NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE PROPOSED REGULATIONS AND REVENUE PROCEDURE RELATING TO PARTNERSHIP EQUITY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES

October 26, 2005

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REPORT ON THE PROPOSED REGULATIONS AND REVENUE PROCEDURE RELATING TO PARTNERSHIP EQUITY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES

On May 20, 2005, the Treasury Department and the Internal Revenue Service issued proposed regulations[1] (the "Proposed Regulations") and a proposed revenue procedure[2] (the "Proposed Revenue Procedure" and, together with the Proposed Regulations, the "Proposed Rules"), providing guidance regarding the Federal income tax treatment of partnership equity transferred in connection with the performance of services.[3] The Proposed Rules follow: (i) the issuance of Notice 2000-29,[4] which requested public comment on the Federal income tax treatment of options to acquire a partnership interest and debt and preferred equity convertible into a partnership interest,

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1 REG-105346-03, Notice of Proposed Rulemaking Regarding Partnership Equity for Services, 70 Fed. Reg. 29675 (May 24, 2005).

2 Notice 2005-43, Nonrecognition of Gain or Loss on Contribution – Profit Interests Acquired in Exchange for Services, 2005-24 I.R.B. 1221 (May 20, 2005).

3 The principal author of this Report is David H. Schnabel. Substantial contributions were received from Kimberly Blanchard, Michael Bolotin, William Brannan, Andrew Needham, Yaron Reich, Joel Scharfstein, and Vadim Mahmoudov. Helpful comments were received from Lindsey V. Briggs, John Creed, Robert A.N. Cudd, Alex Gelinas, James Graham, Gretchen Harders, David Hariton, John Hart, David Kahen, Adele Karig, Harvey Katay, Charles Kingson, Janet Korins, Eric I. Lowenstein, Stephanie R. McCavitt, Douglas McClintock, David Miller, Steven Mills, Charles Morgan, Adam Mukamal, Amber Nussbaum, David J. Passey, Deborah Paul, Ken Raskin, Lawrence Reich, Jared Rusman, Jack Smith, John R. Smith, Linda Swartz, Alan J. Tarr, William Weigel, and Hagai Zaifman.

4 2000-1 C.B. 1241.

and (ii) the issuance of proposed regulations[5] providing guidance regarding the Federal income tax treatment of noncompensatory partnership options and other rights to acquire partnership equity (the "Proposed Noncompensatory Regulations"). The preamble to the Proposed Noncompensatory Regulations requested comments on the application of Section 83[6] to the issuance of compensatory options and partnership capital interests in connection with the performance of services and comments on how to coordinate the tax treatment of partnership profits interests issued in connection with the performance of services with the tax treatment of options to acquire partnership capital interests issued in connection with the performance of services.

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 adopted the view that compensatory options to acquire partnership interests generally should be taxed in a manner consistent with the taxation of non-qualified 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

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

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

Procedure 93-27[7], as modified by Revenue Procedure 2001-43[8] (collectively, the "Existing Revenue Procedures").

On January 23, 2004, the Tax Section issued another report (the "Second Report") providing our views, observations and recommendations with respect to the tax treatment of both directly issued compensatory partnership interests and compensatory partnership options.[9] The Proposed Rules are generally consistent with our recommendations in the Second Report with two significant exceptions relating to the application of traditional Section 83 principles to compensatory partnership interests. Specifically, we recommended in the Second Report that Treasury regulations be issued (i) requiring that a compensatory partnership interest be valued based on its liquidation value and (ii) effectively treating a Section 83(b) election as having been made in the case of a transfer of an unvested compensatory partnership interest unless the recipient elects otherwise. We expressed a preference for these regulations to be issued under Section 83, but recommended that the regulations be issued under Subchapter K if Treasury concluded that it did not have authority (or that it was otherwise inappropriate) to issue the regulations under Section 83.[10] These recommendations were consistent with

7 1993–2 C.B. 343.

8 2001-34 I.R.B. 191.

9 On January 23, 2004, the Tax Section also issued a third report, "Report on the Proposed Regulations Relating to Partnership Options and Convertible Securities."

