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Options to Acquire Partnership Interests: Can the Tax Law Keep Pace?

Walter D. Schwidetzky*

It has become increasingly common for partnerships to issue options that give the holder the right to acquire an interest in the partnership for a set price. The holder of the option will exercise it if he feels that the partnership interest to be acquired is worth more than the exercise price. There is a dearth of authority on the federal tax treatment of option transactions, and the Service has recently asked for guidance from the tax bar as to what approach it should take. 1 In this article I will focus on one piece of the partnership option puzzle, options to acquire partnership interests where the option is received in exchange for services (services option). 2 While I will use the term "partnership" throughout this article, I ask the reader to recall that for federal income tax purposes, it normally includes limited liability companies (LLCs) provided they have more than one member. 3

In general, I conclude that the service provider's receipt of an option is not income to her, but that she normally will incur income on the exercise of an option to acquire a "capital interest" in a partnership. The exercise of an option to acquire a "profits interest" in a partnership should not be taxable to her. I also conclude that it would be better policy if the exercise of either option were not taxable to the partnership, but that the cur-

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1 See Notice 2002-23.

2 At the outset I must acknowledge my indebtedness to the "Options Group," composed of members of the Partnerships, Real Estate, and Employee Benefits Committees of the ABA Section of Taxation. The Options Group, of which I was a member, submitted extensive recommendations to the Service on the taxation of partnership options, sexily entitled Comments in Response to Notice 2002-29 (hereinafter "ABA Comments"). My understanding of this area was dramatically improved by my participation in this group of first-rate tax lawyers. Several of the examples in this article are derived from examples in the ABA Comments.

3 Reg. 301.7701-3(b), assuming the default rule applies and no election out is made.
rent state of the law is such that it is likely that the partnership is taxable on the exercise by a service provider of the option to acquire a capital interest. The partnership probably recognizes that percentage of the gain or loss inherent in its assets equal to the percentage of the partnership acquired through the exercise of the option. The exercise of an option to acquire a profits interest should not be taxable to the partnership.

Background

Property for Services

Generally, when property is received in exchange for services, the fair market value of the property is income to the service provider. A person transferring property in exchange for services recognizes a gain or loss based on the difference between the fair market value and the basis of the property unless a code or regulatory provision provides relief.

Commonly, property transferred in exchange for services is restricted. The service provider might forfeit the property, for example, if he does not stay employed for a set period of time. Most service providers would not be thrilled to hear that such tenuous ownership rights could constitute income to them, and indeed they do not ordinarily incur income on the receipt of restricted property. Section 83(a) provides that the value of the property is not income to the service provider as long as it is subject to a "substantial risk of forfeiture." Instead, the income is incurred when the forfeiture provision lapses, with the measure of the income being the value of the property at that time.

A service provider has the option of making an Section 83(b) election and taking the property into income on receipt, notwithstanding the risk of forfeiture. The property is valued for these purposes as if there were no restrictions. The advantage of the election is that no further income is incurred when the risk of forfeiture lapses. Further, on disposition of the property, any gain is usually taxed at capital gain rates. If the service provider does not make an Section 83(b) election, then at the time the risk of forfeiture lapses the full value of the property constitutes ordinary in-

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4 Sections 83(a); 61(a)(1); see Boris I. Bittker and Martin J. McMahon, Jr., Federal Income Taxation of Individuals, ¶ 40.311 (hereinafter "Bittker & McMahon").

5 International Freighting Corp., 135 F2d 310 (2d Cir. 1943); see Bittker and McMahon, ¶ 28.411, Reg. 1.1032-1(a), for example, provides such relief when a corporation transfers stock in exchange for services. The corporation need not, in fact may not, recognize a gain or loss.

6 Under Section 83(b), the service provider has 30 days from receipt of the restricted property to make the election. It is rumored that a significant number of malpractice cases arise as a result of advisers being either unaware of the time limit or inattentive to it.
come. No loss is allowed to the service provider if the election is made and the property is subsequently forfeited. The service provider’s income is also the measure of his basis in the property (plus any amount paid).

**Capital Accounts**

It is important to understand the use of capital accounts when evaluating partnerships in the options context. Capital accounts generally are designed to measure a partner’s economic investment in the partnership. Capital accounts are increased by the amount of money and the fair market value of property (net of liabilities) contributed by a partner to the partnership and allocations to a partner of partnership income and gain; capital accounts are decreased by the amount of money and fair market value of property (net of liabilities) distributed by the partnership to a partner, allocations to the partner of expenditures of the partnership that are not deductible in computing taxable income and not chargeable to a capital account, and allocations of partnership loss and deduction. Unlike the calculation of tax basis, a partner’s share of liabilities is not included in the calculation of his capital account. Normally, a partner is paid the positive balance in his capital account on the liquidation of his partnership interest. A partner is generally not allowed to have a negative capital account, which can arise through allocations of partnership losses, unless the partner has an obligation to pay to the partnership the amount of the negative balance. That payment must be made at the time the partnership interest is liquidated, if and to the extent the capital account is negative at that time.

Partnerships often keep two sets of accounts, one set to keep track of the tax bases of the partnership assets and the other to keep track of the book values. Capital accounts are kept at book value. Thus, if a partner contributes property to the partnership, the partnership books will show the property’s tax basis and its book value. The former generally will be a carryover basis, that is the same basis as the contributing partner had in the property. The latter will reflect the fair market value of the property on contribution to the partnership.

