NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON THE TAXATION OF PARTNERSHIP INTERESTS RECEIVED FOR SERVICES AND COMPENSATORY PARTNERSHIP OPTIONS

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I. Introduction

On January 22, 2003, the Treasury Department and the Internal Revenue Service issued proposed regulations regarding the treatment of options and convertible instruments issued by a partnership (the "Proposed Regulations").[2] The Proposed Regulations do not address the treatment of compensatory options issued by partnerships. However, the preamble to the Proposed Regulations requested public comment on the tax treatment of compensatory options, including (1) the applicability of Section 83[3] to the issuance of compensatory options and compensatory capital interests and (2) how the tax treatment of partnership profits interests issued in connection with the performance of services should be coordinated with the tax treatment of compensatory options to acquire capital interests. Furthermore, it is our understanding that the Treasury is conducting an overall review of the tax treatment of the direct issuance of compensatory partnership interests, including a review of existing policy with respect to compensatory profits interests.

The Proposed Regulations follow the issuance of Notice 2000-29,[4] which requested public comment on the appropriate tax treatment of both compensatory and noncompensatory

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1 The principal drafters of this report were William B. Brannan and Joel Scharfstein, with substantial contributions from David H. Schnabel, Karen Krueger, Adam Mukamal and Brian Kniesly. Helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Stephen P. Foley, Patrick Gallagher, Andrew W. Needham, Yaron Z. Reich, Stuart Rosow and Michael L. Schler.

2 REG-103580-02, Notice of Proposed Rulemaking Regarding Noncompensatory Partnership Options, 68 Fed. Reg. 2930 (Jan. 22, 2003).

3 All "Section" references herein are to the Internal Revenue Code of 1986, as amended to date (the "Code"), unless otherwise indicated.

4 2000-1 C.B. 1241.

options to acquire partnership interests. On January 29, 2002, the Tax Section submitted a report in response to Notice 2000-29 addressing issues relating to both compensatory and noncompensatory options (the "First Report"). The First Report examined the existing law and expressed our views regarding the tax consequences of the issuance, exercise and lapse of compensatory options to the option holder, the partnership and its historic partners. The First Report adopted the view that compensatory options to acquire partnership interests generally should be taxed in a manner consistent with the taxation of nonqualified corporate stock options, except to the extent that the principles of Subchapter K warrant a different result. In considering the tax treatment of compensatory options, the First Report generally took as a given the tax treatment of directly-issued compensatory partnership profits interests contemplated by Revenue Procedure 93-27,[5] as modified by Revenue Procedure 2001-43.[6]

Concurrently with the submission of this report, the Tax Section is submitting a companion report on the Proposed Regulations (the "Second Report"). That report, consistent with the scope of the Proposed Regulations, addresses issues relating to noncompensatory options but does not address any issues specifically relating to compensatory options.

In response to the preamble to the Proposed Regulations, this report provides a more detailed explanation of our views, observations and recommendations with respect to the tax treatment of both directly-issued compensatory partnership interests and compensatory options to acquire partnership interests. This report includes an examination of the substantive tax treatment of the receipt of profits interests, as well as capital interests, and the role that Section 83 should have in this context.

The balance of this report is divided into six parts. Part II summarizes our recommendations. Part III discusses the tax treatment of partnership profits interests issued in exchange for services, including issues regarding the applicability of Section 83. Part IV discusses the tax treatment of partnership capital interests issued in exchange for services. Part V focuses on limitations on the scope of the rules we propose and certain other special

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5 1993-2 C.B. 343.

6 2001-2 C.B. 191.

considerations. Part VI covers certain technical issues that would arise if the recommended regulations are issued under Section 83. Part VII addresses the tax treatment of compensatory options to acquire partnership interests. Throughout this report, we assume that the option or partnership interest being discussed has been issued by the partnership to a service provider in exchange for the performance of services to, or for the benefit of, the partnership (except as discussed in Part V(A) below).

II. Principal Recommendations

For the reasons set forth in this report, our principal recommendations regarding compensatory partnership interests and compensatory options are as follows:

- Treasury regulations should be issued providing that the amount of income realized by a service provider upon the receipt of a compensatory interest in a partnership generally should be equal to the liquidation value of the partnership interest at the time it is issued. This treatment would apply to both profits and capital interests in the partnership, and may be subject to certain exceptions. Under these regulations, the receipt of a profits interest would not result in taxable income, since the liquidation value of a profits interest at the time of issuance would, by definition, be zero.

- Treasury regulations should be issued providing, in the case of the issuance of an unvested profits interest, that no taxable income is realized either upon the receipt or the vesting of such interest, without the need to make any affirmative Section 83(b)-type election. In the case of an unvested capital interest, the recipient should realize taxable income upon receipt of its interest based upon the liquidation value of the interest on the date of issuance, unless an affirmative election is made to be taxed at the time of vesting based upon the liquidation value at that time.

- The Treasury regulations addressing the treatment of the issuance of compensatory partnership interests and options, including the regulations recommended above, should be issued pursuant to Section 83. However, if the Treasury does not believe that it is appropriate to issue the recommended regulations under Section 83, then the regulations should instead be issued as regulations under Subchapter K, presumably under Section 707(c).

- If Section 83 is the statutory framework for the regulations, the regulations should affirm the result of Revenue Procedure 2001-43 by providing that a Section 83(b) election would be deemed to be made (with an option to elect out) with respect to receipt of a compensatory profits interest. We also recommend that the deemed Section 83(b) election concept be applicable to capital interests. In addition, certain other modifications to the Section 83 regulations should be considered to reflect certain peculiarities in applying standard Section 83 principles in the partnership context.

- If the Treasury regulations are instead issued under Section 707(c), then the regulations should provide that (i) the issuance of a compensatory partnership interest will be treated as a Section 707(c) guaranteed payment to the service provider in the amount equal to the liquidation value of the partnership interest at the time of issuance, (ii) if the partnership interest (whether a profits interest or a capital interest) is not substantially vested at the time of issuance, the holder will nevertheless be treated as a partner for all tax purposes, unless the holder files an affirmative election to treat the interest as not outstanding for tax purposes until vesting occurs.

- The new Treasury regulations should clarify the tax consequences to the partnership and its historic partners of the issuance (or, if applicable, any later vesting date) of a compensatory capital interest, including in particular whether the issuance (or vesting) is: (i) tax-free to the historic partners under the "circular flow of cash" theory, which would be our preference, or (ii) a taxable event to the historic partners under the "constructive sale of assets" theory. The regulations also should confirm that the partnership's compensation deduction on issuance is allocable to the historic partners, not to the service provider.

- As recommended in the First Report, the new Treasury regulations, as they relate to compensatory options to acquire partnership interests, should provide for a tax result that generally corresponds to the treatment of nonqualified compensatory options to acquire stock. That is, the grant of the option would not be a taxable event for the partnership or the service provider. The exercise of the option would be treated for tax purposes as the issuance, at the time of exercise, of a partnership interest in exchange for services, with the tax consequences being determined under the principles recommended herein.

III. <u>Profits Interests</u>

In order to determine the appropriate tax treatment of compensatory options, it is first necessary to determine the tax treatment of compensatory partnership interests that are directly issued by a partnership to a service provider. As indicated earlier, the First Report assumed that the baseline tax consequences with respect to directly-issued compensatory profits interests were those contemplated by Revenue Procedures 93-27 and 2001-43. Set forth below is a more detailed analysis of the law relating to directly-issued compensatory profits interests, followed by our recommendations as to how that law should be codified and implemented in the forthcoming Treasury regulations.

A. Law Prior to the 1954 Code. Before the enactment of Subchapter K in 1954, the taxation of partnerships was largely based on common law principles and administrative practice. In general, under pre-1954 law, a partnership was viewed as an aggregate of its partners (i.e., a pooling of capital and labor) rather than an entity.[7] Transactions between a partner and a partnership were generally not treated as taxable events, even though there was no applicable non-recognition provision, presumably on the basis that such transactions were not realization events. For example, it was clearly established by a large body of case law that a contribution of property to a partnership in exchange for a partnership interest was not a taxable event, notwithstanding the absence of a nonrecognition provision to that effect.[8]

In addition, payments to a partner designated as salary or some other type of compensation for services were generally not treated for tax purposes as compensation income but instead as non-taxable advances of the partner's distributive share of future partnership profits.[9] The rationale for this result was that the partnership should be treated as an aggregate of

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7 See, e.g., *Thompson v. Comm'r*, 18 B.T.A. 1192 (1930); and *Tilton v. Comm'r*, 8 B.T.A. 914 (1927).

8 This was true even though by contributing the property to the partnership, the contributing partner indirectly exchanged an undivided interest in the contributed property for an undivided interest in the other assets of the partnership, which theretofore had belonged to the other partners. See, e.g., Hearings on H.R. 7835 Before the Senate Comm. on Finance, 73d Cong., 2d Sess. 77 (March 6, 1934) (Statement of Mr. Bartholow); *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934), *cert. denied*, 293 U.S. 594 (1934) (holding that gain on sale of contributed shares due to appreciation in value while in the partner's hands was not taxable to partner until the receipt of a liquidating dividend); *Flannery v. United States*, 25 F. Supp. 677 (D. Md.), *aff'd per curiam*, 106 F.2d 315 (4th Cir. 1939) (finding that a partner's share of partnership profits for the year in which a contributed asset is sold does not include excess of fair market value over basis at the time of contribution); *Archbald v. Commissioner*, 27 B.T.A. 837 (1933), *aff'd*, 70 F.2d 720 (2d Cir. 1934), *cert. denied*, 239 U.S. 594 (1934) (same); G.C.M. 10,092. XI-1 C.B. 114 (1932), *rev'd on other grounds* by G.C.M. 26,379, 1950-1 C.B. 58 (noting that "[i]t has been the consistent position of the Bureau that no gain or loss is realized upon the contribution of assets in kind by partners to a partnership enterprise, nor upon what is obviously the exact converse--a liquidation in kind from the partnership to the partners"); Sol. Op. 42, 3 C.B. 61 (1920), *obsoleted by* Rev. Rul. 69-31, 1969-1 C.B. 307, 308 (finding that "to permit a partner who contributes property to the formation of a partnership to treat as income the difference between the cost, or value [at contribution], of such property and the amount at which it was taken up on the books of the partnership would be, in effect, to hold that appreciation in the value of the property constituted income to the owner prior to its realization"); and T.B.R. 34, 1 C.B. 46 (1919), *obsoleted by* Rev. Rul. 69-31, 1969-1 C.B. 307, 308 (disallowing recognition of a loss to a partnership distributing depreciated securities to its partners).