10 As noted in our Second Report, a substantial minority of the members of the Executive Committee of the Tax Section would have preferred that the regulation be issued under Subchapter K for a variety of reasons, including a belief that Section 83 is not applicable to compensatory profits interest, a concern there may be authority

existing practice and with the treatment contemplated by the IRS in the Existing Revenue Procedures.

The Proposed Rules would "obsolete" the Existing Revenue Procedures and expressly subject compensatory partnership interests to Section 83.[11] Accordingly, the Proposed Rules would require that the value of a compensatory partnership interest be determined under Section 83 and that the recipient of a substantially nonvested partnership interest be treated as a partner only if a Section 83(b) election were made. Under an important but limited safe harbor, if a partnership satisfies a number of detailed requirements, certain compensatory partnership interests transferred by the partnership would be valued based on their liquidation value.

For the reasons discussed below, we believe it would be quite difficult for many partnerships to comply with the safe harbor election contemplated by the Proposed Rules, and it would be a practical impossibility for many partnerships to comply. As a result, in a substantial number of cases the safe harbor election would not apply and compensatory partnership interests would need to be valued under the general rules applicable under Section 83. While we expect that most taxpayers would continue to ascribe a zero value to compensatory partnership profits interests[12] even if the safe harbor election were not

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questions with respect certain aspects of the 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.

[11] Notice 2005-43.

[12] In referring to a "compensatory partnership profits interest" or "profits interest" throughout this report, we generally intend to refer to a partnership interest that has a liquidation value immediately after issuance equal to the cash or other property

applicable, this treatment would clearly be subject to challenge under the Proposed Regulations. As a result, the Proposed Rules would resurrect the uncertainty in valuing profits interest that was created by the Tax Court's decisions in *Diamond* and *Campbell* and eliminated by Rev. Proc. 93-27 and maintain the existing uncertainty in valuing capital interests. Moreover, valuing compensatory partnership interests at something other than their liquidation value would create a variety of issues under Subchapter K and necessitate additional coordinating regulations. Furthermore, the Proposed Rules would replace the very simple set of rules found in the Existing Revenue Procedures with a very complicated set of regulations. This seems hard to justify in light of the fact that the system seems to work quite well under the Existing Revenue Procedures and the fact that the Proposed Rules are generally designed to allow taxpayers to maintain the results available under the Existing Revenue Procedures. Finally, while we understand that the framework of the Proposed Rules is designed to prevent the IRS from being "whipsawed", we believe the Proposed Rules may in fact elevate the whipsaw potential, as compared with the potential that exists today or that would exist if regulations were issued requiring liquidation value to be used.

In light of these issues and the fact that neither Treasury nor Congress has expressed an independent desire to change the long-understood treatment of

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contributed to the partnership by the recipient. Although in the recipient of a profits interest is often required to contribute some capital to the partnership (and thus the interest is not a "pure profits interest"), this is not always the case. In referring to a "capital interest" throughout this report, we generally mean a partnership interest that has a liquidation value immediately after issuance that exceeds the cash or other property contributed to the partnership by the recipient.

compensatory partnership interests, we believe the Proposed Regulations should be revised to provide for a simple rule of general application that requires compensatory partnership interests be valued based on their liquidation value. Such a rule could be enacted under Section 83, Subchapter K or a combination thereof. In the event that Treasury and the IRS do not believe there is authority to adopt this approach, we recommend that they allow the area to continue to be governed by the Existing Revenue Procedures. Alternatively, in this event Treasury and the IRS could seek a legislative change.

The remainder of this report is divided into five parts. Part I summarizes our primary recommendations. Part II summarizes the background against which the Proposed Rules have been issued. Part III summarizes the Proposed Rules governing the amount of income and deduction to be recognized upon the transfer of a compensatory partnership interest and includes our comments to these Proposed Rules. Part IV discusses certain tiered or affiliated arrangements and certain changes that should be made to address these arrangements. Part V discusses the requirement that a taxpayer make an affirmative election to be treated as the owner of an unvested compensatory partnership interest and the tax consequences that may result if such an election is not made. Part VI discusses the extent to which a loss should be allowed under Section 83(b) if a compensatory partnership interest is forfeited, and also discusses the forfeiture allocations contemplated by the Proposed Regulations ("Forfeiture Allocations"). Part VII discusses a variety of technical issues.