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7 Section 83(b).
8 Reg. 1.61-2(d)(2)(i).
9 Reg. 1.704-1(b)(2)(iv)(b). An example of an expenditure that is not deductible and cannot be capitalized is a penalty or fine. See Section 162(f).
10 See Section 752.
11 Reg. 1.704-1(b)(2)(i)(b); there are exceptions when the partnership agreement contains a qualified income offset provision, Reg. 1.704-1(b)(2)(ii)(d); and when the partnership uses nonrecourse debt, Reg. 1.704-2; an explanation of either of these topics is comfortably beyond the scope of this article.
Section 704(c) and Revaluations

Under highly complex rules, Section 704(c) and its regulations generally require tax gain and loss inherent in contributed property to be allocated to the contributing partner. Any depreciation attributable to contributed property is allocated in a manner that reduces the difference between book and tax basis. To the extent possible, the noncontributing partners are allocated tax depreciation equal to their shares of book depreciation. The balance of depreciation, if any, is allocated to the contributing partner.\textsuperscript{12}

A similar issue exists when a new person becomes a partner in a partnership with appreciated or depreciated assets. Tax gain or loss earned before the new partner enters the partnership should be allocated to the continuing partners, not the entering partners. Adjustments in the way depreciation is allocated may also be necessary. One way to achieve this is to do an Section 704(b) special allocation of the relevant tax gain or loss among the partners in a way that takes the varying interests into account.\textsuperscript{13} Another way is to do a revaluation. A revaluation restates the book values and capital accounts of a partnership to fair market value.\textsuperscript{14} This has no tax consequence and the tax bases of the partnership property remain unaffected. The times most relevant to this article when a revaluation can be done are on the contribution or property to the partnership in exchange for a new or increased partnership interest and on distribution of property to a partner in exchange for part or all of that partner’s partnership interest.

If a revaluation is done, the property held by the partnership before the triggering event is treated as if it were contributed by the continuing partners to the extent of their pre-revaluation interests. The book value of the property is restated to its fair market value. Any tax gain, loss and depreciation are allocated accordingly following Section 704(c) principles.\textsuperscript{15} Thus, for example, if a new partner enters the partnership, any

\textsuperscript{12} Reg. 1.704-3. See Willis, Pennell, and Postlewaite, Partnership Taxation, ¶ 10.08(3) (hereinafter “WP&P”).

\textsuperscript{13} A gross oversimplification is again in order. Section 704(b) and its regulations generally permit allocations of partnership income and loss to be made in a manner that is not proportionate to the way the underlying interests are held. For example, a 10% partner could be allocated 90% (or all) of the depreciation deductions. Generally, in order for the allocation to be allowed it must have “substantial economic effect.” This means that capital accounts must be kept in accordance with the rules discussed above. Liquidations must be made in accordance with capital account balance, and a partner with a negative capital account balance must be restore it by the later of the end of the tax year in which the interest is liquidated or 90 days after liquidation (there are some exceptions). See Reg. 1.704-1(b)(2). In the context under discussion in the text, an Section 704(b) allocation would be used to allocate the preexisting gain to the continuing partners.

\textsuperscript{14} Reg. 1.704-1(b)(2)(iv)(f).

\textsuperscript{15} Id.
inherent tax gain or loss in the partnership property at the time of the revaluation is allocated to the continuing partners in proportion to their pre-revaluation interests, and none of such gain or loss is allocated to the new partner.

**Capital Versus Profits Interest**

The tax consequences of the receipt of a partnership interest in exchange for services depends on whether the service provider receives a capital interest or a profits interest in the partnership. A capital interest in a partnership entitles the service provider to a share of the underlying capital of the partnership. Thus, if a service provider receives a 10% capital interest and the partnership is liquidated the next day, she would generally receive 10% of the partnership assets. This is sometimes referred to as a “capital shift,” since rights to capital are transferred amongst the partners. If, as is far more common, the service provider receives a 10% profits interest and the partnership liquidated the next day, she would receive nothing since no profits had yet been earned. Generally, the partnership capital accounts should reflect the type of interest received, assuming they reflect the full value of the partnership when the partner enters the partnership.

Thus, if a partner who receives a partnership interest solely for services starts partnership life with a positive capital account, she will have received a capital interest. If she starts with a zero capital account, she will have received a profits interest.

The federal income tax treatment of the receipt of a partnership capital interest in exchange for services is clear. A contribution of property in exchange for a partnership interest is normally tax free to the contributor and the partnership under Section 721. Section 721 does not apply to a contribution of services. Accordingly, Reg. 1.721-1(b)(1)—using the phrase “right to be repaid contributions” instead of the synonym “capital interest”—provides that the service provider has compensation income when she receives a capital interest in exchange for services:

> [t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), Section 721 does not apply. The value of the interest in partnership capital transferred to a partner as compensation for services constitutes income to the partner under Section 61. The amount of such income is the fair market value of the interest in the transferred capital, either at the time the transfer is

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17 The regulations usually require that a partnership make a liquidating distribution to a partner in an amount equal to that partner’s capital account balance. Reg. 1.704-1(b)(2)(iv)(b).
made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest.

Thus, assuming no risk for forfeiture, the fair market value of a capital interest is ordinary income to the service provider on receipt. While the rule is clear, how it is fully implemented is not and the analysis can become complex in the options context, as I will discuss below.

At first blush, the quoted regulation would seem to provide that the receipt of a partnership profits interest is not income. The regulation provides that the service provider has income to the extent he receives a capital interest, "as distinguished from a share in partnership profits." If a capital interest constitutes income and a profits interest is to receive different treatment, the only different treatment that would seem to be available is for the receipt of a profits interest not to be income. Nonetheless, a series of cases held that the receipt of a profits interest was income to the service provider. This created a host of practical problems, not the least of which was valuing an interest in future profits. In fact, some cases while holding for the Government on the legal principle, concluded that the profits interest had no value. The Service, perhaps recognizing that its judicial victories created more problems than it solved, reversed its field while on appeal from a case it had won at the trial level. In Rev. Proc. 93-27, the Service provides that a profits interest is not income to the service provider unless (1) the profits interest is an interest in a substantially certain and predictable stream of income from partnership assets such as high-quality debt securities or a high-quality net lease, (2) the partner disposes of the profits interest within two years of the grant, or (3) it is a limited partnership interest in a publicly traded partnership. Usually a service provider will not meet any of the exceptions and thus not have to include the value of a profits interest in income.

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18 See Diamond, 56 TC 530 1971, aff'd 33 AFTR 2d 74-852 (7th Cir.); Campbell, TCM 1990-162 (1990), reversed on other grounds, 943 F.2d 815 (8th Cir. 1991); St. John v. United States, 84-1 USTC ¶ 9158 (C.D. Ill. 1983).


