Hensel Phelps Construction Co. v. Commissioner, 74 T. C. 939 (1980)

A partnership interest received in exchange for services must be included in taxable income when the interest becomes transferable or not subject to a substantial risk of forfeiture.

Summary

Hensel Phelps Construction Co. (HPCC) agreed to build an office building at cost in exchange for a 50% interest in a partnership. The U. S. Tax Court determined that HPCC realized taxable income from the partnership interest in the fiscal year it was received, as the interest was transferable and not subject to a substantial risk of forfeiture. The court valued the interest based on the arm's-length value of HPCC's construction services, ruling that the partnership was formed, and the interest vested, upon the execution of the partnership agreement in August 1973.

Facts

In 1972, HPCC agreed with three individuals to construct an office building on land the individuals owned. HPCC was to receive a 50% partnership interest in exchange for building the office at cost, without profit. After feasibility studies and securing financing, a limited partnership agreement was executed on August 1, 1973, officially forming the partnership and transferring the land to it. HPCC's construction services were to be valued at the arm's-length rate, and its partnership interest was set to vest upon execution of the agreement.

Procedural History

The Commissioner of Internal Revenue assessed a deficiency against HPCC for the fiscal year ending May 31, 1974, asserting that HPCC received a taxable partnership interest in that year. HPCC contested the timing and valuation of the interest. The U. S. Tax Court held that the partnership interest was taxable in the fiscal year ending May 31, 1974, and upheld the Commissioner's valuation method based on HPCC's construction services.

Issue(s)

1. Whether HPCC received a partnership interest in exchange for services rendered in the tax year ended May 31, 1974.
2. Whether the value of the partnership interest HPCC received should be determined based on the value of the services HPCC provided.

Holding

1. Yes, because the partnership was formed, and HPCC's interest vested, upon the execution of the partnership agreement on August 1, 1973, which fell within HPCC's fiscal year ending May 31, 1974.

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2. Yes, because the value of the partnership interest received by HPCC was equal to the value of the construction services HPCC provided, as determined by an arm's-length transaction.

Court's Reasoning

The court analyzed whether a partnership existed and when HPCC's interest became taxable. It determined that the partnership was formed, and HPCC's interest vested, on August 1, 1973, when the partnership agreement was executed and the land was transferred. The court rejected HPCC's arguments that the partnership was formed earlier or that HPCC's interest was not taxable because it was subject to a substantial risk of forfeiture. The court applied section 83 of the Internal Revenue Code, which requires income inclusion when property received for services becomes transferable or not subject to a substantial risk of forfeiture. The value of HPCC's interest was based on the value of its construction services, reflecting the arm's-length nature of the transaction.

Practical Implications

This decision clarifies that receiving a partnership interest in exchange for services is a taxable event when the interest becomes transferable or not subject to a substantial risk of forfeiture. It emphasizes the importance of the timing of partnership formation and interest vesting in determining tax liability. Practitioners should carefully document the formation and operation of partnerships, particularly when services are exchanged for partnership interests. The valuation method used by the court, based on the arm's-length value of services rendered, provides guidance for similar cases. This case may influence how businesses structure service-for-equity arrangements to manage tax consequences and could impact how the IRS assesses similar transactions.

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