9 See, e.g., *Foster v. U.S.*, 221 F. Supp. 291, 294-95 (S.D.N.Y. 1963) (holding that no matter the designation, salary payments to partners were in reality either distributions of profits or anticipated profits, because a partner could not be both an employer and an employee); *Klein v. Comm'r*, 25 T.C. 1045, 1050 (1956) (holding that a partner's right to a commission of 5 per cent of the partnership's gross sales "was a factor in determining his [taxable] distributive share," and was to be regarded for income tax purposes as part of his

its partners for this purpose and an individual cannot be his own employee. The only exception to that treatment was where the purported salary came out of another partner's share of capital (rather than out of the partnership's profits).[10]

No case under pre-1954 law expressly addressed the issuance of a partnership profits interest in exchange for services performed for the partnership. However, the compensation authority just described (reflecting an aggregate theory of partnership taxation) strongly suggests that the reason the issue was never raised was because both the Service and taxpayers considered it to be obvious that there was no taxable event. Since the receipt of cash compensation was not treated as a taxable event, but only as an advance against the partner's distributive share of future profits, there would be no reason to treat the receipt of a compensatory partnership profits interest, which represents only a right to potential distributions of future profits, as a taxable event.

B. <u>Internal Revenue Code of 1954</u>. It appears that Congress did not intend to change the tax treatment of compensatory profits interests with the enactment of the 1954 Code. Consider each of the potentially most relevant Code provisions. First, Section 61(a) of the 1954 Code, which defines gross income to include compensation for services, does not evidence an intent to change the taxation of compensatory profits interests. The legislative history to the 1954 Code confirms that Section 61(a) was intended to be merely a restatement of Section 22(a) of the 1939 Code, thereby importing historic concepts of income realization from the 1939

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distributive share, and not as compensation); *Thompson v. Comm'r*, 18 B.T.A. 1192, 1197 (1930) (holding that a partner's salary for services rendered cannot be considered compensation, but part of profit distributions); and *Tilton v. Comm'r*, 8 B.T.A. 914, 917 (1927) (holding that partnership salary payments to partners were not taxable as compensation, but only as distributions of profits or of capital, since a partner, under the aggregate theory, "cannot be considered as an employee of the firm…").

10 See, e.g., *Lehman v, Comm'r*, 19 T.C. 659 (1953) (holding that a transfer of $10,000 into the service partner's capital account from the capital accounts of the other partners pursuant to the partnership agreement was a taxable event); and *Lloyd v. Comm'r*, 15 B.T.A. 82 (1929) (holding that salary payments to partners in excess of their distributive shares of income was paid first out of the partners' own capital and, to the extent paid out of other partners' capital, was taxable income).

Code.[11] There is no indication in the legislative history that Section 61 was intended to change the tax treatment of the receipt of compensatory profits interests.

Section 721 of the 1954 Code codified the tax treatment of the receipt of a partnership interest in exchange for a contribution of property.[12] As with the legislative history of Section 61, nothing in the legislative history of Section 721 suggests that it was intended to change the apparent result under the pre-1954 law that the receipt of a profits interest for services was not a taxable event. Indeed, the regulations promulgated under Section 721 in 1956 support this principle by negative implication in providing that:

> "[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 an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under Section 61 (emphasis added)."[13]

Many commentators,[14] and even the Service,[15] have taken the position that the negative implication of this regulation is that the receipt of a profits interest is not taxable, because the regulation specifically carves out transfers of profits interests from the rule that transfers of

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11 See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 68, A18-19 (1954) (the "1954 House Report"); See also S. Rep. No. 1622, 83d Cong., 2d Sess. 94, 168-69 (1954) (the "1954 Senate Report").

12 The legislative history of Section 721 states that "[c]ontributions to a partnership will have the same effect under the proposed provisions as under present practice" and that it codifies existing law. The 1954 House Report at A227. See also the 1954 Senate Report at 388 ("[c]ontributions to a partnership will have the same effect under the proposed provisions . . . as under present practice").

13 Treas. Reg. § 1.721-1(b)(1), which remains the same today.

14 See, e.g., Levy, R*eal Estate Partnerships*, 16 NYU Inst. on Fed. Tax'n, 183, 193 (1958) (interpreting the parenthetical in Treasury Regulation § 1.721-1(b)(1) as evidence of an administrative decision to not treat the receipt of a profits interest as a taxable event); Herzfeld, *How to Use the Partnership Form for 'Tailor-Made' Tax Results*, 20 J. Tax'n 58, 60 (1964) (same); Whitman, *How a Partner Whose Primary Contribution is Services May Achieve Capital Gain*, 22 NYU Inst. on Fed. Tax'n 653, 663-64 (1964) (same); Rabinowitz, *Realty Syndication: An Income Tax Primer for Investor and Promoter*, 29 J. Tax'n 92, 97-98 (1968) (same); and Bybee, *The Taxwise Ways of Oil and Gas Operations and Sales of Interests*, 27 NYU Inst. on Fed. Tax'n 931, 941 (1969) (same).

15 G.C.M. 36,356 (July 23, 1975).

capital interests for services are taxable. We note, however, that the *Diamond* and *Campbell* decisions discussed below rejected that proposition.[16]

There is an exception to this treatment, codified in Section 707(a) of the 1954 Code, which is that compensation for services paid to a partner while not acting in a partner capacity is treated as compensation paid to a non-partner. In addition, Section 707(c) of the 1954 Code provided special treatment for "guaranteed payments" for services, which are payments to a partner for services where the amount of such payments is not dependent on the income of the partnership. Section 707(c) provided that such payments are considered as made to a non-partner, but only for purposes of Sections 61(a) and 162(a). It is instructive that neither Section 707(a) nor Section 707(c) treat the initial receipt of the applicable partnership interest as being the taxable event but instead look to later payments or accruals. More importantly, neither Section 707(a) nor Section 707(c) would be applicable to a typical compensatory profits interest,[17] which strongly suggests that there was no intent to change the prior law that the receipt of an ordinary compensatory profits interest was not a taxable event. In fact, examples in the Section 707(c) regulations clearly support that conclusion.[18]

Section 83 was enacted as part of the Tax Reform Act of 1969. The legislative history of Section 83 makes no reference to partnership interests and does not contain any specific indication that Congress intended to change the long-standing tax treatment of compensatory

16 See *Campbell v. Comm'r*, 943 F.2d 815, 822 (8th Cir. 1991) ("the receipt of a profits interest never affects the nonrecognition principles of section 721"); and *Diamond v. Comm'r*, 492 F.2d 286, 288-289 (7th Cir. 1974) (rejecting Diamond's argument that Treasury Regulation § 1.721-1(b)(1) implies that a service partner who receives a profits interest does not recognize income).

17 Section 707(a) by its terms does not apply to amounts paid to a partner for services performed in his capacity as a member of the partnership (as would be the case for the typical profits interests). Section 707(c) by its terms is not applicable to payments that are "determined with regard to income of the partnership", which would be the case with typical compensatory profits interests.

18 Examples 2, 3 and 4 in Treasury Regulation § 1.707-1(c), which was adopted in 1956, each involve a partner that receives some sort of profits interest as compensation for services. The examples do not indicate that the service partner is taxed on the receipt of the profits interest but instead provide that the partner is taxed only in the year in which the partnership earns profits or a guaranteed payment is received or accrued.

profits interests.[19] Rather, the focus of the legislative history is on the issuance of restricted stock and the differences between the tax treatment of restricted stock and the tax treatment of deferred compensation in the corporate context.[20] One possible explanation for this corporate focus may have been a view on the part of Congress that, in the partnership setting, a compensatory profits interest is akin to an unfunded promise to pay and, therefore, does not rise to the level of property for purposes of Section 83 (although, as discussed further below, we think the better view is that a compensatory profits interest should be viewed as property for such purposes). While it is true that the statutory language in Section 83 literally applies to all property transferred in connection with the performance of services, the Treasury Regulations thereunder apply Section 83 only to property transferred to employees or independent contractors.[21] Partners are generally not treated as employees or independent contractors, except to the extent they received payments governed by Section 707(a). In addition, it should be noted that in 1971, the Treasury promulgated a package of proposed regulations to implement Section 83 that included a proposal to amend Treasury Regulation § 1.721-1(b) to provide that Section 83 applies to a compensatory <u>capital</u> interest, which suggests that Treasury did not regard compensatory <u>profits</u> interests as being within the ambit of Section 83.[22] That proposal was not adopted as part of the final Section 83 regulations, but it is technically still outstanding as a proposed regulation.[23]

The enactment of Section 707(a)(2)(A) in 1984 and its legislative history also suggest that Congress believed that the receipt of a profits interest for services was a non-taxable event.

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19 See H.R. Rep. No. 91-413(Pt. 1), 91st Cong., 1st Sess. 86-9 (1969); and S. Rep. No. 119-24, 91st Cong., 1st Sess. 119-24 (1969).

20 Based upon the legislative history, Section 83 was arguably intended to address only the timing of the realization of income in the context of transfers of property subject to vesting conditions, and not to expand the scope of Section 61 to include events that were not realization events under prior law.

21 See Treas. Reg. § 1.83-1(a)(1).

22 Prop. Treas. Reg. § 1.721-1(b)(1), published in the Federal Register on June 3, 1971 (36 Fed. Reg. 10787).

23 See T.D. 7554, 1978-2 C.B. 71. Treasury did not either adopt or withdraw the proposed Section 721 regulation when it finalized the rest of the proposed regulation package (and it did not provide any explanation for that action). The preamble to the Proposed Regulations again requests comment on this now 33-year old proposed regulation. The possible application of Section 83 to compensatory capital interests is discussed in Part IV below.

Section 707(a)(2)(A) expanded the scope of Section 707(a) to include cases where the service provider receives an interest in the partnership representing a right to allocations and distributions, and where the performance of services and such allocations and distributions, viewed together, are properly characterized as a transaction occurring between the partnership and a person acting in a capacity other than as a partner of the partnership. Section 707(a)(2)(A) directly addresses cases where a service provider receives an interest in partnership profits for services, and, in the circumstances in which Section 707(a)(2)(A) applies, it treats the payments made in respect of the interest as payments between the partnership and a non-partner. There is no indication in the legislative history of Section 707(a)(2)(A) that Congress believed that the service provider was taxable on the initial receipt of the profits interest, based on its value, and then again when the distributions thereon are received or accrued.[24] In fact, the examples in the legislative history show that when Section 707(a)(2)(A) applies, there is a taxable event only when the service provider receives payments or accrues the right to payments from the partnership.