21 Campbell, TCM 1990-162 (1990), reversed on other grounds, 943 F.2d 815 (8th Cir. 1991).

22 1993-2 CB 343.
Recently, the Service provided additional clarification in Rev. Proc. 2001-43.\textsuperscript{23} The Service concluded that the determination as to whether an interest is a profits interest is made at the time the interest is granted, even if it is not vested at that time. If it is a profits interest, there is no income either on receipt or on subsequent vesting, assuming the requirements of Rev. Proc. 93-27 are met when it is received.\textsuperscript{24} This is important because by the time of vesting the partnership could have earned profits that had not yet been fully distributed and that thus could be reflected in the service provider's capital account. This in turn might suggest that the service provider had received a capital interest instead of a profits interest. The ruling is decidedly taxpayer-friendly and probably also appropriate from a tax-policy perspective. If the interest had vested immediately, it would not have been taxable to the service provider, and it seems reasonable for that tax consequence to remain unchanged when vesting is delayed. The Revenue Procedure, however, seems to conflict with the logic of Section 83. That provides for valuation of the interest and, presumably, ascertainment of its type, at the time of vesting. Of course, the service provider could make an Section 83(b) election and avoid compensation income even without the Revenue Procedure. Perhaps that fact motivated the Service to take the position it did in the Revenue Procedure. Had the Revenue Procedure stuck with the logic of Section 83, informed taxpayers would still typically have avoided income, uninformed taxpayers would have had income on vesting. The tax law does not need any more traps for the unwary.

With hopes of having adequately armed the reader, I move on to a discussion of services options.

**Options to Acquire a Capital Interest in Exchange for Services**

Regulation 1.721-1(b)(1) unambiguously provides that the receipt of a vested partnership capital interest in exchange for services is income to the service provider. It does not provide any guidance with respect to the receipt of an option to acquire a partnership interest. The Section 83 regulations pick up the slack. Regulation 1.83-7(a) provides that in the case of an option given in exchange for services, Section 83(a) does not apply on the grant of the option unless the option has a readily ascertainable fair market value. The regulation does not limit itself to any particular type of option and presumably applies to an option to acquire a partnership inter-

\textsuperscript{23} 2001-34 IRB 191 (August 3, 2001).

\textsuperscript{24} See Glenn E. Mincey, Eric B. Sloan, and Sheldon L. Banoff, "Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests—the Final Facet of Diamond?,” 95 J. of Tax’n 205 (2001).
In order for an option to have a readily ascertainable value it must be either publicly traded, or (among other requirements) (i) be transferable, (ii) be immediately exercisable, and (iii) not be subject to a restriction or condition which has a significant effect on value. In addition, the fair market value of the option includes the value of the entire option privilege, including the right to profit from any appreciation in the underlying partnership assets, all of which must be measurable with reasonable accuracy. In the case of a services option, these conditions will almost never be met. Even if the option is heavily “in the money” and exercise a virtual certainty, it will likely not be possible to measure with “reasonable accuracy” the right to profit from appreciation in partnership assets. Accordingly, it will be very rare for the service provider to incur income on receipt of an option to acquire a partnership interest.

The regulation makes sense. Usually, an option to acquire a partnership interest would have a highly speculative value, one so speculative in fact that the service provider could often be justified in giving it almost no value. If receipt of the option was a taxable event, service providers would have an easy way to end run the fisc. Rather than receiving a partnership interest, still difficult to value but certainly easier than an option, the parties would agree to interpose an option. The service provider would recognize little if any compensation income and then would exercise the option. Since the compensation income, however minor, would already have been recognized, when the option is exercised there should not be another taxable event. Any future gain will typically await disposition of the interest and the associated gain likely would be capital gain taxed at favorable rates. It should not be that easy to reduce compensation income, hence the regulatory rule that ordinarily a transaction is held open during the pendency of the option.

If receipt of the option is not a taxable event, there is no basis for any tax consequence to the partnership or its partners on the issuance of the option. There should be no deduction to the partnership and also no adjustment to the partnership capital accounts. Since the grant of the services option does not represent income to the service provider, he should incur no loss should the option lapse unexercised except to the extent that he paid some amount for the option.

Reg. 1.83-7 is entitled “Taxation of Nonqualified Stock Options,” but nothing in the content of the regulations limits its application to stock options.

Reg. 1.83-7(b)(3).

See Sections 1(h), 1001. Of course, gains and losses from the partnership would still flow through to the partner. If disposition awaits death, gain could be avoided altogether since the heirs normally take a fair market value basis in the interest. Section 1014.

See Section 1234(a)(1).
Regulation 1.83-7(a) governs the tax consequences if the partnership repurchases the option or if the service provider sells the option to another. Now that the service provider has "cashed out" of his option, it seems an appropriate time for income recognition and that is exactly what the regulation requires. The service provider recognizes ordinary compensation income when an option not included in income on issuance is subsequently "disposed of." The measure of income is the amount received on the disposition. In the event of a repurchase of the option, the partnership typically would have a deduction equal to the amount paid, assuming the services are of a type that gives rise to a current compensation deduction.\(^29\) None of this should have any capital account impact.\(^30\) There is no authority for treating the sale of the service option to a third party as a tax-significant event to the partnership or its partners, and there is no reason to think there should be any.

Life gets more interesting if the option is exercised. I will use the following examples to flesh out many of the tax issues that then arise, beginning with an important pre-exercise issue: How to handle a new partner who enters partnership while the option is outstanding but certain to be exercised.

**Example 1**

A and B form a partnership on January 1 of year 1 and each contributes $200 to its capital. The partnership uses the $400 to purchase raw land. On February 1 of year 1, the partnership issues an option to S in exchange for services S rendered in helping the partnership acquire the land. The services added no value to the land. The option entitles S to acquire a one-third interest in the partnership capital and profits in exchange for a contribution of $200. The option may be exercised any time during the subsequent 5 years. On January 1 of year 2, while the option is still outstanding, C obtains a one-third interest in the partnership. At that time the land remains the only asset of the partnership and is worth $720. Under the terms of the option, the interest S is entitled to acquire for $200 is reduced from one-third to one-fourth.