Part I. Principal Recommendations.

For the reasons set forth in this report, our principal recommendations are as follows:

- General Valuation Rule. We believe that Treasury and the IRS have authority to, and should, revise the Proposed Rules to provide for a simple rule that generally requires compensatory partnership interests be valued based on their liquidation value. In the event that Treasury and the IRS remain concerned about their authority to issue such regulations under Section 83, we recommend that they either (i) issue such regulations under Subchapter K or (ii) issue regulations under Section 83 that generally require the use of liquidation value and issue additional coordinating regulations under Subchapter K that eliminate any whipsaw potential. In the event that Treasury and the IRS do not believe there is authority to adopt any of these approaches, we recommend that Treasury and the IRS allow the area to continue to be governed by the Existing Revenue Procedures. Alternatively, in this event Treasury and the IRS could seek a legislative change.

- Electing Safe Harbor Partnership Rules. If our first recommendation is not adopted, various changes should be made to the safe harbor election contemplated by the Proposed Rules, including changes that would eliminate or clarify:

    - The requirement that either the partnership agreement include certain language binding upon each partner or that each partner enter into a separate binding agreement,

    - The proposed rule that would terminate the safe harbor election if the partnership, a partner or a service provider reports the income tax treatment of a partnership interest issued under the safe harbor in a manner inconsistent with the requirements of the Proposed Revenue Procedure,

    - The requirement that the partnership file a tax return in order to make the election, and

    - The rule that various put/call rights create a presumption that a compensatory partnership interest was transferred in anticipation of a subsequent disposition and therefore is not eligible for the safe harbor election.

- Traditional Service Partnerships. The Proposed Rules should be revised to exclude interests in traditional service partnerships from Section 83. Alternatively, additional guidance should be issued concerning how Section 83 applies to interests in traditional service partnerships, and, if the more general regulations are finalized in advance of that additional guidance, interim guidance should be issued providing that a traditional service partnership and its partners will not recognize income, gain, or loss in connection with the grant or vesting of an interest in the partnership so long as certain conditions are satisfied.

- Tiered and Affiliated Arrangements. Certain aspects of the Proposed Rules should be extended to cases in which a partnership interest is issued in exchange for services provided to *or for the benefit of* the partnership.

- Need for Section 83(b) Elections. Treasury and the IRS should consider issuing regulations treating an unvested compensatory partnership interest as owned by the recipient as of the grant date (rather than as of the vesting date) without the need to make a Section 83(b) election, unless the recipient elects otherwise.

- Loss Upon Forfeiture. The Proposed Regulations should be revised to provide that, in computing the loss permitted under Section 83(b), any undistributed taxable income allocated in respect of a forfeited interest be treated as part of the amount paid for the interest to the extent such taxable income is not offset by Forfeiture Allocations.

- Forfeiture Allocations. The Proposed Regulations relating to Forfeiture Allocations should be revised in a variety of respects, including by:

    - Clarifying whether they are based on Section 704(b) book concepts or taxable income concepts.

    - Permitting the character of the Forfeiture Allocation to match the allocation giving rise to the Forfeiture Allocation.

    - Relaxing the requirement that Forfeiture Allocations consist of a pro rata portion of gross income and gain or gross deduction or loss in cases where this requirement would further distort the capital accounts of the partners.

    - Providing greater flexibility in cases where a partnership interest is forfeited only in part, including by allowing Forfeiture Allocations to be made in subsequent years and by allowing Forfeiture Allocations to the made to the other partners.

    - Allowing a partnership to elect to use “notional items” in the event that there are insufficient items otherwise available.

- Additional Section 707(c) Guaranteed Payment Regulations. Additional regulations should be issued under Section 707(c) treating any excess of the liquidation value of a compensatory partnership interest over its fair market value for purposes of Section 83 as an additional guaranteed payment to the service provider. These additional regulations would have no application if compensatory partnership interests were required to be valued based on their liquidation value.