C. <u>Diamond, Campbell and Other Case Law</u>. Since the codification of partnership tax principles in Subchapter K in 1954, only a handful of cases have addressed the treatment of the receipt of compensatory profits interests. In *Diamond v. Commissioner*,[25] which involved taxable years before the effective date of Section 83, the Tax Court held, and the Seventh Circuit affirmed, that a service provider partner was taxable on the receipt of a "profits interest" received for services because the interest had a determinable market value at the time of its receipt. The Tax Court held that the fair market value of the interest was includible in income under Treasury Regulation § 1.61-2(d) and that the Treasury Regulations under Section 721 did not preclude that result.[26] The Seventh Circuit's opinion indicated that it believed that the receipt of a profits interest might not be a realization event, but it also stated that, in the absence of a clarifying regulation, it was sound policy to defer to the expertise of the Tax Court.

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24 See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1216 (1984).

25 492 F.2d 286 (7th Cir. 1974).

26 56 T.C. 530 (1971).

Diamond was widely criticized as being wrongly decided, or at least decided on the wrong grounds, creating severe valuation problems for partnerships with service partners and resulting in double taxation to the recipient partner.[27] General Counsel Memorandum 36,346, issued in connection with a later proposed Revenue Ruling regarding compensatory partnership interests, advocated disavowing the *Diamond* decision to the extent it held "that the receipt by a partner of an interest in future partnership profits as compensation for services results in taxable income."[28] Although the Service never published the proposed ruling, it chose to litigate only four other cases in the area during the twenty years after *Diamond*.

In *Campbell v. Commissioner*,[29] the Tax Court, following *Diamond*, again held that a service provider was taxable on the receipt of a partnership profits interest, and that Section 83 applied. The Eighth Circuit, reversing the Tax Court, held that the profits interest in question did not have any value, thereby sidestepping the question of whether the receipt of a profits interest was a taxable event.[30] The Eighth Circuit indicated, however, that it doubted "that the tax court correctly held that Campbell's profit interests were taxable upon receipt," apparently on the grounds that "nonrealization concepts governing transactions between partner and partnership preclude taxation."[31] In this regard, the Eighth Circuit's decision in *Campbell* notes favorably the argument that the enactment of the 1954 Code did not change the pre-1954 rules relating to the taxation of partner compensation, except to the extent expressly provided in Section 707, as discussed earlier. The Service, in its appeals brief, conceded that the Tax Court had erred in holding that a compensatory profits interest received from a partnership in exchange for services

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27 See, e.g., Cowan, *Receipt of an Interest in Partnership Profits: The Diamond Case,* 26 Tax L. Rev. 161 (1972); and Willis, *Partnership Taxation* 84-85 (1971). As discussed later, *Diamond* could have been decided on the basis that Diamond in fact received a capital interest, not a profits interest, worth $40,000, which would have been an easy resolution of the case. The Seventh Circuit noted that the government argued that the underlying real estate had a value substantially in excess of its purchase price, but that the Tax Court did not make such a finding. See *Diamond*, 492 F.2d at 287.

28 G.C.M. 36,346 (July 23, 1975).

29 TC Memo 1990-236.

30 *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991), rev'g TC Memo 1990-236.

31 The court, however, rejected the argument that the receipt of a profits interest was not a taxable event on the ground that a profits interest is not property for purposes of Sections 61 and 83.

provided to that partnership is a taxable event. Instead, the Service raised the argument, which the Eighth Circuit was not willing to consider because it was first raised on appeal, that the profits interest was received for services provided to Campbell's employer (which was not the partnership).

Both *Campbell* and *Diamond* involved special facts that the Service perceived as abusive, which presumably was at least part of the reason why the Service resorted to arguing that the receipt of a profits interest was a taxable event and which clearly affected the outcomes of these cases. In *Diamond*, it was reasonably clear that Diamond's share of the profit to be realized was $40,000 at the time he acquired the interest, and indeed, less than three weeks after Diamond acquired the interest, the only other partner bought back Diamond's interest in the partnership for that amount pursuant to a prearranged transaction. The intended effect of the arrangement was to convert compensation income into short term capital gain that Diamond could use against his capital losses. In its opinion in *Diamond*, the Seventh Circuit specifically noted that Diamond's profit share was very unusual in that overwhelming evidence existed that it had an immediate value of $40,000 on issuance. The Seventh Circuit's focus on that point has since been viewed by courts and commentators as limiting the application of the Tax Court's decision to partnership "profits" interests that have a determinable market value upon receipt.[32] In *Campbell*, the profits interest had only speculative value and the interest was intended to be held for the long term. However, the profits interest involved also entitled Campbell to a share of partnership losses, and the partnerships at issue were tax shelters. The tax shelter aspect of the case seems to have motivated the Service to pursue the case, and the tax shelter benefits were the basis for the Service's assertion that the profits interest had significant value.[33]

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32 See, e.g., *United States v. Pacheco*, 912 F.2d 297, 302 (9th Cir. 1990) ("Diamond stands for the limited proposition that if a profits interest has a 'determinable market value at the moment of creation'…this value must be declared pursuant to [Section 721] as income by the service partner who receives it…. Moreover Diamond involved a rather unique situation and was so limited by the Seventh Circuit. In Diamond, the service partner received a profits interest and immediately sold it for $40,000, thereby establishing its market value. The court distinguished its holding from those 'typical situations' where the profits interest 'will have only speculative value, if any'.").

33 Many of these deductions were ultimately disallowed. See *Campbell*, 943 F.2d at 823.

In three other cases decided between *Diamond* and *Campbell*, either the court held that the receipt of a compensatory profits interest was not a taxable event or the Service conceded that the receipt of a profits interest was not a taxable event.[34]

D. <u>Recent Revenue Procedures</u>. In order to reduce any uncertainty regarding the tax treatment of typical types of compensatory profits interests, the Service has promulgated two Revenue Procedures on the subject. Revenue Procedure 93-27 provides that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner," the receipt of the profits interest will not be treated as a taxable event. A "profits interest" is defined as any interest in a partnership that would not entitle the holder to a share of proceeds if the partnership's assets were sold at fair market value and the partnership liquidated. For this purpose, the determination of whether an interest is a profits interest is generally made at the time of the receipt of the profits interest. Revenue Procedure 93-27 does not apply if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b). Revenue Procedure 93-27 does not purport to represent the substantive law and it does not cite any legal authority for its conclusions. Accordingly, Revenue Procedure 93-27 technically is only an administrative pronouncement regarding audit practice.

Revenue Procedure 2001-43 later purported to "clarify" Revenue Procedure 93-27 by addressing the treatment of a profits interest that is substantially nonvested at the time of receipt. Revenue Procedure 2001-43 provides that in cases where the conditions of Revenue Procedure 93-27 are satisfied, the service provider will be treated as receiving the profits interest on the date of grant (and not when it later vests), provided that (i) the partnership and service provider

[34] See *St. John v. United States,* 84-1 USTC ¶ 9158 (C.D. Ill. 1983) (holding that the taxpayer at issue received only a profits interest and, since an immediate liquidation of the partnership would have yielded the taxpayer nothing, the taxpayer was not taxable on the receipt of his profits interest); *Kenroy, Inc. v. Commissioner,* T.C. Memo 1984-232 (Service conceded that a profits interest was not taxable, but argued that taxpayer received a capital interest; the Court held that the interest received was a profits interest and thus not taxable); and *National Oil Co. v. Commissioner*, T.C. Memo 1986-596 (holding that the interest received was a profits interest and thus not taxable).

treat the service provider as the owner of the interest from its date of grant and (ii) neither the partnership nor any of its partners takes a deduction (as wages, compensation or otherwise) in respect of the fair market value of the interest at the date of grant or the date of vesting. This treatment applies regardless of whether a Section 83(b) election is filed with respect to the interest. Because the service provider is treated as the owner of the interest from the time of grant, the vesting of the interest is not a taxable event and the service provider must report his distributive share of the partnership's income, gain, deduction and credit at all times the interest is held, even during the period when the interest is not substantially vested.

In practice, the taxation of partnership profits interests in connection with the performance of services generally follows the approach outlined in the Revenue Procedures.[35] This approach is more favorable to the service provider, in almost every case, than an approach that would require the service provider to take into income the true fair market value of the interest. Although this approach may disadvantage the partnership and its historic partners, who might otherwise be entitled to a current deduction, we are not aware of any cases where taxpayers have taken a contrary position.

E. <u>Recommendations</u>. 1. <u>Basic Substantive Rules</u>. Although the tax treatment provided for compensatory profits interests in Revenue Procedures 93-27 and 2001-43 does not rest on a specific statutory provision, we believe that such treatment is proper and should continue to apply. First, as a legal matter, such treatment is supported by the legislative history and case law discussed earlier. We recognize that such treatment may be inconsistent with the result that would be obtained under traditional Section 61 or Section 83 principles (if applied without special rules for partnership interests). However, we believe that the tax treatment described in the Revenue Procedures is well supported by the intent and framework of Subchapter K and the long-standing practice of the tax bar, the Service and the Treasury. Furthermore, as discussed earlier, there is no indication in the legislative history of Section 61 or

35 The only real exception is that in some cases service partners may still file Section 83(b) elections in respect of a profits interest subject to vesting arrangements where there is some fact that may throw the interest outside the literal scope of the Revenue Procedures or where there is a concern that the Service might disagree with the parties' valuation of the partnership's assets and thereby conclude the interest had some capital value on the date of issuance.

83 that Congress intended to change the long-standing treatment of compensatory profits interests.

