of services and profit sharing creates a service partnership. Even though they have profit-sharing arrangements that favor the rainmaker, they each take an interest in the other’s services. The income of service partnerships is income from services. The taxation of interests in these arrangements is not heavily disputed. The lack of controversy regarding the taxation of interests in services partnerships is likely attributable to the character of services partnerships’ income. Because the partners recognize income from services, they do not receive preferential tax treatment.

2. Property-services partnerships. A simple example illustrates a property-services partnership. Rex recently built an office building, which he has been managing alone. As the building fills up, he realizes he needs help to meet all of the demands of managing a full office building. Lee joins Rex to form Leex Partnership. Rex contributes his building, all of the existing leases, and his services to Leex Partnership; Lee contributes his services to Leex Partnership. Thus, they will share the management responsibilities. Rex and Lee agree that they will divide the income from the partnership 60 percent to Rex and 40 percent to Lee. They also agree that if they ever sell the office building, they will equally divide any gain realized from the property’s appreciation after the partnership formation. The arrangement between Rex and Lee is a tax partnership because they combine property and services and share the profits from their combined resources. As partners, Rex and Lee both take an interest in each other’s contributed resources through the combination.

Other property-services partnerships may generate services income. For example, assume Rachel and Christy form Chrichel limited licensing company, a lawn-mowing service. Rachel agrees to contribute all of the lawn-mowing equipment, a customer list, and management and bookkeeping services. Christy agrees to contribute lawn-mowing services. The income of Chrichel LLC will be income from services. The difference between the character of Leex Partnership’s income and Chrichel LLC’s income appears to be whether the property or services are the more dominant income-producing ______

10The landlord has agreed to waive rent for the first six months they occupy their office space. They will cover all other expenses using credit or with revenue they earn.

14Defining “tax partnership” is another challenge. For an arrangement to be a tax partnership, the members must share ownership/control of the property and services. See Bradley T. Borden, “The Federal Definition of Tax Partnership,” 43 Hous. L. Rev. 925 (2006) (discussing the definition of tax partnership generally).

13Courts and the IRS have reduced the definition to sets of factors. See, e.g., Luna v. Commissioner, 42 T.C. 1067, 1077 (1964); Ayerton Metal Co. v. Commissioner, 299 F.2d 741, 742 (2d Cir. 1962); Ailhouse v. Commissioner, 62 T.C.M. (CCH) 1678, 1680 (1991); Rev. Proc. 2002-22, 2002-1 C.B. 733, 735-737. See also Borden, supra note 9, at 975-982 (discussing the use of substantive law to define tax partnership).

15See Borden, supra note 9 (discussing how partners integrate property and services and jointly own/control the combined resources including the product of services).
factor. The property in Leex Partnership arguably plays a bigger income-producing role than the property in Chrichel LLC.

3. Investment partnerships. A third type of arrangement, an investment partnership, also appears to come within the definition of tax partnership. Assume Warbucks has $100 million he would like to put to good use (that is, invest for a significant return). Assume further that Krinkle has a reputation of managing investments well, returns a good profit on invested money, and has access to other resources that help him manage capital. Warbucks and Krinkle agree to form a limited partnership (Kribucks LP) under which Warbucks will contribute $100 million and Krinkle will contribute investment services. The partnership agreement provides that the partnership will pay Krinkle $2 million on formation as a fee for managing Kribucks LP and divide any profits from the partnership 80 percent to Warbucks and 20 percent to Krinkle. All partnership income will be from the property or gain from the sale of the property (that is, investment income) and Krinkle’s activities will be limited to making investment decisions and managing the investments. The discussion below questions whether investment partnerships should come within the definition of tax partnership. Unless stated otherwise, however, this report assumes investment partnerships do come within the definition of tax partnership, to facilitate the analysis.

These four hypothetical partnerships illustrate three general types of tax partnerships and provide a baseline for analyzing profits-only partnership interests. As the analysis proceeds, the report will refer to the partnerships as follows: Jorah Law Firm is a services partnership. Leex Partnership and Chrichel LLC, which combine one person’s property with the contributed active services of at least one other person, are property-services partnerships. Kribucks LP, which combines property with limited investment services, is an investment partnership. Each type of partnership relies on services and property to a different extent for profit. A pure-services partnership relies almost exclusively on partner services for profit. The property-services partnership relies on both property and services for profit. The investment partnership relies primarily on property for profit.

B. Types of Partnership Interests

In the examples above, each partnership grants profits-only partnership interests. Leex Partnership also grants a capital-profits partnership interest, and Kribucks LP also grants a capital-only partnership interest. The following discussion describes each type of interest.

1. Profits-only partnership interests. A profits-only partnership interest gives a partner a share of future partnership profits but no interest in partnership capital on the date of grant. That definition has important implications. First, the holder of a profits-only partnership interest is a member of an arrangement that comes within the definition of tax partnership, which means the holder has the rights and powers of a partner. Second, at the time a partnership grants a profits-only partnership interest, the grantee does not have a right to any of the partnership capital upon admission to the partnership. Third, the grantee of a profits-only partnership interest contributes only services to the partnership. This definition would include the interests Sarah and Joline take in Jorah Law Firm, the interest Lee takes in Leex Partnership, the interest Christy takes in Chrichel LLC, and the interest Krinkle takes in Kribucks LP. Each of those people contributes only services and has no right to a capital distribution immediately following partnership formation. They each are, however, a member of an arrangement that appears to come within the definition of tax partnership.

2. Capital-only partnership interests. A capital-only partnership interest is an interest granted to a person who contributes only property to a partnership. The interest Warbucks takes in Kribucks LP is an example of a capital-only partnership interest. Warbucks contributes only property to Kribucks LP. He will share in the partnership profit, but he will not provide services. If the partnership liquidated immediately following formation, as the sole contributor of capital, Warbucks would receive all of the partnership capital. Rachel also takes a capital-only partnership interest in Chrichel LLC.

3. Capital-profits partnership interests. Capital-profits partnership interests are similar to profits-only partnership interests in some respects and similar to capital-only partnership interests in other respects. The interest of Rex in Leex Partnership has aspects of a profits-only partnership interest because the profit allocation agreement undoubtedly is based in part on the services Rex will contribute. Rex also contributes property, so he will have a capital interest (that is, a right to a capital distribution if the partnership liquidated immediately following formation) in Leex Partnership at the time of formation. Thus, Rex’s interest in Leex Partnership is a combination of both a capital interest and a profits-only partnership interest.

16See Rev. Rul. 75-523, 1975-2 C.B. 257 (ruling that an investment club that did not carry on a trade or business for section 162 purposes was a tax partnership).

17The report uses the term “investment services” to define those services that a taxpayer can perform without being deemed to carry on a trade or business for purposes of section 162.

18This is a very basic example of the traditional “2 and 20” carried interest structure that has received considerable recent attention. See supra notes 2-5.

19See section 163(d)(4)(B) (2000) (defining investment income as income from property held for investment).

20See infra Section IV.C.

21This is consistent with the IRS’s definition of profits interest. The IRS defines a profits interest as any interest in a partnership other than a capital interest. See Rev. Proc. 93-27, 1993-2 C.B. 343, section 2.02. The Service defines capital interest in a partnership as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” Id. at section 2.01. The Service generally determines whether a partnership interest is capital or profits at the time the partner receives the partnership interest.
interest. Because of the similarity to both types of interests, the interest is a capital-profits partnership interest.

Partnership tax policy generally supports the tax-free formation of partnerships and the tax-free admission of new partners to existing partnerships.22 The grant of an interest in partnership capital to a service contributor is not, however, a tax-free transaction. The service contributor will generally have compensation income on the date of the grant of the capital interest.23 With few exceptions, the IRS does not challenge the tax-free grant of a profits-only partnership interest to a service contributor.24 Instead, holders of profits-only partnership interests recognize income as it flows through from the partnership and take the character of the income as determined at the partnership level.

Even though partnerships can grant different types of partnership interests, most thought regarding taxation of partners on a partnership formation focuses on the tax consequences of the grantee of profits-only partnership interests.25 The recent debate more particularly concerns the tax treatment of profits-only partnership interests in investment partnerships.26 The compensation proponents argue that grantees of profits-only partnership interests have compensation income either on grant of the interests or as the partnership allocates or distributes profits to the grantees.27 Something about profits-only partnership interests causes intellectual discomfort. In particular, holders of profits-only partnership interests provide only services to a partnership but recognize income as determined at the partnership level. In the case of an investment partnership, that income could be long-term capital gain. The payment of tax at long-term capital gains rates for income received by a person who provides only services is intellectually uncomfortable for some of us. Compensation proponents recommend partnership disaggregation as a way to alter the character of income flowing from an investment partnership to holders of profits-only partnership interests. The nature of partnerships, however, makes partnership disaggregation an unsuitable remedy for the intellectual discomfort the taxation of profits-only partnership interests causes.

C. Nature of Partnerships

Tax partnerships are unique arrangements and often deserve analysis independent of that applied to corporations or other nonpartnerships. A defining attribute of a tax partnership is that it is an integration of services and property (or the services of two people).28 That integration gives the service contributor and property contributor an interest in both the partnership property and partnership services. The property owner commits the property to partnership use. Thus, although the service contributor would not receive a share of the property on liquidation of the partnership immediately following formation, the service contributor does share in directing the use of the property, any increase in the property’s value, and its product. That level of control distinguishes a partner from an employee.29 Partners also take an interest in contributed services. The 13th Amendment generally prohibits one individual from controlling another individual and the product of an individual’s labor should belong to the individual who produces it.30 Nonetheless, individuals should be able to transfer the product of their labor to others, and thereby grant to others co-ownership in their services.31 By contributing services to a partnership, a service-contributing partner grants the other partners a co-ownership interest in the contributed services. Thus, partners become co-owners of partnership property and services.

22See Borden, supra note 8; Schmolka, supra note 5, at 297-299 (recognizing the unique nature of partnerships as mini-exchanges between the partnership as the partnership conducts business and each mini-exchange is taxed as the partnership allocates tax items to partners under subchapter K).
23See, e.g., 42 T.C. 1067 (1964) (considering whether the parties shared control and responsibilities of the enterprise in holding that no partnership existed); Fishback v. United States, 215 F. Supp. 621 (D.S.D. 1963) (finding that parties were joint proprietors and holding that arrangement was a tax partnership); Beck Chem. Co. v. Commissioner, 27 T.C. 840 (1957) (finding that the parties had mutual proprietary interest in profits and holding that the arrangement was a tax partnership); Copeland v. Ratterree, 53 AFTR 1309 (N.D.N.Y. 1957) (holding no partnership existed even though parties shared profits because they did not share control).
24See supra notes 2 and 3.
The co-ownership of partnership property and services makes tracing income from either the contributed property or services to the contributor impossible. A tax partnership's income flows from the combined output of partnership property and services, both of which the partners control. Consider the nature of the various types of partnerships. Joline and Sarah each contribute services to Jorah Law Firm. If Joline brings in a new client matter and Sarah works on the matter, the partners cannot separate income derived from the client origination from income derived from the legal work when deciding how to divide the profit from the matter. They have agreed, however, that they will divide the profit from that matter 60 percent to Joline and 40 percent to Sarah. Both the origination and legal work are required for the matter to create profit. As partners, Joline and Sarah each control the origination and legal work and each share in the profits from those combined services. They cannot trace the profits directly or accurately from the exact source, so their agreed allocation determines each partner's share of the partnership income.

The nature of partnerships also manifests itself in property-services partnerships. The income from Leex Partnership flows from both the property Rex contributes and the services Rex and Lee contribute. The partners cannot separately trace income from property and services. The income from one source fuses with the income from the other source. The income from the combined sources becomes partnership income and flows to the partners with the character determined at the partnership level. Thus, the income from Rex's and Lee's contributed services and Rex's contributed property becomes rental income. Gain or loss from the sale of the office building should be gain or loss from the sale of a section 1231 asset. The amount of gain recognized after formation will depend on both the contributed property and the contributed services. The inability to trace income from services contributed by the service provider and property contributed by a property owner gives partnerships their distinctive tax nature.

A profits-only partnership interest grants the owner of the interest an interest in income from the combined property and services of the partnership. The income does not merely flow from the service provider's services. The income also flows from the property in which the service provider takes an interest as a partner. Similarly, because a property contributor takes an interest in the service contributor's services, income allocated to the property contribution comprises income from property and services. Furthermore, the combination of the contributions should create output that exceeds the sum of the output of the contributions working separately. Partners take an interest in that excess that cannot be traced specifically to either the property or services. The partners' interests in the product of all contributed resources give tax partnerships their unique nature. Because both parties co-own the resources needed to generate the rental income or gain from sale of a section 1231 asset and cannot trace income directly from the respective contributions, they both recognize the income in the character it takes at the partnership level.

Investment partnerships differ, from pure-services partnerships and property-services partnerships in one potentially significant aspect — by definition, the level of services contributed to an investment partnership are nominal. The sale of an investment partnership's assets generates capital gain or loss, which means that tax law treats the income as derived almost exclusively from the property, not services. The implication is that the services do not contribute to the profits of the partnership. Because the income derives from the property, the partners should be able to trace the partnership income from its source to the owners of the property. The ability to trace the income from the source makes the arrangement look less like a partnership — at a minimum, investment partnerships do not have the unique lack-of-traceability that characterizes partnerships.

---

32Law firms may routinely allocate a share of profits from a matter to the origination originating partner to recognize the importance of origination. The allocation does not necessarily reflect the source of income, but may merely reflect the law firms' perceived importance of rainmaking. The profit allocation to the originator is a form of monitoring that helps discourage shirking. See Borden, supra note 8 (describing how partners might allocate partnership profits to reduce shirking and agency costs).

33See Borden, supra note 9, at 1024-1025 (providing that the inability to trace from arrangements that combine property and services justifies the use of the partnership tax accounting and reporting rules).

34See section 1231 (2000).

35See Borden, supra note 8 (discussing the nature of partnerships and the inability to trace income from the contributed source).
attributes of both pure-service partnerships and property-services partnerships.\textsuperscript{39} Partnership tax law recognizes the inability to trace partnership income from its source and allows partners to allocate partnership income in any reasonable manner. The allocation rules are a compromise between the assignment-of-income doctrine and the inability to trace.\textsuperscript{40} They should, however, be reserved only for arrangements that create tracing difficulty.\textsuperscript{41} Pure-services partnerships and property-services partnerships both present tracing difficulty; investments partnerships, lacking the unique character of partnerships, do not. Thus, investment partnerships do not appear to require the application of the partnership tax allocation rules like other partnerships. The proper way to address that difference is to disregard investment partnerships. Nonetheless, recommendations regarding carried interests (which take the form of profits-only interests in investment partnerships) have been to disaggregate investment partnerships to cure the ill effects they cause. The byproduct of attempted investment partnership disaggregation has been complexity and a proposed law that would breach the integrity of subchapter K and adversely affect the application of other tax law provisions.

**III. Partnership Disaggregation**

Most commentary regarding profits-only partnership interests assumes the arrangements are tax partnerships and proceeds from that premise (the following discussion of disaggregation generally accepts that premise for the sake of analysis).\textsuperscript{42} Under the assumption that an arrangement is a partnership, the analysis suggests that partnership disaggregation will help properly tax profits-only partnership interests. Partnership tax law provides generally that partnerships compute taxable income and allocate it to their partners who pay tax on the partnership income.\textsuperscript{43} The character of income at the partnership level flows through to the partners.\textsuperscript{44} Thus, if a partnership has long-term capital gain on the sale of an asset, it would allocate that gain to its partners, each of whom would report the income as long-term capital gain. Similarly, income from partnership services would flow through to the partners as income from services. The rules do not consider the separate activities of the partners or what they contribute in applying the character flow-through rule.

Partnership disaggregation alters the character of partnership income as it flows from the partnership to partners. Thus, partnership disaggregation might change income that is long-term capital gain at the partnership level to compensation at the partner level. Compensation proponents appear to recommend partnership disaggregation as the appropriate method for determining the taxation of profits-only partnership interests. They use two primary analytical models to support disaggregation in the case of income allocated to the holder of a profits-only partnership interest: a partner-shareholder comparison and a contribution-focused analysis. An analysis of each method reveals their weaknesses. Furthermore, partnership disaggregation would cause complexities and difficulties that could outweigh possible benefits.

**A. Partner-Shareholder Comparisons**

The partner-shareholder comparison is a form of horizontal equity analysis. The comparison reasons that service-contributing partners are similar to service-providing shareholders and should be taxed similarly. That analysis appears to follow horizontal equity, which requires tax law to treat similarly situated taxpayers similarly.\textsuperscript{45} A convincing application of horizontal equity is often difficult, however, because all taxpayers are alike in some respects and different in some respects.\textsuperscript{46} Whether two taxpayers are deemed to be alike depends on the criteria used to establish the taxpayer comparison.\textsuperscript{47} Thus, the starting point of a horizontal equity analysis is determining the proper criteria to compare. The criteria used in the partner-shareholder comparison are: (1) the provision of services, and (2) the receipt of an interest in an entity. A service-providing shareholder

\textsuperscript{39}The legislation proposed to change the tax treatment of carried interests recognized the distinction and limited the scope of the proposed rule to investment partnerships. See proposed section 710(c) (limiting the scope of the recharacterization of income to services provided with respect to specified assets, which include only securities, real estate, commodities, and options or derivatives in such assets).


\textsuperscript{41}See Borden, supra note 40, at 338-344 (identifying potentially abusive uses of the allocation rules).

\textsuperscript{42}See supra commentary cited in notes 2-5.

\textsuperscript{43}See sections 701, 702, and 703.

\textsuperscript{44}See section 702(b).
provides services and receives an interest in a corporation. A service-contributing partner provides services and takes a partnership interest. A service-providing shareholder must recognize income as a result of the grant of compensatory corporate interest as compensation income. The partner-shareholder comparison therefore suggests that a grantee of a profits-only partnership interest should also recognize compensation income as a result of a grant of a profits-only partnership interest. The criteria used in the partner-shareholder analysis make the analysis intellectually attractive but ultimately ineffective because partnerships and corporations are distinctly different.

Comparing members of partnerships to shareholders for income tax purposes is often the proverbial comparison of apples to oranges. A significant attribute distinguishes partnerships from corporations and is relevant to the analysis of the taxation of profits-only partnership interests. The basic organizational structure of a corporation differs from a partnership's organizational structure. Corporations grant shareholders the right to elect a board of directors. The board of directors appoints officers to manage the corporation. A corporate board of directors may appoint a shareholder to be an officer, and a corporation may grant equity interests to corporate employees. Thus, an individual may be both a shareholder and employee of a corporation. A shareholder generally may not, however, act on behalf of the corporation in the capacity of a shareholder. Individuals act on behalf of a corporation in the capacity of corporate employee or independent contractor. That being the case, any property that a shareholder receives from a corporation in exchange for services provided to the corporation will be compensation to the shareholder-employee acting as a corporate employee, not as a shareholder. Taxing the grant of corporate stock to a service provider as compensation is therefore appropriate.

Partners, however, may act on behalf of a partnership in either a partner or nonpartner capacity. The same is true for members of member-managed limited liability companies. This distinction undermines the comparison of partners and shareholders. A partner's ability to act in a partner capacity often makes comparing a partner to a sole proprietor more appropriate than comparing a partner to a corporate employee. A sole proprietor acts in the capacity of a sole proprietor, not in the capacity of an employee of the proprietorship. A sole proprietor who provides services to others generates services income. A sole proprietor may also acquire rental property and perform only tenant services for the property, which would generate rental income for the sole proprietor. A sole proprietor also may acquire and hold investment property. Too much activity on the part of the sole proprietor regarding investment property will convert it to property that produces ordinary income. Otherwise, income from that property will be investment income. Thus, not all income derived from a sole proprietor's services is compensation. Tax law characterizes income derived from a sole proprietor's services depending on the comparative levels of involvement of the property and services in creating the income.

Because partners can act in their partner capacity, tax law should treat them more like sole proprietors, who act in their individual capacities. Partners acting on behalf of partnerships may generate partnership services income or partnership investment income. The distinction should depend on the level of activity performed at the partnership level. Partners who act on behalf of an investment partnership perform nominal services. The nominal services do not convert the partnership income to services income. The service provider’s services are so

---

82 TAX NOTES, October 6, 2008

(Continued on next column.)
limited in nature that the partnership remains an investment partnership. Altering the character of income as it flows from the partnership to the partner would create services income where none may otherwise be present.®7 The arrangement among partners often will differ significantly from the arrangement between corporations and service-providing shareholders.®8 The nature of partnerships and corporations also varies significantly, and partner-shareholder comparisons fail to distinguish between the various types of partnerships. Therefore, an equity analysis should not compare service-contributing partners to service-providing shareholders. An equity analysis more appropriately compares service-contributing partners to sole proprietors.

B. Contribution-Focused Analysis

Compensation proponents also rely on a contribution-focused analysis to argue for partnership disaggregation. A contribution-focused analysis merely considers what a partner contributes to determine the character of income allocated to a partner. Thus, partnership income allocated to a service contributor would be income from services; partnership income allocated to a property contributor would be income from property. Most commentary that applies contribution-focused analysis limits the discussion to service contributions. If applied at all, a contribution-focused analysis should apply to all contributions, so any analysis that focuses solely on contributed services is incomplete. Changing the character of income to reflect contributed resources will, however, produce difficult-to-justify results.

The example of Leex Partnership helps illustrate how a fully functioning contribution-focused analysis should work. Recall that the Leex Partnership agreement provided that Rex would contribute both property and services. Under a contribution-focused analysis, a portion of all income allocated to Rex would be consideration for services provided and a portion would be a return on his contributed capital. That varies from the tax treatment to Rex as sole owner. As sole owner of the office building, Rex would recognize income from the office building as rental income, and income from the sale of the office building would be gain from the sale of section 1231 property. Under a contribution-focused analysis, the character of Rex’s income would change by his contributing the building to a partnership. That result is unjustified because the building continues to generate rental income after the partnership formation. The change of tax treatment would cause inefficient results because parties would avoid partnership formation if the result would be unfavorable and form partnerships to obtain favorable tax results when possible. The inefficiency makes a contribution-focused rule unattractive.

Another unexpected result of the contribution-focused analysis is that partnership income allocated to a property contributor would be income from property. Thus, if Piers contributed dry-cleaning assets and no services to Piergan LLC, a dry-cleaning partnership formed with Morgan, all partnership income allocated to Piers should be rental income from the property or gain from the sale of the property. Thus, even though the partnership may have only income from services, when allocated to Piers, that income would transform to rental or other investment income. If Piers had contributed cash instead of property, income allocated to him should be interest income under a contribution-focused analysis. The contribution-focused analysis ignores the operations at the partnership level and considers only the partners’ contributions. Thus, the contribution-focused analysis may also require income from property to reflect the character of the property in the hands of the contributor. As a result, gain allocated to an investor from a dealer partnership should be capital gain income if the investor had contributed a capital asset. That potential result reveals how a contribution-focused analysis produces a result that is incongruous with established partnership tax rules.

The ultimate effect of a consistent application of the contribution-focused analysis would be uncertain. Some partnership income that is currently investment income would become services income when allocated to holders of profits-only partnership interests. Services income allocated to holders of capital-only partnership interests would become investment income. The result may be a wash from a revenue standpoint (the increased tax revenue from invested income converted to compensation income may be offset by service income converted to investment income). Nonetheless, if a contribution-focused analysis were to apply to profits-only partnership interests, it should apply to all other types of interests. Merely altering the tax treatment of holders of profits-only partnership interests would be inappropriate because it applies different standards to members of the same partnership. Thus, a contribution-focused analysis is an unattractive tool for analyzing profits-only partnership interests.

C. Complexities of Mis-Taxing Interests

Using partnership disaggregation to tax profits-only partnership interests raises the policy concerns discussed above. It also would cause technical complexity, which makes it more unattractive. In the case of carried interests, the proponents of partnership disaggregation appear to recognize that investment partnerships are different from other types of partnerships. Therefore, they attempt to limit partnership disaggregation to investment partnerships.®9 That attempt merely exacerbates the problems partnership disaggregation raises.

®7Income from a service partnership will not, however, be treated as services income for self-employment tax purposes if allocated to a limited partner who does not provide services. See section 1402(a)(13). For income tax purposes, it will, however, retain the character derived from the partnership and be service income to the limited partner. Section 702(b).
®9See Fleischer, supra note 2 (focusing on private equity funds); proposed section 710(c) (limiting the scope of the
Treating partnership profits allocated to a partner as compensation raises many technical complexities and threatens the integrity of subchapter K. Several commentators have revealed many of the problems such a rule would impose. Simply altering the character of partnership profits allocated to a service-providing partner misallocates the allocated amount. First, it does not provide an offsetting deduction for the amount characterized as compensation income. The payment of compensation generally results in a deduction for the party who pays the compensation. Failing to provide such a deduction creates an anomalous asymmetrical treatment of compensation. Second, it does not take into account other tax law provisions. For example, if the receipt of the interest were a taxable event under section 83, the holder of the interest would be taxed a second time on allocations of partnership income. Third, the law must consider the tax treatment of non-U.S. partners in U.S. partnerships, and U.S. partners in non-U.S. partnerships. Fourth, the law may mischaracterize gain or loss on the sale of a profits-only partnership interest and not properly account for the basis the purchaser would take in that interest. Those and many other issues demonstrate that disaggregation will cause significant technical complexities, in addition to the policy concerns discussed above.

The nature of partnerships make partnership disaggregation an unattractive method for solving the perceived inequities caused by the current tax treatment of profits-only partnership interests. Partnership disaggregation proposals also have difficulty properly distinguishing between the various types of partnerships. Furthermore, partnership disaggregation raises technical complexities that make the proposed rules untenable. A better alternative is to examine whether purported partnerships truly come within the definition of tax partnership, whether holders of profits-only partnership interests act in nonpartner capacities, and whether the definition of tax partnership is sufficiently narrow to keep undeserving arrangements out of subchapter K. The next section considers these aspects of disregarding partnerships.

IV. Partnership Disregard

“That which we call a rose by any other name would smell as sweet,” and that which is a nonpartnership by any other name, including “partnership,” should remain a nonpartnership for tax purposes. Interestingly, the recent discussions about carried interests all appear to assume that the subject arrangements are partnerships, without scrutinizing the underlying agreements and economic arrangements. Although the law provides that state law classification of an arrangement does not determine its tax classification, commentary on profits-only partnership interests appears to disregard that aspect of federal entity classification rules. Blind acceptance of state law classification would provide taxpayers the opportunity to disguise any number of arrangements as tax partnerships and take advantage of the partnership tax law accounting and reporting rules (in particular, the allocation rules), even though tax policy may not support that classification. Furthermore, even if the current definition of tax partnership includes investment partnerships, the definition may be too broad as it now stands and may need modification to ensure that it reflects current business practices and partnership tax theory.

Tax law can avoid the policy problems and complexities that result from attempting to disaggregate partnership interests by focusing on the classification of an arrangement labeled a partnership and interests labeled as partnership interests. Tax law should disregard any arrangements that do not come within the definition of tax partnership. If an arrangement is a tax partnership, the analysis should also consider whether any partners act in a nonpartner capacity. The analysis will require clearer definitions of what is a tax partnership and when a partner acts in a nonpartner capacity. With clearer definitions and better analytical techniques, partnership disregard has the potential of ending any intellectual conflict between compensation proponents and proponents of partnership-level characterization. The compensation proponents’ discomfort with current law may result from a subconscious inkling that an arrangement between two or more parties is not a tax partnership. Compensation proponents would also feel discomfort if a partnership existed and a partner acted on behalf of a partnership in a nonpartner capacity without recognizing...

63Some commentators have suggested that profits-only partnership interests should be treated as implicit or constructive loans to the service provider. See Cunningham and Engler, supra note 2 (advocating treating the carried interest as an implicit loan); Schmolka, supra note 5, at 302. (“Economically, that temporary shift is the equivalent of an interest-free, compensatory demand loan. Though the relationship among partners obviously is not that of debtor and creditor, the essential fact is that S’s services are in part compensated by S’s use of A’s and B’s money.”) Schmolka did, however, raise partnership disregard as an appropriate way to analyze the proper tax treatment of a profits-only partnership interest. See id. at 299-301. The latter recognition that a purported partnership may not be a tax partnership is the essence of partnership disregard. Constructive recharacterization misses the mark because it fails to recognize the true nature of tax partnerships and because there is no real loan. See Schler, supra note 6.

64See reg. section 301.7701-1(a)(1) (as amended in 2006) (“whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law”).

65See Borden, supra note 9, at 1010-1011 (describing the policy deficiencies of a test for tax partnerships that adopts state-law classification).
compensation income. The recommendation to disaggregate tax partnerships may be an inability to clearly identify and express the source of the problem. The misdiagnosis has led, however, to a prescription that will not alleviate the discomfort. Partnership disregard, which includes disregarding arrangements that are not tax partnerships and recognizing nonpartner activities of partnerships, may be a better prescription for the perceived ills under the current taxation of profits-only partnership interests. Narrowing the definition of tax partnership may also provide needed relief.

A. Hired Services vs. Hired Property

One method of disregarding partnerships is to recognize a purported tax partnership as either a hired-services or hired-property arrangement. As described above, a partnership is an integration of at least two persons’ property and services or an integration of the services of at least two persons. It is unlike other arrangements that join property and services. Parties can also join property and services in nonpartnership arrangements in at least two other ways. First, the property owner can hire the services, or, second, the service provider can hire the property. A disregarded partnership should generally be one of those two types of arrangements. In the case of hired services, income the service provider receives is compensation. In the case of hired property, income the property owner receives is interest or rent, depending on the type of property and use. Payment as a share of profits should not change the classification of an arrangement as either hired services or hired property. In either situation, the proprietor may determine the amount to pay for the hired item as a percentage of profits without converting the arrangement to a tax partnership.

Discussions regarding the taxation of profits-only partnership interests have focused mainly on the tax treatment of the service provider. If an analysis disregards a purported partnership, however, it should not automatically assume that the default arrangement is a hired-services arrangement. Instead, after concluding to disregard a partnership, the analysis must consider whether the arrangement is a hired-service arrangement or a hired-property arrangement. The analysis following the disregard of a purported partnership would likely focus on who controls the property and services. If the service provider controls the joint service-property arrangement, the arrangement would be a hired-property arrangement. Alternatively, if the property owner has control, the arrangement would probably be a hired-services arrangement.

After determining whether a disregarded partnership is a hired-services arrangement or a hired-property arrangement, the analysis still may not be complete. If the analysis returns the result that an arrangement is a hired-property arrangement, the service provider would either borrow money from the property owner or rent property from its owner. In those hired-property arrangements, the payments representing return on capital to the property owner should be interest or rent, even if paid out of a percentage of profits. The character of the service provider’s share of profits will depend on the use to which the service provider puts the property. If the service provider subleases the property, the service provider’s share of profit should be rental income. If the service provider invests borrowed money in investment property, the service-provider’s share of profits should be investment income. Gain from the subsequent sale of investment property should be capital gain to the borrower.

Some disregarded partnerships will undoubtedly be hired-property arrangements. Suggesting that the law should treat a disregarded partnership as a hired-property arrangement may raise a hue and cry from the

---

66 See Jerome Groopman M.D., How Doctors Think, 24 (2008) (reporting that inadequate medical knowledge is rarely the cause of medical error, whereas as many as 15 percent of all diagnoses are inaccurate); Kaveh G Shojania, Elizabeth C. Burton, Kathryn M. McDonald, and Lee Goldman, “Changes in Rates of Autopsy-Detected Diagnostic Errors Over Time,” JAMA 289, 2850-2852 (June 4, 2003) (discussing the results of a study of diagnostic error rates detected in autopsies). The medical analogy may not be too far afield as lawyers and legal scholars are also surely open to the possibility of misdiagnosing legal problems.

67 For example, a property manager could hire an office building by leasing it from the owner and subleasing it to tenants. A borrower hires money and pays for it with interest. See generally, Arthur Vennari Co. v. United States, 341 F.D 337, 342 (Ct. Cl.1965) (holding that an advance did not create a tax partnership, even though the creditor would share in the profits of the borrower); Place v. Commissioner, 17 T.C. 199, 206 (1951), aff’d 199 F.2d 373 (6th Cir. 1952) (holding that sharing of profits was not sufficient to show arrangement was a tax partnership and not a lease); 42 T.C. 1067, 1079 (1964) (holding that an arrangement was an employment arrangement, not a tax partnership, even though parties shared profits).
tax bar. An initial response may be that the arrangement cannot be a loan or a lease, and considering the arrangement from that perspective raises the debt-equity question (in the case of lending arrangements), which most of the bar would prefer to avoid. The debt-equity question is no more difficult, however, than the partner-employee question.72 An analysis that assumes away a partnership must consider all possible outcomes and justify the selection of any particular one. If nothing justifies the fixation on the hired-services approach, an analysis that merely adopts that approach is unsound.73

Once an analysis determines that a labeled partnership should be disregarded and properly identifies the arrangement, the correct tax result falls into place. The analysis turns, however, on the definition of tax partnership. The definition of tax partnership leaves much to be desired. As the separator between disregarded arrangements and tax partnership, the definition should be clearer.74 Most entity classification discussions focus on the difference between tax partnerships and tax corporations. The focus has to change. The definition of tax partnership needs further attention and refinement. Further study should also consider how to distinguish between hired-property and hired-services arrangements when an analysis disregards a purported partnership.75 Until those issues are firmly established and clarified in the law, the analysis of profits-only partnership interests will undoubtedly continue to prove frustrating. Compensation proponents will continue to sense an inequity while proponents of partnership-level characterization will worry about the integrity of partnership taxation. Proposed or adopted rules will never be satisfactory.

B. Partner-Nonpartner Capacity

An analysis may conclude that an arrangement is a partnership and that the holder of a profits-only partnership interest is a partner, but may leave compensation proponents with a bitter distaste for the tax treatment of the profits-only partners. The distaste may result from a subconscious inkling that the holder of the interest is acting on behalf of the partnership in a nonpartner capacity. In that situation, recommending partnership disaggregation flows from a misdiagnosis, and the subconscious inkling does not properly manifest itself in the recommendation to disaggregate the partnership. Parties may enter into agreements that look like partnership agreements primarily to obtain the tax benefits that only the partnership tax and accounting rules offer.76 The substance of those arrangements may prove that a so-called partner is not a partner or is acting in a nonpartner capacity.77 An interest labeled “profits-only partnership interest” may be a combination of a profits-only partnership interest and an interest in the future profits of a partnership granted to the partner for services to be performed in a nonpartner capacity.78 Such an interest would be part partnership interest and part compensatory arrangement.

If a service provider is a member of a partnership, holds a profits-only partnership interest, and acts on behalf of the partnership in a nonpartner capacity, the analysis must determine the extent to which the service provider acts in a nonpartner capacity.79 After making

72See Borden, supra note 58 (suggesting possible analytical techniques that would help distinguish the various arrangements).

73Id.

74See Borden, supra note 9, at 974-975 (suggesting that the definition should derive from tax concepts), 1028 (recommending the following as a definition of tax partnership: “a tax partnership is two or more persons, at least one of whom provides significant services, who have (or will have) common gross income”).

75This question of arrangement classification remained open after the court in TIFD III-E Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) (the Castle Harbour case), held that the arrangement was not a tax partnership but failed to identify what the arrangement was and how it should be taxed.

76See Finance Committee, supra note 7, at 228: “The fourth factor is whether, under all facts and circumstances, it appears the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available if he had rendered the services to the partnership in a third party capacity.”

77Id. “Treasury and courts should be careful not to be misled by possibly self-serving assertions in the partnership agreement as to the duties of a partner in his partner capacity but should instead seek the substance of the transaction.” The compensation proponents’ distaste may be a subconscious sense that that service providers either are not partners in substance or they act in nonpartner capacities in substance.

78The Eighth Circuit in Campbell v. Commissioner recognized that so-called profits-only partnership interests may actually be payments to a nonpartner. See, 943 F.2d 815, 822 (8th Cir. 1991): “In Diamond, where the service provider became a partner solely to avoid receiving ordinary income, we have no doubt that the receipt of the profits interest was for services provided other than in a partner capacity. That is, Diamond was likely to (and in fact did) receive money equal to the value of his services and apparently did not intend to function as or remain a partner. Thus, the receipt of his partnership profits interest was properly taxable as easily calculable compensation for services performed.”

79The law on this issue is far from fully developed. See section 707(a)(2)(A) (providing that if a partner performs services, the partnership makes a related allocation and distribution to the partner, and the services and allocation and distribution viewed together are properly characterized as a transaction between a partnership and a partner acting in a nonpartner capacity, then the allocation shall be treated as occurring between a partnership and a person who is not a partner). The legislative history of section 707(a)(2)(A) lists several factors that the Finance Committee suggests may indicate whether allocations and distributions are payments to a nonpartner and providing two examples of the application of the factors. See Finance Committee, supra note 7, at 227-230. The list has not proven entirely helpful. See McKee, Nelson, and Whitmire, supra note 23, at para. 13.02[4][A]. (“Distinguishing ‘true’ from ‘disguised’ partners is difficult. Congress identified the need to make this distinction when it enacted section 707(a)(2)(A) as part of the Deficit Restoration Act of 1984. Unfortunately, section 707(a)(2)(A) does not come to grips with the difficult task of actually making the distinction.”) Furthermore, the case law and rulings that address the distinction between a partner acting in a partner capacity and a partner acting in a nonpartner (Footnote continued on next page.)
that determination the analysis should bifurcate the service provider's share of profits into two categories. The right to future profits granted to a nonpartner (or partner acting as a nonpartner) depends on the nature of the rights granted. The right to future partnership profits granted to a nonpartner (or partner acting as a nonpartner) should trigger compensation income to the service provider either at the time of grant, as the profits accrue, or when the partnership pays the service provider. For example, if the grant gives the grantee the unconditional and transferable right to an interest in future partnership profits, the grantee should have income on receipt of the right, which would be similar to the taxation of compensatory stock. The grant of an interest in a partnership's future profits may, however, be more similar to an employment arrangement under which the employer agrees to pay the employee out of future profits. Under that arrangement, the grantee of the profits interest would recognize income as the partnership profits accrue or as the partnership pays the service provider a share of the profits. The partnership should take an offsetting deduction or capitalize the expense under existing laws.

The law taxes income allocated to a service provider properly if the service provider is a nonpartner or acts in a nonpartner capacity. The difficulty, however, is in correctly describing and identifying arrangements that are not tax partnerships and partners who act in nonpartner capacities. The intellectual power of the partnership bar, tax academics, and law makers should focus on developing tools that will help properly analyze those arrangements. Principles of division of labor suggest that academics should carefully study and articulate partnership tax theory as it relates to the difference between partnerships and disregarded arrangements and between acting as a partner and acting in a nonpartner capacity. They may consider many of the developments in the theory of the firm and other economic thought in their studies. Members of the bar may apply their technical skills and familiarity with current business practices to help create the needed tools. Surely the combined resources of both camps can work toward suitable conclusions. Attention should also focus on whether the definition of tax partnership should include investment partnerships.

C. Investment Partnership Misconception

The analysis of profits-only partnership interests will not be complete until it revisits the definition of tax partnership. The ongoing debate over the proper tax treatment of carried interests concerns the proper tax treatment of a holder of a profits-only partnership interest in an investment partnership. Earlier theoretical work has suggested that investment partnerships should not qualify for subchapter K treatment. The reasoning considers the nominal level of activity performed by members of an investment partnership. The nominal capacity are generally difficult to distinguish and do not present clear general rules for drawing the distinction. See Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977) (holding that partners who managed a partnership were not acting in nonpartner capacities because the services they provided were duties for which the partnership was created); Rev. Rul. 81-301, 1981-2 C.B. 144 (ruling that an adviser partner who managed the investment and reinvestment of a partnership's assets acted in a nonpartner capacity because the adviser general partner provided similar services to others as part of its regular trade or business, director partners supervised the adviser partner's work, director partners could fire the adviser partner, and the adviser partner could resign).

See section 707(a) (providing that a partner who acts in a nonpartner capacity shall be treated as a nonpartner for tax purposes). See also McKee, Nelson, and Whitmire, supra note 23, at para. 13.02[4][a] (discussing the tax treatment of a partner acting in the nonpartner capacity and a partnership allocating partnership items to a partner acting in a nonpartner capacity).

See section 83(a) (2000) (requiring taxpayers to include in gross income the value of property received in exchange for services at the time the beneficial interests in the property are transferable and not subject to a substantial risk of forfeiture); reg. section 1.83-3(e) (as amended in 2005) (defining property to include "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future").

The right to future profits would not satisfy the reg. section 1.83-3(e) definition of property because it would be unfunded and unsecured. Id.

One commentator cursorily concluded that holders of carried interests satisfy the factors listed in the Finance Committee's 1984 committee print, supra note 7, and therefore act as partners. See Weisbach, supra note 3. An analysis of this issue requires more than a cursory conclusion that the factors apply. The analysis must include a careful examination of the factors to determine whether they adequately distinguish between partners acting in partner and nonpartner capacities.

In 1984 the Finance Committee directed Treasury to draft regulations that would help define the line between partners acting in a partner and nonpartner capacities. See Finance Committee, supra note 7, at 226-227. As of the date of this article, 24 years after the direction from the Finance Committee, no regulations exist providing that guidance. The recent focus on carried interests suggests the time is ripe to revisit the issue and begin working to define when a partner acts in a nonpartner capacity.

See, e.g., supra note 58 (discussing economic factors that should help determine whether a partner acts in a nonpartner capacity).