The first question is what C would pay for a one-third interest. Without S's option, C would pay $360 ($720 + $360/3 = $360). Since the op-

\(^{29}\) Section 83(h) and Reg. 1.83-7; if a taxpayer realizes meaningful benefits from an expenditure beyond that tax year in which an expenditure is incurred, the expenditure must be capitalized rather than expensed. It may be possible to recover the capitalized expenditure through depreciation or amortization. Sections 263, 168, Indepco, Inc., 503 U.S. 79 (1992).

\(^{30}\) Other than, of course, the associated deduction flowing through and reducing the partner's capital accounts.
tion is heavily in the money, it is highly likely that S will contribute $200 to exercise the option. C would likely assume that S will exercise the option and pay only $306.66 for the partnership interest ($720 + $200 + $306.66/4 = $306.66). That will be C’s basis in the partnership interest.

The next question is what the partners’ capital accounts should be. The entry of a partner provides an opportunity for a “revaluation.” As discussed above, a revaluation is a nontax adjustment that restates the capital accounts and book bases of the partnership assets to fair market value. Revaluations are only allowed under limited circumstances, the relevant ones in this context being on contributions or distributions of property or money in exchange for a partnership interest. If S’s potential interest in the partnership is ignored, the total value of the partnership is $720 + $306.66, or $1026.66, and each partner’s capital account would be one third of that amount, or $342.22. This approach would give C a capital account exceeding the amount of the funds he just contributed, an anomalous result. But it, of course, does not make sense to ignore S when S in all probability will exercise the option. The logical amount by which to value the capital accounts of A, B and C is $306.66, the amount C paid and the value of each partner’s interest assuming a current exercise of the option of S. Is it possible to do that under the regulations? The answer is unclear. Regulation 1.704-1(b)(2)(iv)(f)(1) provides that “the [revaluation] adjustments are based on the fair market value of partnership property, ...on the date of adjustment.” Since the fair market value is $1026.66, one could read the regulation to require the capital accounts to be increased to $342.22. The regulation does not say, however, that the revaluation must yield capital account balances that are equal to the fair market value of the partnership property, but simply that the adjustments be based on the fair market value. Since the calculation of the economically more appropriate $306.66 does take the fair market value of the partnership property into consideration, as well as S’s outstanding option, one could argue that indeed the capital account adjustment is based (albeit not exclusively) on the fair market value of the partnership assets and complies with the regulation.

Of course, S might not exercise the option in fact. The value of the partnership property could drop precipitously. But it seems clear that C would discount what he would pay due to S’s option. Likely the amount of the discount would be substantial, though C might reduce it somewhat to factor in the possibility of S not exercising his option. I have ignored these value adjustments to keep the example reasonably simple.

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31 This means that the option exercise price is well below the value of the partnership.
32a If S does not exercise the option in fact, C’s capital account most likely will not accurately reflect the value of his partnership interest. This is not a problem. In the snapshot taken when C acquired his interest, his capital account properly reflects what he paid and the value of the partnership interest at that time. There can always be subsequent events that change the values.
Calculating the capital accounts of the partners by taking S's outstanding option into consideration avoids any artificial capital shift and inappropriate gain recognition on S's entry. If A, B, and C's capital accounts are valued at $342.22 before S's entry into the partnership, then a capital shift could take place when S enters the partnership. Assuming the values do not change, then upon S's entry the four partner's capital accounts should be $306.66 each, assuming the partnership does a revaluation (permissible since S contributed money to exercise the option). That would suggest that capital has been shifted from A, B, and C to S. Since the transfer of property in exchange for services is a taxable transaction to the property transferor, the capital shift suggests a taxable event for A, B, and C. As I will discuss below, S's entry into the partnership may be a taxable event for A, B, and C, but that taxable event should not result from an artificial capital shift. A, B, and C should not be given a capital account of more than $306.66 for the reasons discussed above.

If the values do not change, when S exercises his option he will pay $200 and receive an interest worth $306.66. He will recognize $106.66 of ordinary, compensation income on the transaction and the partnership will receive a deduction of that same amount, assuming S's services are of the type for which Section 162 allows a current deduction. Logically, the deduction should be allocated to the continuing partners. The calculation of S's capital account is problematic as the regulations do not permit the value of a capital account to be increased for the value of services, but only by the amount of money and fair market value of contributed property. If S is only given credit for the money contributed, S would have a capital account of $200, less than the actual value of the interest. Yet capital accounts on entry of a partner should measure the full value. While a revaluation permits the partnership to restate existing capital accounts to fair market value, it is not clear whether or not it permits an entering part-

33 International Freighting Corp., 135 F2d 310 (2d Cir. 1943); see Bittker and McMahon at ¶ 28.4[1].

34 See notes 47 to 65 infra and accompanying text.

35 The gain recognized might be offset, at least in part, by a deduction. The compensation income to the service provider would be treated as a deductible payment of compensation to the partnership, assuming the payment would qualify for a current deduction and not need to be capitalized. See note 36 infra.

36 Generally, a business expenditure will generate a current deduction if it does not provide significant benefits beyond the current tax year, and it must be capitalized and depreciated or amortized if it does. See Indopco, Inc., 503 U.S. 79 (1992) and Sections 167, 168. Section 83(b) modifies the general rule by providing that in the case of payment for services with restricted property, payer can only take the deduction in its tax year in which the service provider includes the property received in income.

ner to receive a capital account greater the value of what he contributed. If not, a way around this dilemma is to use the "cash out cash in" method, though there is no authority for this approach in the partnership context. Under this approach the partnership would be considered to have paid S $106.66 for his services, then S would be considered to have contributed a total of $306.66 for his partnership interest. S ends up with an appropriate capital account of $306.66. Since maintaining correct capital account balances is vital, the regulations should be amended to either adopt the cash out cash in method or permit capital accounts to be increased by the value of contributed services at least where necessary to get to a proper amount. Actually, that authorization might already exist. Regulation 1.704-1(b)(2)(iv)(q) provides for appropriate adjustments to capital accounts where the existing rules do not provide adequate guidance and the adjustments are necessary to properly reflect the underlying economic arrangement of the partners. Conceivably this regulation could be used to get S to the right capital account balance. The regulation, essentially a stop-gap measure, gives little guidance on when it should apply, however, and more specific direction is necessary in this area.