Second, as a policy matter, there are several reasons why taxing a service provider on the receipt of a profits interest would be inappropriate. One policy argument is that, in view of the typically speculative value of partnership profits interests, they should be regarded as being more akin to an open transaction or an unfunded promise to pay and, therefore, it would be inappropriate to tax a profits interest at the time of receipt. Moreover, taxing a service partner on the receipt of a profits interest would lead to burdensome double taxation. A service partner is taxable on his distributive share of partnership income as it is realized by the partnership. If the service provider were also taxed on the value of the right to receive his share of future partnership income, he would be taxed twice on the same income, once when he received the interest and again when the partnership realized the income, with such double taxation being reversed only on complete liquidation of the partnership, the sale of his interest in the partnership or to the extent (if any) the income realized upon receipt of the interest resulted in tax benefits pursuant to a Section 754 election.[36]

At the same time, if the receipt of a profits interest were a taxable event, then the historic partners may realize a double tax benefit. This could result because the partnership would be entitled to a corresponding deduction under Section 83(h) or 707(c), subject to applicable capitalization and other limitations,[37] which presumably would be allocated to the historic partners.[38] The partnership and the historic partners would later, in effect, receive a second

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36 Some offset to double taxation might be obtainable if the partnership had a Section 754 election in effect and the acquisition of the interest were viewed as a sale or exchange, since that would result in an inside basis step-up pursuant to Section 743. However, in most cases, any such basis step-up would be allocable primarily to goodwill, which, prior to enactment of Section 197, would have been non-amortizable and, under current law, generally would be amortizable over 15 years. In any event, any such offset would, at best, be realized over some extended period of time and, therefore, would not offset the cost of the immediate income recognition on a present value basis.

37 In some cases, the expense would have to be capitalized into the basis of partnership property; in other cases, it might be treated as a prepaid expense and be required to be amortized over some period.

38 Although allocation of the deduction to the historic partners would seem to be the appropriate result, it might be necessary, as suggested in note 39 below, to allocate the deduction to the service provider to produce proper capital account balances for the partners. If the deduction were allocated to the service provider, then the double deduction concern (and the double taxation concern) would be mitigated.

deduction for the same compensation when profits were allocated to the holder of the profits interest. This is a clearly inappropriate result, and there does not seem to be a current mechanism under Subchapter K to address it.[39] Furthermore, if the receipt of a profits interest were a taxable event, it is possible that the partnership and its historic partners would recognize gain or loss on the issuance of the profits interest if the partnership held any appreciated or depreciated assets and the "constructive sale of assets" approach applied (see Part IV(E) below).

Further, there is no clear basis for distinguishing the case of a grant of a profits interest to a new partner for services from the case where the profit share of an existing partner is increased on a prospective basis through a timely amendment of the partnership agreement. If a shift in profits interests were generally a taxable event, an existing service partner whose interest in partnership profits is increased for future years by a partnership agreement amendment would recognize additional taxable income as a result of the amendment at the time of the amendment. This result is clearly contrary to current Subchapter K practice and taxpayer expectations, where the nearly universal working assumption is that such an amendment would cause the existing service partner to recognize additional income only later as the partner is allocated a greater distributive share of the partnership's underlying taxable income. Consider the following example:

> Example 1. A is an existing service partner who has a 4% profits interest in partnership P. A's services have become more valuable to P because (i) A has committed to spend a greater amount of time working on P matters in the future, (ii) A has become more experienced and (iii) A's stature and reputation have increased. In recognition of such greater value from A's services, the P agreement is amended to increase A's share of future profits to 5%. It seems clearly inappropriate to treat the increase in A's share of P profits as a taxable event.

The result in this example should be the same if A was not previously a partner, but instead became a partner and received a 5% profits interest for services to be performed for P.

Finally, if the receipt of a compensatory profits interest were a taxable event, the proper accounting for the issuance of the profits interest would appear to require results that are at variance with the Subchapter K principles embodied in the Section 704(b) and Section 704(c)

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[39] Unlike the case with the service provider's double inclusion of income, this double deduction effect would not appear to be mitigated by a Section 754 election.

regulations. In particular, difficult issues regarding the proper maintenance of capital accounts would arise.[40]

2. <u>Effect of Vesting Arrangements</u>. It is common practice for compensatory profits interests to be subject to vesting arrangements pursuant to which the service partner will forfeit all or part of his interest if he ceases to work for the partnership within a specified time period. If Section 83 principles relating to vesting arrangements were applied, the service partner would not be regarded as receiving the interest for tax purposes until the risk of forfeiture ended.[41] However, at that time, the interest may represent an interest in partnership capital due to any realized or unrealized income that has arisen since the date of issuance. This raises the question of whether the interest should be taxable to the service partner to the extent of any such capital value at the time of vesting. Historically, this issue was of sufficient concern to well-advised service providers that it was fairly common practice for them to make an election under Section 83(b) to treat the interest as received for tax purposes when issued.[42]

This issue has largely been eliminated by Revenue Procedure 2001-43. As noted earlier, Revenue Procedure 2001-43 provides that a service provider that receives a profits interest in exchange for services will be treated as receiving the profits interest on the date of grant (and not when it becomes substantially vested), regardless of whether he makes a Section 83(b) election, provided that (i) the partnership and service provider treat the service provider as the owner of the interest from its date of grant, (ii) neither the partnership nor any of its partners deduct any

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40 The most obvious issue is that if the service provider were taxable on the receipt of the interest, it would follow that the service provider should receive capital account credit for the income inclusion amount. However, since the interest is intended to be only an interest in future profits as a business matter, the service provider's initial capital account should be zero, and therefore some mechanism would need to be devised to offset such capital account credit. One possibility would be to specially allocate the resulting compensation expense that arises at the partnership level to the service provider, but that may not be an appropriate result as a Subchapter K policy matter. That would be particularly true in cases where the expense must be capitalized and amortized or depreciated over an extended period of time (and in such cases there would be no immediate capital account offset, even if the amortization or depreciation deductions were allocated solely to the service provider).

41 See Treas. Reg. §§ 1.83-1(a) and -3.

42 See Treas. Reg. § 1.83-2. However, this practice was by no means universal, as some taxpayers were of the view that Section 83 did not apply to compensatory profits interests and other taxpayers were not sufficiently well advised to be aware of the potential need for the election.

amount (as wages, compensation or otherwise) in respect of the interest and (iii) the requirements of Revenue Procedure 93-27 are satisfied. We believe Revenue Procedure 2001-43's treatment of compensatory profits interests is appropriate and recommend that that treatment be continued and confirmed by regulation. Requiring an affirmative election under Section 83(b) would create a real trap for the unwary in a context where an election would result in no income to the service provider.

Accordingly, we recommend that the forthcoming Treasury regulations provide that the service provider will be considered to be the tax owner of an unvested compensatory profits interest from the date of grant, without the need to make a Section 83(b) election. Consideration should also be given to allowing the service provider to elect to treat the interest as not owned by him for tax purposes until substantial vesting (which would be a reversal of the normal Section 83(b) approach). Such a reverse election actually would be consistent with the approach of Revenue Procedure 2001-43, since it in effect provides for elective treatment of vesting arrangements by disregarding them only if the service provider and partnership both treat the interest in that manner. If for any reason this recommendation is not adopted, consideration should be given to allowing a partnership to make the Section 83(b) election on behalf of all its service partners that receive unvested profits interests by filing a single election form with the Service and requiring in its partnership agreement that both it and such partners treat the interests as being fully vested for tax purposes from the date of issuance.

3. Statutory Basis for Regulations. A further issue is whether future Treasury regulations regarding compensatory profits interests should be issued pursuant to Subchapter K or pursuant to Section 83. Given that Section 83 governs the treatment of transfers of "property" in connection with the performance of services and a normal interpretation of the word "property" would include a partnership interest, we believe that it would be more appropriate for such regulations to be issued under Section 83.[43] In order to maintain the general approach of

43 However, it should be noted that a substantial minority of the members of the Executive Committee of the Tax Section would prefer that the regulations be issued under Subchapter K for a variety of reasons, including a belief that Section 83 is not applicable to compensatory profits interests, a concern there may be authority questions with respect to certain aspects of our recommendations if implemented under Section 83 and, more broadly, a belief that working within the framework of Subchapter K would produce a more coherent result.

Section 83 that compensatory transfers of property are taxable based upon the fair market value of the property, we recommend that the regulations provide that, for purposes of applying Section 83 in the partnership context, the fair market value of a compensatory partnership interest should be deemed to be its liquidation value. As a result, the receipt of a profits interest generally would not result in current income under Section 83. In addition, we recommend that the regulations provide that a Section 83(b) election be deemed to have been made in the case of a compensatory profits interest, unless the recipient affirmatively elects contrary treatment.

Although we recommend that the future regulations be issued under Section 83, we understand that the Treasury might choose not to do so if it concludes that compensatory profits interests are simply not subject to Section 83 or it becomes concerned about its authority to modify existing Section 83 principles.[44] In the event that the Treasury determines that it should not issue the recommended regulations under Section 83, we recommend that they instead be issued pursuant to Subchapter K. More specifically, we recommend that they be issued pursuant to Section 707(c), because that Section deals with compensation income payable to partners and Treasury Regulation § 1.721-1(b)(2) already provides that issuances of taxable capital interests give rise to income to the service provider as a guaranteed payment under Section 707(c).

IV. Capital Interests

A. <u>General Treatment</u>. Under Subchapter K principles, whether an interest is a capital interest is determined on a liquidation basis. As stated in Revenue Procedure 93-27, a capital

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44 One possible authority concern might be that because the existing Section 83(b) election procedure is codified in the statute, the recommended deemed election approach for compensatory partnership interests might be viewed as an unauthorized modification of the statue. Another concern might be that the use of a liquidation approach to value compensatory partnership interests would be at variance with the statute. However, we believe that the Treasury does have the authority to issue the recommended regulations under Section 83, because such regulations would represent a reasonable interpretation of the statute as applied in this special context (which, as indicated earlier, Congress apparently never considered in enacting Section 83). <u>Cf.</u> *Earl. A. Brown v. United States*, 890 F.2d 1529 (5th Cir. 1989); and *United States v. Vogel Fertilizer*, 455 U.S. 16, 24 (1982). There is also support for such regulations under Section 7805(a). Finally, it should be noted that there are other contexts where regulations, for administrative convenience or other reasons, introduce flexibility into a rigid statutory election rule. For example, Section 1295(b)(1) provides that "a taxpayer may make [a qualified electing fund] election" with respect to a PFIC. The regulations, however, provide that (1) if a domestic partnership holding stock of a PFIC makes a QEF election, the election is binding on all of its partners other than any tax-exempt organization and (2) a tax-exempt organization directly owning PFIC shares is not permitted to make a PFIC election. See Treas,. Reg. §§ 1.1295 -1(d)(2) and -1(d)(6). This is because, given the nature of the unrelated business taxable income rules, a QEF election would never benefit a tax-exempt organization.

interest is defined 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." Under this definition, a capital interest includes not only an interest in capital contributed by other partners and gains and income realized before the grant of the interest, but also an interest in any unrealized gains of the partnership.[45]

The receipt of a partnership capital interest in connection with the performance of services is a taxable event under current law. Treasury Regulation § 1.721-1(b)(1) provides that:

> "[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 an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under Section 61 (emphasis added)."