- Allocation of Deduction upon Grant of Profits Interest. Additional regulations should be issued under Section 704(b) requiring that the partnership's deduction for transferring a compensatory partnership interest be allocated to the recipient partner to the extent of any excess of the fair market value determined under Section 83 over the liquidation value of the interest. These additional regulations would have no application if compensatory partnership interests were required to be valued based on their liquidation value.

- Meaning of Transfer. The Proposed Rules should be revised to clarify that various routine transactions are not treated as involving a "transfer" of a partnership interest.

- Effective Date. Unless the Proposed Regulations are modified to require the use of liquidation value or to make it considerably easier for existing partnerships to qualify for the safe harbor election, Treasury and the IRS should consider extending for some period the application of the Existing Revenue Procedures to partnerships in existence at the time the regulations are finalized.

Part II. Background

A. Historical Context.

As discussed in great detail in the Second Report, it has generally been understood for a very long time that a taxpayer who receives a partnership profits interest in exchange for performing services to the partnership generally does not recognize taxable income upon the receipt of the interest, but rather recognizes income as the partnership generates future profits. Prior to the enactment of Subchapter K in 1954, when the taxation of partnerships was largely based on common law principles and a partnership was viewed as an aggregate of its partners, it would have been considered obvious that the receipt of a compensatory partnership profits interest was not currently taxable. At that time, even cash payments to a partner designated as compensation were generally treated as non-taxable advances against the partner's distributive share of future partnership profits and, in light of this treatment, there would have been no reason to treat the receipt of a compensatory partnership profits interest as currently taxable. The legislative history to the 1954 Code, which adopted the Subchapter K statutory framework for taxing partnerships, does not include any suggestion that Congress intended to change this historic treatment. On the contrary, Sections 707(a) and 707(c) of the 1954 Code both seem to assume that the issuance of a compensatory partnership profits interest is not currently taxable, and this is reflected in the Treasury Regulations issued under Section 707(c) in 1956.[13] The general understanding that the receipt of a compensatory partnership interest does not result in current taxable income is similarly reflected, by negative implication, in Treasury Regulations promulgated under Section 721 in 1956:

> "[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 incomes to the partner under Section 61 (emphasis added)"[14]

The legislative history of Section 83, enacted in 1969, 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 partnership interests. Indeed,

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13 Treas. Reg. §1.707-1(c), Examples 2, 3, and 4, which involve a partner receiving an interest in partnership profits in exchange for services, but do not indicate that the partner is taxed on the value of the profits interest upon receipt.

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

Treasury Regulations, proposed in 1971 but never finalized, provided that partnership capital interests are subject to Section 83 but do not include a similar rule for partnership profits interests.[15] The legislative history of Section 707(a)(2)(A), enacted in 1984, similarly suggests that Congress believed that the receipt of a profits interest for services did not result in current tax.[16]

Only a handful of cases have addressed the treatment of receipt of a compensatory partnership interest. In *Diamond v. Commissioner*,[17] which involved taxable years before the effective date of Section 83, the Tax Court held that a service provider partner was taxable under Section 61 on the receipt of a "profits interest" received for services because the interest had a determinable market value at the time of its receipt. Although the Seventh Circuit affirmed, it indicated that the receipt of a profits interest might not be a realization event, but stated that, in the absence of a clarifying regulation, it was sound policy to defer to the expertise of the Tax Court. *Diamond* was widely criticized as being wrongly decided, or at least decided on the wrong grounds, and in GCM 36,346 the IRS advocated disavowing *Diamond* 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.

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15 Prop. Treas. Reg. § 1.721-1(b)(1), 36 Fed. Reg. 10787 (June 3, 1971).

16 See H.R. Rep. No. 432, Pt.2, 98th Cong., 2d Sess. 1216 (1984). The Congressional examples do not indicate that the receipt of an interest in partnership profits is a taxable event, instead only providing for the taxation of the accrual of payments from the partnership.