Besides the deduction, the partnership may have gain to recognize. In a nonpartnership context, if a person transfers property in exchange for services, he recognizes the gain or loss inherent in the property. Presumably, that same rule should apply to partnerships. The question is how. Preliminary questions are who is transferring the property and what is the property transferred. Partnerships are sometimes considered an entity apart from its partners and sometimes are considered to not be a separate entity.

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38 Reg. 1.704-1(b)(2)(iv)(f) provides that a partnership may "increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property." "Partners" here could conceivably include the entering service partner, though ordinarily revaluations are thought of as applying to the continuing partners, not entering ones. See WP&P, ¶ 10.04[3][c].

39 See ABA Comments, ¶¶ 4.4(a) and 6.1. Also see Alan Gunn, Partnership Income Taxation (3d ed.) at p. 40 (hereinafter "Gunn"). This approach is used in the Section 1032 context. Section 1032 provides that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of the corporation. Reg. 1.1032-1(a) provides that a transfer by a corporation of its own stock as compensation for services is considered as a disposition by the corporation of such shares for money or other property. The regulatory language suggests a cash out cash in approach. The service provider is, in effect, considered to be paid money and then using the money to buy the stock from the corporation. This brings the issuance of the stock under Section 1032 and makes its issuance tax free to the corporation.

40 International Freighting Corp., 135 F2d 310 (2d Cir. 1943); see Bittker and McMahon, ¶ 28.4[1].

41 Interestingly, the Service appears never to have made this argument, even in cases where it argued that the value of a partnership interest received in exchange for services is income. See note 18 supra.
but rather an aggregation of the partners. I will use the following example to explore this area:

Example 2

A and B form a partnership on January 1 of year 1 and each contribute $200 to its capital. The partnership uses the $400 to purchase raw land. On February 1 of year 1, the partnership issues an option to S in exchange for services rendered in helping the partnership acquire the land. The services added no value to the land. The option entitles S to acquire a one-third interest in the partnership capital and profits in exchange for a contribution of $200. The option may be exercised any time during the subsequent 5 years. On January 1 of year 3, when the land remains the only asset of the partnership and is worth $550, S exercises the option. In this scenario, S is receiving an interest worth $250 (($550 + $200)/3), is paying $200, and so has $50 of income. The partnership would commonly have a deduction equal to S’s income.

I will address treating the partnership as a separate entity first. In this case the property that the partnership is transferring on exercise of the option is the partnership interest. If the partnership did a revaluation on S’s entry, the book value of its assets and its capital accounts would be restated to fair market value. I am aware of no authority for adjusting the partnership’s basis in its own to-be-issued interests, however. Conceivably, the partnership could have book gain on the disposition of its partnership interest. This would not make a lot of sense, given that all of the assets and capital accounts are restated to fair market value at the time of the revaluation, and any additional book gain from disposition of the partnership interest would increase the capital accounts beyond their fair market values. Accordingly, the better approach would be to not recognize book gain on the transfer of the partnership interest to S. Here the transfer is partly for property and partly for services. Section 721(a) shields the partnership from recognizing gain to the extent the partnership interest was transferred for property, but not to the extent the transfer was for services. Thus, the partnership would recognize a tax gain or loss on the services part of the transaction. As noted above, that has a value of $50. The partnership’s basis in its own interest should be zero, and thus there would be $50 of gain to the partnership.

The gain would presumably be allocated equally to A and B. The difficulty with this approach is that it would ultimately cause A and B to recognize the same economic gain twice and cause a timing distortion.

42 See WP&P, ¶ 1.04.
The gain is attributable to the underlying property, but if it is the partnership interest that is deemed exchanged, there would be no basis adjustment to the property. There would, however, be an increase in the bases in A’s and B’s partnership interests of $25 each for their shares of the gain. 44 When the property is sold, in effect that same $25 of gain would be recognized again, and it would again increase A’s and B’s outside bases. If all the gain and losses inherent in the partnership property were recognized, A and B would ultimately have a basis in their respective partnership interests that was $25 higher than the fair market value of the interest; that is, there would be an loss of $25 inherent in each partner’s basis. That loss when recognized would offset the prior “extra” $25 of gain that was recognized, but there would be a timing distortion as the loss might be recognized many years after the gain was recognized. 45 Further, A and B would take any unrecognized losses with them when they die. 46 Given that these disjunctures yield inappropriate results, it would be preferable not to use the entity approach, at least if the aggregate approach yields better results. As I discuss next, it does.

Under an aggregate approach, while the property would never actually leave partnership solution, A and B are considered to sell their proportionate shares of one third of the partnership assets, since S is becoming a one-third partner. The only partnership asset, the land, has a fair market value of $550 and a tax basis of $400. Accordingly, A and B are viewed as selling one third of the asset with a fair market value of $183.33 and a basis of $133.33. The gain of $50 is allocated equally to A and B, or $25 each. Since S has income of $50, A and B will also have a deduction of $50, assuming S’s services are of a type that give rise to a current deduction. 47 Accordingly, for A and B the transaction will be a tax wash. Their tax bases in the partnership interests will be increased for the $50 of gain and then reduced by a $50 deduction.

S is considered to acquire an asset with a fair market value of $183.33. While the ultimate outcome would not be changed whether S is considered to acquire the property for cash or part cash and part services, I will assume for the sake of simplicity that S acquires the property for cash. 48

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44 Section 705(a)(1).
45 Note that there should not be a character distortion since the gain and loss should be capital in nature.
46 Section 1014 gives an heir a fair market value basis in the inherited partnership interest, eliminating the inherent loss.
47 Sections 162, 83(h).
48 S is contributing cash of $200 and services of $50. For purposes of the calculation, it does not make any difference what proportions of cash and services are allocated the property acquisition. No matter how it is done, S ends up with a basis in the property.
His Section 1012 cost basis thus is $183.33 and he is then considered to contribute the property to the partnership which takes a carryover basis in it under Section 723. S’s basis in the partnership interest is $183.33 plus the balance of cash he contributes or $17.67 plus the compensation income of $50 for a total of $250. The holding period of the partnership in the asset and of S in the partnership interest starts afresh. If a revaluation is done on S’s entry, the partnership capital accounts are booked up to fair market value of $250 per partner. The aggregate approach obviously yields more sensible results for all of the parties than the entity approach and would be the one to use in this context. The tax gain is recognized in an appropriate amount only by the parties who earned it; the capital accounts accurately reflect the value of the partners’ interests, and the tax and book bases are not out of balance.