As noted above, Treasury Regulation §1.721-1(b)(2) further provides that the issuance of a partnership capital interest to a service provider in exchange for services is treated as a guaranteed payment under Section 707(c). In addition, numerous cases have held that the receipt of a partnership capital interest in connection with the performance of services is a taxable event.[46]

B. Valuation. 1. Measurement of Income and Expense. The Service has not adopted, nor have the courts developed, a consistent methodology for valuing capital interests to determine the amount the recipient must include in income. In *Mark IV Pictures,*[47] the Service took the position, and the Tax Court agreed, that the value of a capital interest received for services was the liquidation value of the interest based on the fair market value of the

45 See also G.C.M. 36,346 (July 23, 1975) (capital interest includes unrealized gains). The GCM states that this is simply an extension of the rule in Treas. Reg. § 1.61-2(d)(1) that property received as compensation is taxed at its fair market value.

46 See, e.g., *McDougal v. Comm'r*, 62 T.C. 720 (1974); *Hensel Phelps Construction Co. v. Comm'r*, 74 T.C. 939 (1980); *Larson v. Comm'r*, T.C. Memo 1988-387; *Mark IV Pictures, Inc. v. Comm'r*, 969 F.2d 669 (8th Cir. 1992); and *Johnston v. Comm'r*, T.C. Memo 1995-140.

47 T.C. Memo 1990-571.

partnership's assets. In two other cases, *Larson*[48] *and Johnston*,[49] the Tax Court determined the value of the capital interest received by reference to the amount paid in cash for other partnership interests that were sold around the time at issue. In at least one other case, *Hensel Phelps Construction Co.*, the court valued the capital interest received by reference to the value of the services performed.[50]

In contrast, if the valuation principles generally applicable under the Code and specifically applicable under Section 83 applied to the receipt of a partnership interest, then the interest may have to be valued under traditional tax principles that would look to the true fair market value of the interest,[51] taking into account all relevant facts and circumstances (determined without regard to any restriction other than a restriction which by its terms will never lapse). This would require taking into account not only the economic attributes of the interest, but also the non-economic attributes, such as any transfer restrictions and the presence or absence of management rights. In most cases, the application of Section 83 principles would likely lead to a substantially lower valuation for a compensatory capital interest than would be the case with the liquidation value approach.

As noted earlier, Treasury Regulation § 1.721-1(b)(1) provides that upon a compensatory capital shift to a service partner (i) the "value" of the "interest in the capital so transferred" is income to the partner under Section 61 and (ii) the amount of such income is the "fair market value of the interest in capital so transferred." This regulation does not purport to equate the fair market value of the interest in capital with the fair market value of the partnership interest. Indeed, the wording of the regulation suggests a focus solely on the value of the capital interest without regard to entitlement to profits or non-economic features associated with the partnership interest. Arguably, the value is intended to be the liquidation value at the time of issuance,

48 T.C. Memo 1988-387.

49 T.C. Memo 1995-140.

50 74 T.C. 939 (1980). In this case, the taxpayer agreed to construct an office building for a partnership at cost in exchange for a 50 percent capital interest in the partnership. Because the value of the partnership interest was difficult to assess, the court used the value of the petitioner's services as calculated by the Service.

51 We note, however, that the Service has, on occasion, departed from this approach. See note 55 below.

although there is no clear statement or example to that effect. The reference to fair market value may well have been to distinguish the liquidation value of the capital accounts (determined by reference to the fair market value of the underlying property) from the partnership's actual capital accounts without regard to book up. This view is consistent with the aggregate approach to partnership taxation with its greater focus on the underlying property. This approach is also consistent with actual practice in a number of partnership contexts. For example, it is not uncommon for a partnership to shift capital on an annual basis to a service partner's capital account as compensation for services and to treat the shifted amount as a guaranteed payment. This approach is also consistent with the rule in the Proposed Regulations requiring the holder of a noncompensatory option, upon exercise, to be allocated partnership gross income, on a dollar-for-dollar basis, to the extent necessary to cover the difference between the intended liquidation value of the holder's partnership interest and his capital account balance following the special capital book-up procedure.[52]

Currently, the uncertainty regarding the proper method of valuation of a capital interest presents a potential for inconsistent positions being taken as between the service provider receiving the interest and the issuing partnership. Thus, the service provider may take the position that a taxable capital interest should be valued based upon its true fair market value as determined using traditional Section 83 principles (assuming that produces a lower income inclusion amount than the liquidation value approach), while the partnership may take the position that the interest should be valued using the liquidation value approach (assuming that would produce a higher deduction or other tax benefit than the traditional Section 83 principles). Clarification of the proper valuation approach is needed to ensure consistency and avoid the Service being whipsawed.

Consistent with our recommendations in the First Report and the first part of this report, we believe that Subchapter K principles rather than normal Section 83 principles should apply in valuing partnership capital interests issued in connection with the performance of services and that, accordingly, a liquidation value approach should be used.[53] In large part, that conclusion is

52 Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3).

53 First Report, p. 67.

driven by our desire to avoid discontinuities between the valuation of profits interests and capital interests. Discontinuities like this tend to place a premium on clever drafting and present the potential for taxpayers to game the system. Revenue Procedure 93-27, for example, already applies a liquidation approach to valuation. As discussed herein, we support the approach of Revenue Procedure 93-27 and believe that a consistent approach should be followed for valuation of capital interests.

Set forth below is a brief discussion of some of the complexities that can arise if a different valuation methodology is adopted for capital interests and profits interests. The principal concern is that having different approaches would place enormous pressure on distinguishing between profits interests and capital interests, when in practice most partners who own profits interests also own capital interests. In particular, we believe certain bifurcation rules would need to be developed. In the next few pages, we explore some of the issues that will need to be considered in issuing proposed regulations should a decision be made to adopt different valuation methods. Consider the following example:

> Example 2. A agrees to provide services to partnership P and in exchange receives a partnership interest which entitles A to a $1,000 capital account plus 10% of all distributions after the partners have received, in the aggregate, distributions equal to $100 million. Upon A's admission, P's capital accounts are booked up to an aggregate of $100 million reflecting its liquidation value. Assume that under normal valuation principles the right to receive 10% of distributions in excess of $100 million is worth $2 million. Under the recommended liquidation value approach, A would have $1,000 of income upon receipt of the interest. If, instead, A were required to take into income the fair market value of its interest (because in addition to its pure profits interest it received a $1,000 capital account), A would be required to include up to an additional $2 million in income upon receipt of the interest.

In this case a high premium is placed on the accuracy of the parties' judgment as to the value of the partnership's assets and liabilities in determining the liquidation value of the partnership,[54] since a small difference in value could cause a pure profits interest to become a profits interest with a small capital component and therefore the service provider would have income based upon the full fair market value of the interest (not just the small capital value that

[54] In addition to uncertainties regarding the actual value of its property, the partnership may inadvertently omit some asset (e.g., an available refund) or inadvertently overstate its net liabilities.

would be created by such value change). Consequently, small variations in the appraisal of the liquidation value of the partnership could potentially cause radically different consequences to the service provider or the partnership and would raise the possibility that the Service could be whipsawed.[55]

One possible way to address the foregoing problem would be to bifurcate the interest for tax purposes into a pure profits interest (which could be received tax-free) and the remaining interest (which would be taxable).[56] Presumably any such bifurcation approach would split out only the disproportionate profits component into the pure profits interest, leaving the balance of the profits with the capital interest. If more than the disproportionate profits were allocated to the profits interest and Section 83 principles were applied to value the residual capital interest, its value and the amount of taxable income realized by the service provider would be inappropriately low.

> Example 3. P is a partnership that has only one class of limited partnership interests ("Units"). S receives one Unit with a liquidation value and fair market value of $100 for services and as a result has $100 of taxable income. The interest received by S clearly has no disproportionate profit allocation. If instead S were allowed to bifurcate the Unit into a "B Unit" representing the profit of one Unit and a "C Unit" representing the capital of one Unit (but no share of profits), then S might take the position that (i) that receipt of the B Unit was a non-taxable receipt of a pure profits interest and (ii) that the receipt of the C Unit was taxable, but of relatively little value, say $5, since all it represented was the right to get up to $100 on liquidation at some potentially remote point in the future.

If a bifurcation approach were adopted, identifying the "disproportionate" part of the profits interest would be difficult in the context of a partnership with multiple classes of equity interests (which is not unusual given the flexibility inherent in the partnership structure). Consider the following example:

> Example 4. Partnership P issues (i) 10 "A Units" that each have an initial $100 capital account and senior liquidation preference and provide a $10 cumulative

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55 The service provider might argue that it had a pure profits interest requiring no income recognition while the partnership takes the position that there was a slight capital component justifying the partnership taking a deduction for the full fair market value of the interest.

56 We observe that this approach is inconsistent with the customary understanding that a partner in a partnership holds a unitary interest, regardless of how that interest is sliced up.

> return per annum plus 1% per Unit of profits above the return and (ii) 45 "B Units" that each have a $100 initial capital account and a $100 subordinated preference on liquidation and provide a 2% share of profits per Unit above the preferred return of the A Units. If Partner S receives a B Unit for services, is there a "proportionate" profits interest that can be carved out of the B Unit and treated as non-taxable? If so, what is it?

Another concern with a bifurcation approach is that it might allow service providers to use self help by actually bifurcating what would otherwise have been a single compensatory capital interest into two interests consisting of a pure profits interest and a residual capital interest, which would lead to an inappropriate gaming of the system. The amount of taxable income recognized on receipt of a compensatory partnership interest should not depend on the drafting mechanics employed. Hence, any approach providing for the bifurcation of interests would have to include rules providing for the aggregation of multiple interests held by the service provider where appropriate to determine what represents a disproportionate share of profits. Consideration would also have to be given to whether and under what circumstances interests held by parties related to the service provider would have to be taken into account for this purpose. In all events, any rule relating to bifurcation would have to require consistency between the issuing partnership and the service provider to prevent the Service from being whipsawed by the partnership claiming a larger deduction than the income reported by the service provider.

The above discussion relating to bifurcation is merely a first step in addressing how the rules might work should the regulations adopt different valuation approaches to profits interests and capital interests. There are undoubtedly other approaches that could be taken. In any case, these problems would need to be studied in more detail if the regulations adopt that approach.