17 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

In *Campbell v. Commissioner*,[18] 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 reversed,[19] holding that the profits interest in question did not have any value, thereby avoiding the question of whether the receipt of a profits interest was a taxable event. The Eight Circuit indicated, however, that it doubted "that the tax court correctly held that Campbell's profits interests were taxable upon receipt," apparently on the grounds that "nonrealization concepts governing transactions between partner and partnership preclude taxation." The IRS, 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 provided to that partnership is a taxable event and instead 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 someone other than the partnership.

In several other cases decided between *Diamond* and *Campbell*, either the Court held that the receipt of a compensatory profits interest was not a taxable event because

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[18] T.C. Memo 1990-162.

[19] *Campbell v. Comm'r*, 943 F.2d 815 (8th Cir. 1991).

the recipient would receive nothing upon an immediate liquidation of the partnership,[20] or the IRS conceded the issue.[21]

In order to reduce any uncertainty regarding the tax treatment of typical types of compensatory partnership interests, the IRS 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 generally is not treated as a taxable event. Revenue Procedure 2001-43 further provides that in cases where Revenue Procedure 93-27 is satisfied, the service provider is treated as receiving the profits interest on the date of grant (and not when it later vests), so long as the partnership and the service provider treat the service provider as the owner of the interest from the date of grant, and neither the partnership nor any of its partners takes a deduction in respect of the fair market value of the interest at the date of grant or the date of vesting. This treatment expressly applies whether or not a Section 83(b) election is filed with respect to the interest.

The IRS has not adopted, nor have the courts developed, a consistent methodology for valuing capital interests to determine the amount the recipient must

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20 See *St. John v. United States*, 84-1 USTC ¶9158 (C.D. Ill. 1983) (holding that the taxpayer's receipt of a profits interests was not taxable since an immediate liquidation of the partnership would yield the taxpayer nothing); *National Oil Co. v. Comm'r*, T.C. Memo 1986-596 (holding that the interest at issue was a profits interest and that receipt of the interest was not taxable).

21 *Kenroy, Inc. v. Comm'r*, T.C. Memo 1984-232 (IRS conceded that the receipt of a profits interest was not taxable).

include in income. In *Mark IV Pictures*,[22] the IRS 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 partnership's assets--the same valuation the Tax Court used for profits interests. In two other cases, *Larson*[23] and *Johnston*,[24] 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 Tax Court valued the capital interest received by reference to the value of the services performed.[25]

B. Current Practice.

In practice, most compensatory partnership interests are structured as profits interests, and the taxation of these interests generally follows the approach outlined in the Existing Revenue Procedures, except that in many cases the recipient files a "protective" Section 83(b) election in case the interest is viewed as outside the scope of the Existing Revenue Procedures. Accordingly, taxpayers who join a partnership and receive a compensatory partnership profits interest typically expect that they will not recognize any

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[22] T.C. Memo 1990-571.

[23] T.C. Memo 1988-387.

[24] T.C. Memo 1995-140.

[25] 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 IRS.

taxable income upon the receipt of the interest, but rather will recognize income as the partnership generates future profits.[26] Issuing a compensatory partnership profits interest is a routine transaction undertaken by a vast number of partnerships each year in a variety of businesses, including a wide-array of investment partnerships,[27] partnerships that operate more traditional businesses and traditional service partnerships. The issuance of compensatory partnership profits interests by these partnerships typically reflects the parties' desire to operate as a partnership in which one or more persons join the enterprise but will generally only participate in distributions if the enterprise actually generates profits going forward.

For example, in the leveraged-buyout context it is commonplace for investment managers to organize a partnership with substantial cash commitments from third-party investors and issue the management team a 20% profits interest (referred to as a "carried interest") in exchange for making the investment decisions for the partnership. This 20% "carried interest" is held by a separate entity that serves as the general partner[28] (or

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[26] As a partner, the taxpayer is generally allocated whatever type of income is recognized by the partnership. Thus, for example, most of the profits allocated to the general partner of a private equity buyout fund consist of long-term capital gain (or qualifying dividend income) because most of the profits recognized by the underlying private equity fund consist of long-term capital gain (or qualifying dividend income) and most of the profits allocated to a service partner of a traditional service partnership consist of ordinary income because most of the profits recognized by a traditional service partnership consist of ordinary income.