See Borden, supra note 38, at 360.
activity indicates that the income of such an arrangement comes almost exclusively from the property, so property and services never combine to a significant degree — thus the capital gain treatment on sale of the partnership assets.\(^{89}\) The absence of a property-service combination in an investment partnership makes tracing simple — all income can be traced from the property to the property contributors and the property contributors should recognize income from the property.\(^{90}\) To the extent another party provides investment services, income paid to that party should be compensation. If income is paid in the form of an interest in the property, the service provider should have compensation income on receipt of the interest.\(^{90}\) Otherwise, the service provider would recognize income as a share of profits.

The current federal definition of tax partnership appears to include investment partnerships,\(^{91}\) but grants them the option to elect out of all or part of subchapter K.\(^{92}\) Partnerships that elect out of subchapter K under section 761 are qualified tax partnerships.\(^{93}\) With virtually no explanation of the reason for qualified investment partnerships, speculation directs the analysis.\(^{94}\) The breadth of the definition of tax partnership subjects investment partnerships to the subchapter K partnership tax accounting and reporting rules. The simplicity of investment partnerships (a single source of income traceable from the property) does not justify the application of the complex partnership tax accounting and reporting rules. The members of an investment partnership should merely allocate partnership income to the members based on their ownership interests. Recognizing that possibility, Congress provided an option for the arrangements — the option to elect out of subchapter K. Thus, subchapter K is elective for investment partnerships, and many investment partnerships elect to remain within subchapter K because the allocation rules provide wonderful planning opportunities.

One way to address the concern raised by profits-only partnership interests in investment partnerships (which is the source of the carried interest debate and the primary concern about profits-only partnership interests) is to narrow the definition of tax partnership to exclude investment partnerships. The option those arrangements have to elect out of subchapter K is evidence that they do not need to be subject to partnership taxation. The members of the arrangements can determine their respective shares of income and loss without use of the partnership tax accounting and reporting rules. The broad definition of tax partnership currently provides members of investment partnerships the opportunity to take advantage of the partnership tax accounting and reporting rules, even though policy does not justify it.\(^{95}\) Thus, changing the focus of analysis from the proper tax treatment of a partner with a profits-only interest to whether the definition of tax partnership should include investment partnerships would help resolve the concern raised by profits-only partnership interests in investment partnerships. Because that is the main focus of concern, such a change would resolve many of the inconveniences of profits-only partnership interests.

If the definition of tax partnership excluded investment partnerships, the analysis of carried interests would become simple. All income from the property would belong to the property owners. Any income they allocated to the service providers would be compensation income to the service providers in the case of a hired services arrangement. To the extent that the service providers become co-owners of the property upon formation of the arrangement, they would have income upon receipt of the interest in property from the owners. Existing tax laws could easily handle either type of arrangement.

In contrast, a definition of tax partnership that excluded investment partnerships would not affect the tax treatment of profits-only partnership interests in service partnerships and property-services partnerships. The income of those partnerships derives from the combination of at least two persons' services or services and property. Tracing income from the source of those arrangements is impossible, so the members need the partnership tax accounting and reporting rules. The main issue with the arrangements would be the extent to which the service provider received a share of partnership profits for services performed in a nonpartner capacity. The focus on partnership disregard helps distinguish between the different types of arrangements and the capacity in which a service provider provides services.

V. Conclusion

Profits-only partnership interests present an inviting intellectual challenge. The services contributed to a partnership by a service provider indicate that income allocated to a service provider should be compensation. Not all partnerships are alike, so such a broad statement may not be accurate as applied to services partnerships and property services partnerships. Furthermore, the nature of partnerships frustrates efforts to disaggregate them.

\(^{88}\) See supra notes 36-37.

\(^{89}\) In the case of a pooling of assets that does not have a significant services component, the parties would recognize gain upon pooling, because the pooling (as a disregarded arrangement) would not qualify for section 721 nonrecognition, unless the pooling qualified for nonrecognition on some other provision, such as section 1031.

\(^{90}\) See section 83 (a).

\(^{91}\) See Borden, supra note 38, at 331-333.

\(^{92}\) See section 761(a)(1).

\(^{93}\) The IRS coined the phrase “qualified partnership” in 1948. See I.T. 930; 1948-2 C.B. 126, 129 (“the Bureau, under I.T. 2749 and I.T. 2785] has consistently treated all such operating agreements as creating qualified partnerships” (emphasis added)). This article uses “qualified tax partnership” instead of “qualified partnership,” as used originally by the IRS, because it uses the term “tax partnership” to refer to arrangements tax law recognizes as partnerships. See Borden, supra note 38, at 325 (explaining briefly the history of the development of the qualified tax partnership concept).

\(^{94}\) Id. at 332.

\(^{95}\) See Borden, supra note 9, at 951-956 (explaining that partnership tax law should apply to arrangements that are unable to trace income from its source to the owner of the income's source).
Partnership disaggregation in turn threatens the integrity of partnership tax law and the application of other provisions of tax law. Thus, partnership disaggregation is not an attractive means for establishing the tax treatment of profits-only partnership interests.

Partnership disregard, however, presents a viable method for addressing profits-only partnership interests. Intellectual attention should focus on establishing tools for determining when a purported tax partnership should be disregarded and when a partner acts in a nonpartner capacity. Many arrangements that parties treat as tax partnerships may not actually come within the definition of tax partnership. Furthermore, many partners may act in nonpartner capacities. Thus, some interests labeled “profits-only partnership interest” may really be an employment arrangement, at least in part. If tools existed to help identify the arrangements, the taxation of disregarded partnerships would become more obvious.

Simply identifying arrangements that do not come within the current definition of tax partnership may not, however, be sufficient. Attention must also focus on the definition of tax partnership to ensure that it is not too broad. This article suggests that the current definition of tax partnership, which includes investment partnerships, is too broad. Investment partnerships have no business using the partnership tax accounting and reporting rules and should be excluded from doing so. Narrowing the definition of tax partnership would properly exclude them from subchapter K. Such exclusion would eliminate the angst created by the current tax treatment of carried interests. It would also help preserve the integrity of subchapter K. Thus, partnership disregard presents a win-win method for analyzing profits-only partnership interests.