2. Subchapter K Accounting Concerns. In addition to the discontinuity between the treatment of profits interests and capital interests that would result if liquidation value were not used, the use of a different valuation method would also set up other inconsistencies with Subchapter K principles, including inconsistencies with the basic approach under the Sections 704(b) and 704(c) regulations and issues regarding the treatment of the partnership and the historic partners. In this regard, consider the following example:

Example 5. A and B are equal partners in partnership P which owns assets with a basis of $100 and a value of $100. C, in exchange for the performance of services, is granted a vested 10% pro rata interest in P. Assume that the fair market value of the 10% interest is only $8 because of illiquidity and other non-economic attributes of the interest.

In Example 5, if liquidation value is used, an aggregate of $10 would be shifted from A and B's capital accounts to C's capital account and this would correspond to C's income inclusion and P's Section 707(c) deduction (subject to applicable limitations). On the other hand, if the tax consequences of the issuance were based on the $8 fair market value of the interest, the income and deduction amounts would be only $8 and this would suggest that C should end up with an $8 capital account, assuming capital accounts would be booked up upon issuance of the interest. However, an $8 capital account for C would be inconsistent with the fundamental approach of the Section 704(b) and 704(c) regulations, which necessitates that C's initial capital account balance be equal to the amount that C would receive on an immediate liquidation of the partnership.

To illustrate a further concern, assume that in Example 5, the assets had a value of $200 (so there is built in gain inherent in the partnership's assets of $100). In the First Report, we described two basic analytical approaches for determining the tax consequences to the partnership and its historic partners of the exercise of compensatory options, which approaches were the "circular flow of cash" approach and the "constructive sale of assets" approach.[57] In discussing both approaches, the First Report assumed that taxable capital interests would be valued based upon liquidation value. Under the "constructive sale of assets" approach, issuance of the interest is treated as a transfer of an undivided interest in the partnership's assets to the service provider as compensation in a transaction resulting in gain or loss recognition with respect to the portion of the assets transferred, followed by a tax free contribution of the undivided interest back to the partnership. If the constructive sale of assets approach were determined to be the required approach, the use of a valuation method other than the liquidation value approach would seem to necessitate that a consistent methodology be used to determine the

57 First Report, pp. 71-78.

portion of the assets deemed sold, which would then add further complexity to the overall treatment.

Interestingly, this concern does not arise with the "circular flow of cash" approach. Under this construct, the partnership is deemed to have paid cash to the service provider in an amount equal to the value of the interest received and the service provider is deemed to have recontributed the cash to the partnership in exchange for the partnership interest. Under the circular flow of cash theory, no gain or loss is generally recognized to the partnership or the historic partners, so the above-mentioned concern relating to the portion of the assets deemed sold would not be present.

C. Effect of Vesting Arrangements. Treasury Regulation §1.721-1(b)(1) currently includes a rule that applies where a transfer of a capital interest is conditioned on the completion of future services. The rule provides that the amount of income is the "value of the interest in capital so transferred," either at the time the transfer is 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 Regulation further provides that "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." This rule, which predates Section 83, serves a role somewhat similar to the risk of forfeiture concepts in Section 83. As noted earlier, Proposed Treasury Regulation § 1.721-1(b)(1), issued in June 1971 after Section 83 was enacted, proposed replacing the rule described above with a rule treating a transfer of a partnership capital interest as a transfer of property to which Section 83 and the regulations thereunder would apply.[58]

In the context of compensatory capital interests, we believe that service providers that receive substantially nonvested capital interests should not be required to include in income the value of such interests prior to vesting. However, we also believe that to minimize confusion, the existing vesting regulations under Section 721 should be deleted and replaced with a single set of regulations addressing both compensatory profits interests and compensatory capital

58 This regulation was proposed to be effective for transactions occurring after June 30, 1969. As noted earlier, it was never finalized or withdrawn, so it remains outstanding as a proposed regulation.

interests. As discussed earlier, we believe that in the context of compensatory profits interests, the normal Section 83(b) election procedure should not be applicable and that instead regulations should be issued that implement the principles of Revenue Procedure 2001-43 by providing for a deemed election. We also believe that it would be best to avoid a discontinuity between the treatment of profits interests and the treatment of capital interests, and therefore, we recommend that the regulations also provide for a reversal of the normal election procedure under Section 83(b) in respect of the receipt of a compensatory capital interest, so that, in effect, there would be a deemed election (again with the service provider having the ability to affirmatively elect to the contrary).[59] This election would differ from the normal election under Section 83(b) in that the interest would be treated as outstanding for tax purposes absent the election (vs. the standard Section 83 result of being treated as not outstanding absent the election). Our recommendation that the election procedure be flipped (i.e., the interest is treated as outstanding for tax purposes absent an election) is based on our belief that such treatment is indisputably the preferable treatment for compensatory profits interests and that it would be desirable to have a consistent approach for compensatory capital interests. Furthermore, the deemed election often will be the preference of the service provider in the case of compensatory capital interests, so we would not anticipate a large number of affirmative elections to the contrary.[60]

If a consistent Section 83(b) election approach for both profits and capital interests is not adopted, consideration should be given to the situation where there is an inadvertent failure to make the appropriate election (where one is needed) because the service provider believed the interest to be a profits interest, but due to a valuation error, was in fact a capital interest (or vice versa). One possible way to address that situation would be to provide that a good faith determination that an interest is a capital or profits interest would result in the interest being subject to the appropriate election if that determination proves to be incorrect. In addition, if a deemed Section 83(b) election approach is not adopted for capital interests, consideration should

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59 In lieu of a unilateral election by the service provider, the regulations might alternatively provide that the election would have to be made jointly by the service provider and the partnership.

60 While the deemed election would result in immediate income (assuming the capital value exceeded the amount (if any) paid for the interest), the service provider would avoid later taxation, at ordinary income rates, on the growth in the value of the interest attributable to the profits component of the interest. However, this incentive might be reduced if the bifurcation approach discussed earlier were adopted.

be given to allowing a partnership to make the election on behalf of any of its service partners that receive unvested capital interests (as suggested in Part III(E)(3) for unvested compensatory profits interests).

One other point to consider regarding elections is timing considerations. The timing rules for making an affirmative election in the partnership context might also be different than under Section 83.[61]

D. <u>Section 83 Considerations</u>. As discussed above, we believe that the application of the normal valuation rules of Section 83 to the receipt of a compensatory capital interest is, as in the case of a profits interest, not mandated by the statute. As discussed earlier, a strong case can be made that normal rules of Section 83 should not apply and were not intended to apply to the receipt of a profits interest. Further, as noted above, problems and anomalies arise if one set of rules and principles applies to profits interest and a different, inconsistent set of rules applies to capital interests. Moreover, although Section 83 is broadly worded, the current Treasury Regulations under Section 83 by their terms address only transfers of property to employees or independent contractors, not partners receiving guaranteed payments under Section 707(c).[62] Arguably, then, compensatory transfers of partnership capital interests to service partners, which are treated as Section 707(c) payments, are currently not subject to the existing Treasury Regulations under Section 83. In the context of Section 707(c) guaranteed payments, the Tax Court has acknowledged that not all the provisions that apply to compensation under Section 61 should apply equally to Section 707(c) payments. [63] Even if Section 83 is applicable, we believe

61 Under Section 83(b)(2), the Section 83(b) election must be made within 30 days of the transfer of the interest. Given the short time frame for making the election, and the apparent inability to obtain an extension, the potential for an inadvertent failure to file represents a trap for the unwary taxpayer. However, any modification of the 30 day rule may raise further authority questions. See also NYSBA Tax Section, *Report on Possible Modification to Section 83 and the Regulations Thereunder*, Part III, p. 17-22 (December 7, 2000) (the "Section 83 Report").

62 See Treas. Reg. § 1.83-1(a)(1) ("Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor."). Section 83 by its terms applies to any "property that is transferred to any person other than the person for whom such service are performed", which would seem to include the exchange of a capital interest in a partnership for services.

63 See *Miller v. Comm'r*, 52 T.C. 752 (1969). This was based in part on the legislative history to Section 707(c), which provides that "[n]o inference is intended, however, that a partnership is to be considered as a separate entity for the purposes of applying other provisions of the internal revenue laws if the concept of

it would be a reasonable interpretation of the statute, as applied in the partnership context, to provide for the application of a liquidation approach to valuation.

In view of all of the above, we believe that the Treasury has the authority to provide by regulation that the normal rules of Section 83, particularly as to valuation, do not apply to compensatory capital interests, and that there is authority under Subchapter K to issue a set of rules, preferably gathered in a single place in the Treasury Regulations under Section 83, that will address the treatment of the issuance of such interests.[64]

E. <u>Tax Consequences to the Partnership</u>. As noted in the First Report, an important issue regarding compensatory capital interests is whether the issuance of such interests causes the partnership and the historic partners to recognize gain or loss.[65] We described the two competing analytical approaches that might be applied in resolving that issue—the circular flow of cash approach and the constructive sale of assets approach. We acknowledged that the choice between the constructive sale of assets and circular flow of funds approach presents a difficult policy issue, but concluded that we tended to favor the circular flow of cash approach. We reiterate that preference. We also reiterate our strong recommendation that the law be clarified to eliminate the uncertainty that now exists with respect to this issue.

Another important issue at the partnership level is how the deduction for compensation expense should be allocated among the partners. As stated in the First Report, we recommend that this issue also be addressed in the regulations and we recommend that the deduction be required to be allocated among the historic partners of the partnership.[66]

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the partnership as a collection of individuals is more appropriate for such provisions." H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). See also *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968).

64 For further discussion of authority considerations, see note 43 above.

65 First Report, pp. 71-78

66 First Report, pp. 70-71.

V. Limitations on Scope of the General Rule and Certain Special Considerations

If the basic issue is resolved in favor of valuing a compensatory partnership interest on the basis of its liquidation value (and accordingly not taxing the receipt of a profits interest since it has a zero liquidation value), certain limitations on the scope of this treatment would seem to be appropriate. As discussed below, we believe that this treatment should generally be limited to cases where the partnership interest is received from the partnership in respect of services provided to or for the benefit of the partnership. In addition, the Treasury might consider carving out certain potentially abusive cases through a regulatory anti-abuse rule or otherwise.