Comment on the ABA Comments

In the ABA Comments, members of the ABA Tax Section responded to the Service’s request for comments on how the issuance and exercise of partnership options should be taxed. The ABA Comments recommend that no gain be recognized by the partnership when a service option is exercised. The ABA Comments point to the treatment of corporations and Section 1032 in this regard. Section 1032 generally provides that a corporation does not recognize gain or loss when it issues stock for money or property. The regulations extend that treatment to the issuance of stock in exchange for services. There is no analogous regulation in the partnership context,

deemed transferred to him of $183.33. See note 49 infra. S’s compensation income is also unaffected. S is ultimately paying $200 for something worth $250, and so has $50 of compensation income no matter what is swapped for what.

Section 1012, International Freighting Corp., 135 F2d 310 (2d Cir. 1943); see Bitker and McMahon at § 28.4[1].

See notes 13 to 15 supra and accompanying text. While the revaluation regulations, Reg. 1.704-1(f)(2)(b)(iv)(D), do not state exactly at which time point the revaluation occurs, presumably it happens after the tax and book account consequences of S’s entry have been calculated. Thus, $50 of book and tax gain and deduction precede the revaluation. To do otherwise would mean that the capital accounts would not reflect the fair market value of the partnership assets, i.e., $750 total value and capital accounts of $250 per partner.

See note 2 supra.

Also see Gunn, at 40-41.

Reg. 1.1032-1(a); see note 39 supra. Neither Section 1032 or its regulations discuss the interposition of an option, though that should not change the regulatory result. If issuing the stock for services is not taxable to the corporation, neither should the issuance of a services option to acquire the stock. The issuance of the option would generally be a nontaxable event under Reg. 1.83-7. The exercise of the option would typically involve the exchange of property for stock, bringing the transaction under the literal language of Section 1032.
and the ABA comments acknowledge that the more general rule of gain recognition could apply. As the ABA Comments note, until recently there may not have been a need to address the issue. Partnerships of professionals have been common for some time. While in the service business, professional partnerships do not typically issue capital interests for services. New partners make what is often a relatively modest capital contribution and thereafter share in future profits. It is only fairly recently, particularly with the advent of LLCs, that the use of tax partnerships for nonprofessionals has become widespread and with it the need to address the issue.

As the ABA Comments note, when a new partner enters a partnership by contributing cash or property, Section 721 generally provides that no gain or loss is recognized, even though the preexisting partners may hold appreciated interests. It is not apparent why the rule should be different for a contribution of services for a partnership interest. Accordingly, the ABA Comments would recommend the cash out cash in approach of the Section 1032 regulations. In Example 2, the partnership would be considered to have paid $550 in cash and S would be considered to have contributed $250 to the partnership. If this hypothetical restructuring were respected, Section 721 would shield the deemed contribution from gain or loss to S and the partnership (though S would still have $50 of income on the deemed receipt of $50 of cash, of course).

The ABA Comments’ reference to Section 1032 is dubious. The corporate and partnership tax rules involve two very different statutory regimes. Corporations are, of course, taxed very differently than partnerships. In the case of a c-corporation, income can be taxed twice, once at the corporate level and a second time when dividends are distributed. Part­nerships are flow-through entities with taxation occurring only at the owner level. Property generally cannot leave corporate solution without the inherent gain and, in the case of liquidations, loss being recognized. This is not generally true for partnerships. Doubtless no one would argue that partnerships should be subject to the same rules as corporations in these regards. It is, to put it mildly, questionable to cherry pick a more taxpayer-friendly regulation out of the corporate tax mix and say similar rules should apply in the partnership context. Given the more onerous tax burden to which corporations are subject and the specific benefits Congress con-

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54 See ABA Comments, ¶ 6.2(ii).
55 Id. See note 39 supra and accompanying text.
56 Sections 11, 61, 316.
57 Sections 311(b), 336(a).
58 Sections 731(b); there are exceptions; see Sections 704(c)(1)(B) and 737.
ferred on corporations with Section 1032, the Service could reasonably
give corporations an advantage in the area of stock for services without
doing the same for more generously treated partnerships.59

While it is true that tax partnerships have become more common
with the advent of LLCs, it is not as if the Service has not thought exten­sively about the partnership interest for services issue. The Service has
been on record for some time as stating that if someone receives a capital
interest in exchange for services, Section 721 “does not apply.”60 The Ser­
vice has been involved in extensive litigation in the area.61 It is hard to see
the increased use of LLCs somehow trumping all that history. While the
Service could conceivably promulgate regulations under Section 721 like
those under Section 1032, and the ABA Comments imply it should do so,
the Service is likely institutionally incapable of taking that deep of a breath.
It would be a first order about face for the Service to say now that contri­
bution of services to the partnership are not taxable to the partnership.

Nonetheless, there is a strong argument in favor of the approach of
the ABA Comments. It is one that I feel does not get made often enough.
This is the need for simplicity. The complexity of the tax law in out of
hand, and there needs to be a focus on reducing complexity, particularly in
cases where doing so involves little risk to the fisc. If the aggregate ap­
proach is used, as discussed above, the continuing partners will have to
recognize their shares of the relevant gains and losses inherent in partner­
ship property (albeit possibly with a compensation deduction). That will
require a valuation of those assets. In a partnership with many assets, it
could be difficult, often speculative, and possibly expensive to value the
assets.62 Also, many partnerships have shifting allocations of partnerships
gains and losses, and it may be difficult to know what a given partner’s
share of gain or loss from a given asset is.63 Further, if gain recognition is
required, particularly where there is no offsetting compensation deduc­
tion,64 the partnership will simply plan around it. The partnership can do
this by issuing profits interests instead of capital interests in exchange for
services, perhaps increasing the profits share to compensate for a lack of
an immediate participation in capital.

59 For a contrary view see Gunn, at 40-41.
60 Reg. 1.721-1(b)(1).
61 See notes 18 to 23 supra and accompanying text.
62 See note 73 infra and accompanying text.
63 To use a simple example, the partnership might provide that 90% of the gains and
losses are allocated to the “investor” partners until they have been allocated gains equal
to the prior allocation of losses, and thereafter gains and losses are allocated equally
between the managers and the investors.
64 See note 36 supra.
As I will discuss below, the issuance of a profits interest is usually not taxable to the partnership.\textsuperscript{65} This rule should not change if what is issued is an option to acquire a profits interest. Moreover, a partnership would be in the position to manipulate the system, particularly where valuation of the assets is not unduly burdensome. It would issue an option for a capital interest and create a taxable event when the partnership anticipates holding mainly loss assets. It might also do so when it is able to offset any gain with a current compensation deduction as there may be no net tax effect and the bases of partnership assets could be stepped up. It will issue an option for a profits interest and avoid a taxable event when it holds mainly gain assets and/or when it cannot offset all of the gain with a compensation deduction. There are other variations on the theme. A partnership might be more willing to recognize a gain if its partners have sufficient net operating loss carryovers. The point is that the partnerships can readily achieve the tax consequences they want by changing the form. While a capital interest admittedly represents a bird in the hand and a profits interest—which necessarily looks to the future—does not, in reality service providers and the continuing partners are usually focused on the partnership's profit generating capacity and not on the immediate liquidation value of the partnership assets. Thus, the typical service provider, while perhaps preferring a capital interest, will tend to be open to receiving a profits interest, particularly since it normally will not constitute income to her. Ultimately then, the cash out cash in method suggested by the ABA Comments provides a system that will likely cost the fisc little revenues and make the tax laws simpler and easier to administer.

One question is whether the Service could limit such a change to options. If the exercise of an option to acquire a capital interest is not taxable, but directly receiving a capital interest for services is, parties will be tempted to interpose an option in the compensation setting. As I said above, it seems doubtful the Service would be willing to walk away from the underlying rule that a capital interest received in exchange for services is taxable to the partnership. Doing so, though, would likely generate little loss to the fisc given the easy alternative of giving a profits interest and avoiding taxation. If the Service cannot see its way out of the underlying rule, it can still carve out viable exception for options by making the option price meet some minimum standard, perhaps 20\% of the value of the capital interest that would be acquired measured at the time the option is issued. Making the service provider pay a significant amount on exercise of the option would substantially impede the undue use of options to end-

\textsuperscript{65} See discussion under "Option to Acquire Profits Interest in Exchange for Services" below.
OPTIONS TO ACQUIRE PARTNERSHIP INTERESTS

run the underlying rule that the issuance of a capital interest for services is a taxable event to the partnership as well as the service provider.

As I discussed above, to make the numbers "crunch" right and avoid inappropriate capital shifts, the partnership may need to revalue partnership assets and capital accounts. Revaluations are generally optional, but a revaluation may be critical for an intelligent calculation of capital accounts. Partnerships ordinarily abide by the "substantial economic effect rules" which provide for capital account calculations and require that on liquidation of a partnership interest a partner be paid the balance in his capital account.66 In Example 2, when a revaluation is done, the "book basis" of the partnership property is stepped up to fair market value of $550. The tax basis, of course, remains unchanged. As I also discussed above, when a revaluation is done, the regulations require that Section 704(c) principles be followed in allocating the tax gain or loss. Section 704(c) generally provides that tax gain or loss inherent in contributed property must be allocated to the contributing partner. Following Section 704(c) principles after a "book-up," means that the tax gain equal to the book gain immediately before the book up will be allocated to the continuing partners. In example 2, A and B are treated as if they had contributed property with a fair market value of $550 and a tax basis of $400. The $150 of inherent gain is taxable to them when recognized. Any gain in excess of that amount can be allocated between the partners based on their general partnership interests, in this case one third each to A, B, and S.

Not doing a revaluation can cause problems. Assuming the property held by the partnership remains at a book and tax basis of $400 and a fair market value of $550, how should the book and tax gain be allocated if there is no revaluation? Logically, it should be in the same manner as it was in the case of a revaluation. The partnership would specially allocate to A and B the book and tax gain that was earned when they were the sole partners. If this is not done, all of the book and tax gain would be allocated one third to each partner. S would receive more tax gain than he truly earned and could have a capital account in excess of fair market value of his interests, since his capital account should have been equaled fair market value on his entry into the partnership. This higher amount is not just an accounting entry since, as noted above, S is entitled to his capital account balances on liquidation.67 Barring inadvertence, hardly an impossibility given the complexity of the code, this suggests that something else is going on. Perhaps S is receiving disguised compensation.68 While spe-

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66 Reg. 1.704-1(b)(2)(i),(ii).
67 See notes 8 to 11 supra and accompanying text.
cial allocations are a viable alternative to revaluations, revaluations have the advantage of “resetting” the capital accounts to where they need to be each time a partner enters and exits. It also helps serve as a reminder of how tax gain and loss needs to be allocated down the road when the property is sold, something that the parties might lose track of as the years go by.

Moreover, it is difficult to do a revaluation downstream if it was not done upstream. If a revaluation is not done in Example 1 on C’s entry into the partnership, and the values change before S’s entry, doing a revaluation on S’s entry could be problematic. It is not clear from the regulations how a revaluation on S’ entry would work. Would the tax gain earned before the revaluations, when A and B were partners, still be allocable only to A and B, and would C only be allocated the tax gain (or loss) that was incurred after C became a partner, or would all such gain and loss be allocated one third each? Further, the partnership may not have kept adequate books and records for the calculations.

As I discussed above, revaluations are only allowed under limited circumstances, the relevant ones in this context being on contributions or distributions of property or money in exchange for a partnership interest. These requirements were met in the examples, as the revaluation occurred on C’s or S’s entry into the partnership, when money was exchanged in whole or in part for the partnership interest. And indeed, in the typical service option scenario, cash or property will be contributed and a revaluation will be allowed. Further, if the suggestion of the ABA Comments is adopted, the entry of a service partner will normally be deemed to include a contribution of money. Outside the option context, partnership interests are often issued exclusively for services. It is also conceivable that this could occur in the options context, with the exercise of the option being triggered by the performance of services. If only services are contributed in exchange for a partnership interest a revaluation is not permitted, as no contribution or distribution of money or property is involved. It is not apparent why this is so. The partnership is receiving value, and all the issues that justify a revaluation when property is contributed still exist. There can still be precontribution gain or loss inherent in partnership property that should be allocated to the continuing partners. It is unlikely that Regulation 1.704-1(b)(2)(iv)(q) can be used to solve this problem as the revaluation regulations are very specific on when a revaluation can be made and it does not seem that the “q regulations” can be used to add an alternative that the Service presumably consciously omitted.