[27] These include, for example, private equity funds, hedge funds and real estate funds.

[28] For the purposes of this report, "general partner" shall include the managing member of an LLC. In some funds, such as those organized in the United Kingdom, the 20% carried interest is embodied in a special limited partnership interest that is held by an entity owned by the management team.

managing member) of the partnership and that is owned by the management team. Moreover, interests in the entity serving as the general partner are regularly (often at least annually) reshuffled in a manner that gives a new or existing member an increased share of the carried interest for future investments. Interests in the general partner are typically structured to ensure that they are treated as profits interests and, accordingly, the recipient does not report any current income upon the receipt of the interest. We are not aware of a single instance in which anyone has taken a compensation or other deduction in connection with the issuance of a compensatory partnership profit interest or, more generally, where a deduction was claimed that differed from the amount included in income.

C. Rationale of the Proposed Regulations.

From what we understand, the decision to issue rules governing compensatory partnership interests was not motivated by a decision to change this long-understood treatment of compensatory partnership interests or to address any perceived abuse.[29] Similarly, as far as we are aware, Congress has not expressed any concern over this treatment or voiced any need to study or change the treatment. Rather, it appears that the Proposed Rules grew out of the general regulatory project involving partnership options (both compensatory and noncompensatory) and the perfectly sensible conclusion that regulations governing compensatory partnership options should not be issued until there were regulations governing compensatory partnership interests. Since Section 83

[29] Indeed, the Proposed Rules appear to be straining to allow taxpayers to apply the same principles applicable today.

generally governs the taxation of transfers of property in connection with the performance of services, it would certainly seem logical for regulations governing compensatory partnership interests to be issued under Section 83.[30]

However, we understand that the Proposed Rules reflect concerns about the authority to issue regulations under Section 83 that would conform with the long-understood treatment of compensatory partnership interests. This concern appears to stem from the fact that Section 83 on its face seems to apply to the issuance of compensatory partnership interests, in light of the plain meaning of the word “property” used therein. When combined with the absence of any express statutory authority to apply a different valuation rule, Section 83 could be read to foreclose the adoption of any special rules in the case of compensatory partnership interests and to require that valuation and vesting rules generally applicable under Section 83 apply to such interests.

In addition to the basic concerns with issuing a regulation that is potentially beyond the scope of its authority, we understand that Treasury and the IRS are worried that they could be whipsawed if it issued a regulation requiring the use of liquidation value and the regulation was held invalid. The clearest potential for whipsaw could arise if a partnership issues a compensatory capital interest and the partnership claims a deduction based on the hypothetically required liquidation value of the interest while the recipient of the interest takes the position that the regulation requiring the use of liquidation value is invalid and discounts the value of the interest (and reports income)

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[30] We recommended this in our Second Report.

using traditional Section 83 principles that take into account minority and illiquidity discounts.

> Example 1: Assume that regulations were issued under Section 83 requiring that compensatory partnership interests be valued based on their liquidation value. A and B form an equal partnership and each contributes $30 to the partnership. The partnership uses the $60 to buy income producing property. In exchange for services rendered to the partnership, C is granted an interest in 1/3 of the partnership's capital and future profits. Based on the Section 83 regulation, A and B would claim a compensation deduction based on the interest's $20 liquidation value. However, if C successfully challenged the validity of the regulation, C could contend that, under traditional valuation principles applicable under Section 83, in light of his minority position in the partnership and lack of liquidity, the value of the interest transferred to C (and therefore the amount of income recognized by C) is less than the interest's liquidation value.

Another potential for whipsaw could arise if a partnership issues a compensatory profits interest and the recipient reports compensation income using the interest's liquidation value (presumably zero), but the partnership (or one of the other partners) claims a compensation deduction on the basis that the regulation requiring the use of liquidation value is invalid and that the interest may be valued using traditional Section 83 principles (which could well reflect a positive value).

> Example 2: Same as Example 1, but instead of granting C an interest in 1/3 of the partnership's capital and profits, C is only entitled to 1/3 of the partnership's profits after the issuance of the partnership interest. