

STEP UP IN BASIS

- An owner of any kind of entity could get an opportunity for a step-up in basis in various ways
 - Death of the owner
 - When a new owner buys in and pays the current FMV
 - Etc.
- Definitions
 - Inside basis is the entities basis in the assets it owns and, in most cases, depreciates
 - Outside basis is the sum of all owner's individual basis in their ownership interests
- When outside basis of a C-corp or S-corp shareholder increases
 - The extra basis is stuck on the outside
 - Generally the basis is useable only
 - To reduce gain on an eventual sale
 - To support pass-through losses in a S-corp
- When outside basis of a partner in a partnership is greater than or less than inside basis
 - An election under § 754 allows the partnership to bring the extra basis inside
 - Allocate extra basis to partnership assets
 - May increase depreciation
 - Excess depreciation is specially allocated back to the partner who caused the step-up (§ 704(c))
 - OR the partnership may decline to make the election
- CAVEATS:
 - Once made the election is irrevocable and applies to all future year
 - Step-down in basis is also possible



"I move that we accept the treasurer's report as having been gloated over."



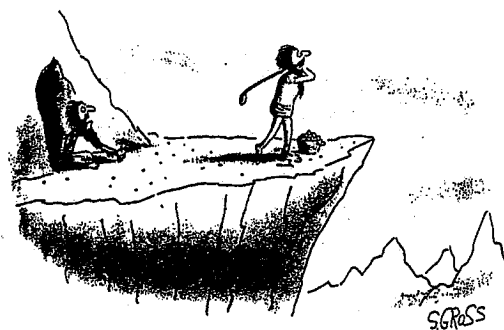
"I just want to say that I'm perfectly willing to serve as treasurer, provided every penny doesn't have to come out exactly even."

OWNERSHIP INTEREST IN EXCHANGE FOR SERVICES

- Both § 351 and § 721 specifically prohibit their application to exchanges for services
 - Also normal rules relating to compensation for past, present, or future services would not apply
- § 83 fills the gap by providing that income must be recognized whenever a taxpayer receives property in connection with the performance of services
 - A substantial risk of forfeiture delays the tax until the risk lapses, but imposes the tax at the FMV on the date the risk lapses
 - But does a profit only interest qualify as property - the courts have been inconsistent
- When a partnership interest is exchanged for services the tax consequences are based on two separate transactions under § 707 regulations
 - A proportionate share of all partnership property is treated as if it were distributed to the service partner in payment of services rendered
 - Treated as a guaranteed payment which is income to the partner and deductible by the partnership
 - The partnership property is then contributed back to the partnership in exchange for a partnership interest
 - Non-taxable under § 721
 - But partner's outside basis is equal to the fair market value of the property contributed (amount of compensation reported and therefore the basis of the property immediately prior to the contribution)
 - PARTNERHIP's basis in its assets is also increased by the compensation reported
- But what is the effect on the other partners?
 - The partnership made a guaranteed payment which generates a deduction
 - But the guaranteed payment was paid in property which generates a gain or loss at the partnership level equal to the difference between the fair market value and the PARTNERSHIP's basis



"As president of an independent island republic, I'd like to apply for a loan from the World Bank."



"If you're so enlightened, how come you can't lick that slice?"

RISKS OF FORFEITURE

- § 83 allows a PARTNER to make an election of when to recognize the income
 - When the partnership interest is transferred, or
 - When the substantial risk of forfeiture lapses
- Substantial risk of forfeiture can include
 - Future services are required before the interest vests
 - Certain income projection or other contingencies must occur before the interest vests
 - Etc.
- If the PARTNERSHIP elects taxation in the earlier year
 - Tax consequence is recognized immediately (ordinary income when compensation for services are involved)
 - Fair market value in this year is used to determine income
 - Future appreciation is taxed when the partnership interest is sold (capital gain)
- If the PARTNER elects taxation in a later year (when the risk lapses)
 - No tax consequence is recognized in earlier year
 - Tax consequence is recognized later (all ordinary income when compensation for services are involved)
 - Fair market value at the time of income recognition is used to determine the amount of income (usually a higher number)
- In nearly all cases the PARTNERSHIP gets the deduction in the same year the PARTNER recognizes the income

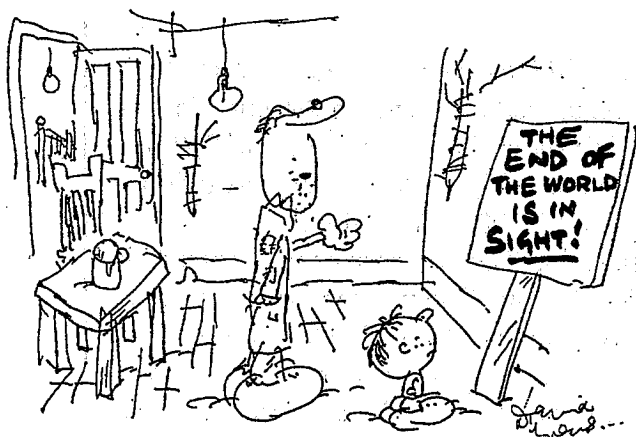
EXAMPLE

If A's interest does not vest for five years, the initial transfer has no immediate tax consequences unless the Section 83(b) election is made. Assume no election is made. At the end of five years, the partnership's assets have appreciated to \$40,000 and its basis in those assets has declined to \$10,000. Upon lapse of the restrictions (i.e., at the end of five years), A will recognize a \$10,000 gain and will take a \$10,000 inside and outside basis in the partnership. The non-service partners will be entitled to a \$10,000 deduction, offset by a \$7,500 gain. The partnership's basis in its assets will be increased to \$17,500 of which \$10,000 is attributable to A under Section 704(c) and \$7,500 to the non-service partners. If an election under section 83(b) had been made, the consequences of the transaction would have been reported in the first year.

Always yield to temptation, because it may not pass your way again.

TRANSFER OF AN INTEREST IN PROFITS

- A transfer of an ownership interest in exchange for services generates income
- So creative CPAs have turned to an interest in profits, detached from the ownership interest
- Revenue Procedure 93-27 says (because of the valuation problems inherent in a profit only interest) the exchange of an interest in profits for services will not generally be taxable unless
 - The profits interest relates to a substantially certain and predictable stream of income; or
 - The service partner disposes of the profits interest within two years; or
 - The profits interest is in a publicly traded partnership
- Note: Corporations cannot separate profits from ownership, so can't play this game
- History of a profits only interest
 - § 721 seems to exclude it from taxation
 - The Tax Court in Sol Diamond ruled that it was fully taxable when received
 - The IRS (which won in Sol Diamond) has announced that it will not follow this decision
 - The IRS has issued a series of conflicting opinions which attempt to rule that the profits only interest is sometimes taxable and sometimes non-taxable, depending on the detailed circumstances



"One day, son, all this will be yours."

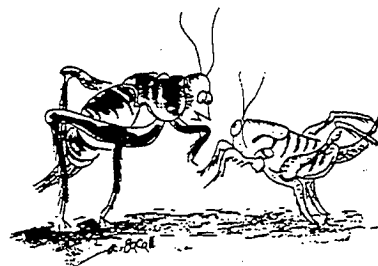


THE CAMPBELL CASE

- Mr. Campbell helped a partnership get organized and find investors
- His compensation was a percentage of future profits of the partnerships, over a long period of time
- The Tax Court found the profits only interest to be taxable
 - The usual problem in these cases is how to value the profits only interest
 - But Campbell issued a prospectus to potential investors which contained future income projections
 - The Tax Court simply discounted these income projections (but does anyone really rely on income projections in a prospectus, its all hype anyway)
- The Eighth Circuit reversed the Tax Court decision
 - The IRS which won in the Tax Court, argued against the Tax Court decision claiming
 - The Tax Court erred in finding a profits only interest received in exchange for services to be immediately taxable
 - And Campbell performed the services in the capacity of the EMPLOYEE, rather than a PARTNER
- The Eight Circuit examined § 707(a)(2) which deals with taxation of payments to a PARTNER when the PARTNER is acting in a capacity of a non-owner (employee).
 - If 707(a)(2) is to have any meaning, then whether Mr. Campbell was acting as a PARTNER or EMPLOYEE when performing the services must be important
- Campbells profits only interest was
 - Non-transferrable (could not be sold)
 - Not likely to provide any short term benefit (losses were expected for several years)
- The Eight Circuit expressed doubt that Campbell was acting as an employee
 - His only real chance for a profit was to remain a partner for the long term
- But the Eight Circuit ultimately ruled the profits only interest to be non-taxable because there was no way to put a value on it (which was the taxpayer's original argument).



"I wheeled when I should have dealed!"



"Be careful! The light at the end of the tunnel could be an ultraviolet electronic bug zapper."