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70 See note 55 supra and accompanying text.

71 See notes 39 to 40 supra and accompanying text.
vice should amend its regulations to permit revaluations on the contribution of services. 72

The challenge of a revaluation is the need to reappraise the assets and capital accounts of the partnership, particularly for partnerships that do not hold publicly traded assets. The regulations provide some assistance in this regard and generally respect how the partnership does its valuations if they are "reasonably" agreed to by the partners acting at arm's length, and the partners have sufficiently adverse interests. 73 Thus, the partners commonly can do the valuation based on their own estimates of value without the need to incur the expense of hiring a professional appraiser, at least as long as they act in good faith. It would be helpful if the Service would provide some kind of a safe harbor as to when partners are acting "reasonably" and at arm's length. Perhaps any valuation within 20% of what a professional appraiser would estimate could be deemed to meet the standard. Such a standard would tend to restrain the Service from challenging partnership valuation estimations, since it would have to go to the expense of hiring an appraiser and expect the taxpayer's appraisal to be far afield. Some additional guidance as to what constitutes arm's length negotiations would be valuable. Can family members ever be at arm's length? What about employers and employees or related corporations? Many family partnerships will not have what could reasonably be considered arm's length partners. Yet these types of partnerships are common and revaluation issues could of course arise for them as well. Given the importance of revaluations, particularly in the options context, the Service should consider adopting rules so that family partnerships could also do revaluations without the expense of hiring an independent appraiser. In many cases, the expense of retaining an appraiser will make the revaluation impractical. Again, perhaps a 20% standard could be applied.

Option to Acquire Profits Interest in Exchange for Services

The receipt of an option to acquire a partnership profits interest in exchange for services thankfully does not (or at least should not) provide nearly the host of complexities that an option to acquire a capital interest option does. Normally the receipt of a profits interest in exchange for services is not a taxable event. 74 The receipt of an option to acquire a profits

72 For a similar opinion see WP&P ¶ 10.04(3)(c).

73 Reg. 1.704-1(b)(2)(iv)(h). Specifically, the regulation applies to property contributed by the partnership, property distributed by the partnership, and property otherwise revalued by the partnership. If the partners are not dealing at arm’s length and/or do not have sufficiently adverse interests, an appraiser may indeed have to be retained to generate values that would be respected by the Service.

74 See notes 16 to 23 supra and accompanying text.
interest should be even further removed from taxable status, if that is possible, and in any event would fall within the regulatory rules that usually make the receipt of an option in exchange for services not taxable. Further, if the receipt of a profits interest in exchange for services is not taxable, the exercise of a services option to acquire a profits interest should also not be taxable. Ultimately, the profits interest is still being received for either services and property (to the extent of the exercise price), and under Rev. Proc. 93-27 and Section 721 the transaction should not be taxable. On exercise of the option, the service provider should have a starting capital account equal to the amount paid for the exercise of the option, and not higher, since he is only receiving an interest in future profits and does not have any rights to the existing assets of the partnership.

My analysis assumes that the interest is truly one in future profits. If the interest includes a right to unrealized profits inherent in existing assets, it is more akin to a capital interest, and the discussion in “Options to Acquire a Capital Interest in Exchange for Services” above would be applicable. It is important, therefore, to account for this. The partnership can do a revaluation on the service provider’s exercise of the option, assuming cash or property is contributed on the exercise. Alternatively, the partnership can make a special allocation of any unrealized gains and losses on the service provider’s entry to the partners on whose watch the gains were earned. To achieve this, the partnership will need to value its assets on the service provider’s entry into the partnership. Of course, the valuation has to be accurate to remedy the problem. If the partnership values its assets at $500,000, but in fact they are worth $1,000,000, then notwithstanding the fact that the service provider has a zero capital account, he will have an interest in existing unrealized gains and, in substance, a capital interest. As I discussed above, the regulations generally respect valuations if they are agreed to by the partners acting at arm’s length and the partners have sufficiently adverse interests. As I also discussed above, we need more guidance from the Service as to when such valuations will be respected and how related parties can proceed without the need to incur the expense of an appraiser. Indeed, a cogent reason for the Service

75 See note 25 to 26 supra and accompanying text.
76 See notes 16 to 23 and accompanying text.
77 Id. would ordinarily be allowed since presumably the service provider would be paying something to exercise the option. Otherwise there would be no need to give the option to begin with. See notes 14 to 15 supra and accompanying text.
78 Reg. 1.704-1(b)(2)(iv)(h) If the partners are not dealing at arm’s length and/or do not have sufficiently adverse interests, an appraiser may indeed have to be retained to generate values that would be respected by the Service.
79 See note 73 supra and accompanying text.
to make taxpayer-friendly modifications to the treatment of options to acquire capital interests is that partnerships may create them inadvertently in the case where a profits interest is intended but effectively a capital interest is created by a good faith, but incorrect, valuation of the partnership assets.

**Conclusion**

Life is change. The legal environment in which businesses operate is increasingly fluid. The advent and increased use of LLCs has made partnership taxation an increasingly important area of tax law. As businesses develop creative ways of paying compensation, the tax law needs to stay apace, providing appropriate solutions. It won't do for the Service to rigidly adhere to hoary shibboleths, nor can it be expected to hand taxpayers the keys to the fisc. Under current rules, the exercise of service options to acquire capital interests in partnerships causes appropriate ordinary income recognition to the service provider. It also probably creates a taxable event for the continuing partners, which might be defensible in a world of perfect information, but breaks down under the weight of practical problems of valuation and the ease with which partnerships can plan around it. In promulgating its rules, the Service should focus not only on technical precision, but also on the burdens of compliance, and place simplicity high on its list of priorities, particularly where there is little risk to the fisc.