A. <u>Services Performed For or For the Benefit of the Partnership</u>. Revenue Procedures 93-27 and 2001-43 only apply in cases where the profits interest is received for providing services "to or for the benefit of the partnership." They do not attempt to distinguish between services provided in a partner capacity and services provided as an "employee or independent contractor,"[67] as long as the services are for or on behalf of the partnership. However, these Revenue Procedures, by their terms, do not apply where the profits interest is issued as compensation for services provided to and for the benefit of a third party or another partner. We believe this limitation on the application of the recommended rule is appropriate. The discussion and analysis above and our recommendations assume that the services are performed for or on behalf of the partnership. In cases where the services are performed solely for the benefit of a third party and not for the benefit of the partnership, the receipt of a compensatory interest for services should be taxable to the service recipient under the general rules of Section 83 based on the fair market value of the interest at the time the interest became substantially vested.[68] It may be appropriate for the regulations to apply the recommended

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67 This issue should be addressed by the application of Section 707(a). However, the Service has made this distinction in a prior ruling. See G.C.M. 36,346 (July 23, 1975.)

68 If the services are performed for a third party, that person would be entitled to a compensation deduction equal to the fair market value of the interest, subject to the capitalization rules and other limitations on deductions, and would recognize gain or loss to the extent the fair market value of the profits interest exceeded its tax basis for the interest. See Section 83(h) and Treas. Reg. §§ 1.83-6(a)(1) and - 6(b). The service provider, in addition to being taxable upon receipt of the interest, would be required to pay tax on his distributive share of partnership income. If the partnership has a Section 754 election in place, the service provider would presumably be entitled to the benefit of a Section 743 basis adjustment equal to amount of income he recognizes on receipt of the interest. See Treas. Reg. § 1.743-1(b) (increase is equal to the excess of the transferee's basis for its interest over its share of the adjusted basis of partnership

approach not only to cases where the partnership interest is issued directly by the partnership to the service provider, but also to certain types of secondary transfers to the service provider, so long as the service partner is in fact receiving the interest in exchange for services provided to or on behalf of the partnership.[69]

B. <u>Past Services vs. Future Services</u>. Under existing legal authority, the treatment of the receipt of a profits interest for services does not depend upon whether the services were provided before or after the formation of the partnership, provided that in the case where the services were provided before formation, they were provided in furtherance of the partnership venture.[70] For example, a profits interest received for providing services in connection with the organization or promotion of a partnership to be formed would generally be covered by the same rule as applies to profits interests received for ongoing or future services.[71] Consistent with the existing authorities, we believe that the application of the recommended treatment should not depend on whether the services were provided before or after the time of the grant of the compensatory partnership interest as long as at the time the services were provided it was intended that they be compensated through the delivery of a partnership interest.

C. <u>General Partnership Interests vs. LP, LLC, or LLP Interests</u>. Whether a service provider is a limited partner or non-managing member, as opposed to a general partner or a managing member, should not be relevant for determining whether the receipt of a compensatory interest is subject to the recommended rule, except insofar as it relates to the question of whether

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property (which is zero in the case of a profits interests)). It appears the adjustment would be allocated solely to capital gain property and among the assets of the partnership in proportion to their relative fair market values. See Treas. Reg. §§ 1.755-1(b)(2) and (b)(3)(ii).

69 For example, we suggest that consideration be given to applying the principles of the Revenue Procedures to situations in which a general partner receives a compensatory interest from a partnership, and transfers a portion of that interest to an employee of the general partner that will be performing substantial ongoing services in respect of that partnership.

70 Rev. Proc. 2001-43 is consistent with this approach in that it applies to partnership interests received for services rendered in either a partner capacity or "in anticipation of becoming a partner". See also Rev. Proc. 93-27, 1993-2 C.B. 343.

71 However, if the services are performed before formation of the partnership, in some cases, an issue may be raised as to whether the services were for the benefit of the partnership or for the benefit of those persons who become the other partners. See *Justice Brief in Campbell Limits Recognition of Income on Receipt of Partnership Profits Interest,* 91 TNT 53-39 (March 8, 1991).

the service provider received his interest for services to or for the benefit of the partnership. Likewise, there is no reason to distinguish between compensatory interests in general partnerships, limited partnerships, limited liability companies and limited liability partnerships. Neither the Revenue Procedures nor any other authorities invoke any such distinctions in this regard.

D. Other Exclusions. Revenue Procedure 93-27 excludes profits interests from its scope if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (2) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b) or (3) within two years of receipt, the partner disposes of the profits interest. The first two exclusions appear to be targeted at profits interests that, on the date of issuance, have a fair market value that is relatively ascertainable based on expected cash flows and/or have a high degree of marketability. The third exclusion appears aimed at cases like *Diamond* where the value of the interest is relatively clear at the time of issue because of a contemplated sale or disposition and, more broadly, at cases where the value is established within a relatively short period after the issuance, by an actual sale or disposition of the interest.

We believe that exclusions from the application of the general rule are appropriate in cases where (i) the partnership interest received has a clearly ascertainable fair market value at the time of issuance, (ii) the value of the interest is not clearly ascertainable at the time of issuance, but at the time the interest is issued, a sale or other disposition of the interest within a relatively short time is intended or contemplated or (iii) the cash flows with respect to the interest are not subject to entrepreneurial risk and are highly predictable. For purposes of determining whether a compensatory partnership interest has a clearly ascertainable value at the time of its issuance, the regulations might adopt rules similar to those in Treasury Regulation §1.83-7, which apply for purposes of determining whether a nonqualified option has a readily ascertainable fair market value and, therefore, is treated as property taxable on receipt. For purposes of determining whether a sale or other disposition of an interest is intended or contemplated, the regulations might adopt a rebuttable two year presumption, similar to the presumption in Treasury Regulation § 1.707-3(c)(1) for purposes of the disguised sale rules (but any such presumption should exclude any forfeiture pursuant to vesting arrangements). Also we believe that the sale or disposition exclusion should be limited to taxable transactions.

Because any exclusions of interests from the recommended rule will raise the Subchapter K accounting and other issues described herein, we believe that exclusions should be kept to the minimum necessary to prevent inappropriate tax avoidance. In this regard, we observe that certain abusive cases, such as *Diamond*, can be addressed by the existing anti-avoidance rules of the Code or otherwise.[72] In addition, the regulations to be issued under Section 707(a)(2)(A) may be an appropriate framework for addressing cases that would otherwise be candidates for exclusion,[73] including cases where the distributions to be received in respect of the interest are not subject to material entrepreneurial risk and cases where the duration of the service provider as a partner is relatively short. Section 707(a)(2)(A) provides that if (i) a partner performs services for a partnership and (ii) there is a related allocation and distribution to such partner, then the "transaction" will be treated as occurring between the partnership and a person that is not a partner if, under all the facts and circumstances, the transaction is more properly characterized as a payment to a partner acting other than in his capacity as a partner of the partnership.[74]

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72 See footnote 27 above and the discussion in Part III (c) to the effect that *Diamond* could have been decided on the basis that Diamond in fact received a capital interest. In addition, given the transitory existence of the partnership, arguably no bona fide tax partnership was formed. *See* Treas. Reg. § 1.701-2 (anti-abuse rule) ("The partnership must be bona fide…"; "…partnership formed or availed of in connection with a transaction a principal purpose of which is to reduce ..tax liability…inconsistent with the intent of subchapter K").

73 To date, no regulations have been issued under Section 707(a)(2)(A). However, the legislative history provides significant guidance as to their intended scope, as do the Treasury Regulations promulgated under Section 707(a)(2)(B) relating to disguised sales of property to a partnership. See S. Rep. No. 169, Vol. 1, 98th Cong., 2nd Sess. 227-228 (1984). Moreover, in a recent T.A.M., the Service concluded that it had the authority to treat a distribution as a disguised sale of a partnership interest even without implementing regulations. T.A.M. 200301004 (August 4, 2002).

74 The legislative history indicates that the relevant factors include (i) whether the payment is subject to significant entrepreneurial risk (which the legislative history indicates is the most important factor), (ii) the duration of the partner status of the service provider, (iii) whether the distribution and allocation are close in time to when the services are performed, (iv) whether the partner became a partner to obtain tax benefits and (v) whether the value of the recipient's interest in general and continuing partnership profits is small in relation to the allocation in question.

If Section 707(a)(2)(A) applied to the receipt of a partnership interest, it could be implemented in the regulations by providing that the interest is taxable on receipt. Alternatively, it could be implemented by not taxing the receipt of the interest but providing that distributions received from the partnership should be treated as compensation when received or accrued. The latter approach would be simpler and would address character issues, but leave open the possibility of deferral. If the regulations did not cause interests to be taxable on receipt, the Section 707(a)(2)(A) framework would not cover those cases where the cashing out of the interest was through a sale or other disposition of the interest to a person other than the partnership.

E. Tiered Partnerships. Adoption of the recommended liquidation value approach presents significant issues in the context of tiered partnership arrangements, regardless of whether the interest is issued as a pure profits interest or a capital interest. In the basic tiered partnership fact pattern, partnership P receives a profits interest in partnership P1 for services it provides to P1, and A receives a partnership interest in P for services that A provides to P. The issue is how to value the interest that P has received in P1 for purposes of determining whether A has received a profits interest in P and, if it is determined that A has received a capital interest, for purposes of valuing that capital interest. More specifically, the issue is under what circumstances, if any, the liquidation value of P may be determined by reference to the liquidation value of P1 (rather than the fair market value of P's interest in P1, which is what would be relevant if P held any other type of property). Consider the following example:

> Example 6. Partnership P performs services for partnership P1 and receives for such services an interest in P1 that has a zero liquidation value (i.e., it is a pure profits interest) and a fair market value of $10. Assume P's only assets are its profits interest in P1 and certain investment assets with a fair market value of $20. A performs services for P and receives an interest in P that entitles A to 10% of all distributions from P once the other partners have received distributions of $20. The liquidation value of A's interest in P is zero if P's interest in P1 is valued at zero (its liquidation value). If P's interest in P1 is valued at its $10 fair market value, then the liquidation value of A's interest would be $1 and A will be taxable on receipt of the interest to the extent of the capital shift of $1.

If there had been no tiered partnership structure and instead there had been one partnership owning all the assets, it would be clear under our recommended general rule that A's interest would be worth zero on a liquidation basis. Accordingly, in cases where there is a business purpose to the tiered partnership structure, we recommend that the liquidation value approach, as applied to a service partner in an upper tier partnership, be applied on a look through basis without separately valuing the interest that the upper tier partnership holds in the lower tier partnership. We would note that this approach may be less favorable to the fisc in some cases as compared to the results using the true fair market value of the interest in the lower tier partnership, but we believe that there generally should be consistent tax consequences as between a tiered partnership structure and a comparable single partnership structure. In any event, the future Treasury regulations should provide guidance as to this issue.

VI. Additional Technical Issues If The Regulations Are Issued Under Section 83

If the forthcoming Treasury regulations are issued under Section 83, then certain additional technical issues would arise in applying standard Section 83 principles in the compensatory partnership interest context. Set forth below is a discussion of three of those issues and our recommendations regarding possible solutions. We assume that these issues would not arise (at least in the same form) if the regulations are issued under Subchapter K, because the Treasury would be starting with a "clean slate" rather than working within an established set of principles.

A. <u>Definition of Amount "Paid</u>." Treasury Regulation §1.83-2(a) provides, in part, that if a Section 83(b) election is made in respect to the receipt of property and the property is subsequently forfeited while substantially nonvested, loss shall be allowed in respect of the forfeiture in an amount equal to the excess, if any, of the amount "paid" for such property over the amount, if any, realized upon such forfeiture. Treasury Regulation §1.83-3(g) defines the amount "paid" as the "value of any money or property paid for the transfer of the property, even though the recipient will have a higher tax basis in the property due to the income inclusion."[75] If this rule limiting the loss to the amount paid stays in effect and applies to compensatory

75 "When section 83 applies to the transfer of property pursuant to the exercise of an option, the term 'amount paid' refers to any amount paid for the grant of the option plus any amount paid as the exercise price of the option." Treas. Reg. §1.83-3(g).

partnership interests,[76] the regulations should clarify that, if a Section 83(b) election is made or deemed made, the amount "paid" for the interest should be properly adjusted for any taxable income or loss incurred (other than any Section 83 income attributable to the initial receipt of the interest) and any distributions received by the service provider prior to any forfeiture. This point is illustrated by the following example:

> Example 7. A acquires an unvested profits interest, for services on January 1, 2004 and elects or is deemed to elect under Section 83(b) to treat the interest as substantially vested. During 2005, A's allocable share of partnership taxable income is $20, so that its basis in its interest is increased to $20 on December 31, 2004. In January 2005, A forfeits his interest and receives no consideration in exchange for the interest. A should have a $20 loss as a result of the forfeiture.[77]

B. Definition of Substantial Risk of Forfeiture. Treasury Regulation § 1.83-3(b) defines a "substantial risk of forfeiture" and provides generally that it is determined based on all the relevant facts and circumstances. Property is not transferred subject to a substantial risk of forfeiture to the extent that the employee must return the property upon ceasing to work for the employer if the employer is required to pay the fair market value of the property to the employee upon such return.[78] In the context of applying Section 83 principles to compensatory partnership interests, the Treasury may want the regulations to confirm that fair market value of a partnership interest for this purpose is its liquidation value rather than its true fair market value, which would provide consistency as between the valuation approach for purposes of determining whether there is a substantial risk of forfeiture and the valuation approach used in determining the recognition of income.

> Example 8. A, a service provider, receives a compensatory profits interest in partnership P. If A ceases to work for P before the second anniversary of the date of issuance of the interest, P has the right to reacquire the interest for its liquidation value, but after that time P will have no buy-out right. Under the

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76 See the Section 83 Report, p. 18 (setting forth the Tax Section's recommendation that this rule, which creates a penalty for the service provider, should be repealed).

77 In the context of Example 7, it would make sense for the other partners to have income equal to the loss recognized by A.

78 Treas. Reg. § 1.83-3(c)(1).

> suggested rule, the profits interest would not be considered to be subject to a substantial risk of forfeiture when received.

However, we would note that it would not automatically follow from the suggested rule that interests subject to a true fair market value buyout right should be regarded as being subject to a substantial risk of forfeiture. Instead, that issue would need to be examined on a case-by-case basis taking into account all the relevant facts and circumstances.

C. <u>Effect of Nonlapse Restrictions</u>. Under the Section 83 regulations, nonlapse restrictions generally are taken into account in determining the fair market value of property.[79] Treasury Regulation § 1.83-3(h) defines a nonlapse restriction as a permanent limitation on the transferability of property that (i) will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula and (ii) will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor). In the context of compensatory partnership interests, it may be appropriate for the regulations to take into account nonlapse restrictions that affect the realizable liquidation value of the capital interest received (but not other nonlapse restrictions) in determining whether an interest is a capital interest and, if so, its liquidation value.

> <u>Example 9</u>. A, a service provider, receives a non-transferable capital interest in partnership P, which interest has a liquidation value of $100 based upon the fair market value of P's assets at the time it is issued. However, based upon the tax basis of P's assets, the interest has a liquidation value of $50. If A ever stops providing services to P, A must resell its interest to P for its then liquidation value based on a tax basis valuation (including any undistributed income). This restriction does not terminate and therefore is a nonlapse restriction. In view of this restriction, it may be appropriate to treat the liquidation value of the interest as $50 rather than $100.

This result would seem to be appropriate because a partnership repurchase of a partnership interest is a liquidation of the interest under Subchapter K principles. However, consideration might be given to limiting this result to cases where a buyout is expected.

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79 Treas. Reg. §§ 1.83-1(a) and -5(a).

VI. **Compensatory Options**

A. Grant and Exercise. In the First Report, we recommended that compensatory options should generally be taxed in a manner consistent with the taxation of nonqualified corporate stock options.[80] Under this formulation, the exercise of a compensatory option to acquire a partnership interest, and the receipt of the corresponding partnership interest, would be treated for tax purposes as if the option holder was directly issued a compensatory partnership interest at the time of exercise.

We continue to recommend that those principles apply. Consistent with our recommendations herein, the regulations would provide that (i) there would be no income on the grant of a compensatory partnership option and (ii) there would be a taxable event upon the exercise of a compensatory option. Under this approach, the service provider will generally have compensation income upon exercise, with the amount of compensation income determined as though the service provider had acquired the partnership interest, at the time of exercise, in exchange for the exercise price plus any option premium paid. The character of the interest as capital versus profits and the value of such interest would be determined based upon all the facts and circumstances at the time of exercise. If at the time of exercise the interest represented is a vested capital interest, the option holder would recognize income equal to the excess of the liquidation value of the capital interest over the sum of the exercise price and any option premium paid. If a pure profits interest were received, the option holder would not recognize any income. If the interest received was not vested at the time of exercise, the consequences described above with respect to the receipt of nonvested partnership interests would apply. These principles are illustrated by the following example:

> Example 10. A provides services to partnership P, and receives an option to acquire a vested one-third interest in P, for $100, at a time when P's assets are worth $200. At the time when P's assets have appreciated to $500, A exercises his option. A will have $100 of compensation income upon exercise of his option ($200 liquidation value of the interest over the $100 paid to exercise the option).

80 First Report, pp. 63-82.

An alternative approach, which we do not recommend, would be to treat the issuance of option and its subsequent exercise as an open transaction in cases where the option, when granted, was out of the money (or at the money). Under this approach, there would be no income upon exercise if at the time of the grant of the option, the optioned interest was only a profits interest. The issuance of the interest would then be governed by the same rules that apply to noncompensatory options.

> Example 11. The same facts as Example 10. Under the alternative approach, A would generally not have income upon exercise of the option. P's capital accounts would be booked up immediately after the exercise of A's option and A's book-tax difference would be addressed under Section 704(c). However, to the extent that there was an insufficient book up adjustment to cause A's capital account to reach its proper level, there would be a gross income allocation to A to cover such shortfall and no related Section 704(c) adjustments.[81]

Adoption of this alternative approach would have the advantage of conforming the treatment of an out of the money (or at the money) compensatory option with the treatment of a profits interest. If this approach were adopted, full open transaction treatment would have to be limited to the out of the money or at the money cases, and could not be extended to options that are in the money at the time of grant, without creating unwarranted discontinuities between the treatment of options and the treatment of grants of capital interests.[82] One further advantage of this approach is that it would then moot the contentious issue of the treatment of the partnership and its historic partners in cases where it applied (i.e., where the option was out of the money or at the money at the time of grant). In particular, the partnership would not obtain a compensation deduction, and there would be no issue of a deemed sale of a part of the partnership assets under any constructive sale of assets approach. Book-tax differences resulting from the exercise of the option would be addressed under Section 704(c) principles or as otherwise provided in the noncompensatory option regulations.

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81 Prop. Treas. Reg. § 1.704-1(b)(4)(x).

82 For example, if A acquires a compensatory option to acquire a $200 vested capital interest for $100 and promptly exercises it, A should have $100 of compensation income upon exercise; the same result as if A had acquired directly a $200 vested capital interest for $100 in a compensatory context. If the approach described in Part IV(E) above were adopted, upon exercise the option holder would have income equal to the excess of the capital value at the time of grant, $100, over the exercise price plus any option premium (i.e., $100), which is the correct result.

While we believe this alternative approach may have some practical merit, we continue to believe that the standard option treatment recommended in this report and the First Report is preferable. In particular, we believe that compensatory option holders should not be able to obtain the generally favorable treatment that is available to holders of profits interests if they are not reporting their allocable share of partnership income in the same manner as an actual partner.

B. Effect on Book Up. As discussed above, the exercise of a compensatory option should generally be a taxable event to the service provider, and, as a result, the service provider will generally have a full liquidation value capital account upon exercise.[83] Accordingly, unlike the case with noncompensatory options, there should be no need to apply the special valuation rule in the Proposed Regulations to reduce the value of the partnership's property upon any pre-exercise book-up by the value of any unexercised compensatory option in order to provide headroom for the book-up upon exercise to create the proper capital account balance for the partners. That said, it would seem that the compensatory option should be treated as being in the nature of a contingent liability in effecting a book up under the Section 704(b) regulations and applying the Section 704(c) regulations.[84] To the extent nonvested capital and profits interests are not treated as outstanding for tax purposes, they should be treated as being in the nature of contingent liabilities.

83 See discussion at Part IV(A); See also Part IV(E) of the First Report.

84 The effect of contingent liabilities on Section 704(b) capital accounts is unclear under the current Section 704(b) regulations. There is not currently authority for applying Section 704(c) to such liabilities. Cf. Treas. Reg. § 1.704-3(a)(4) (applying Section 704(c) rules only to accounts payable and other accrued but unpaid items contributed by a partner that used the cash method of accounting, but not otherwise indicating that these rules should apply to contingent liabilities).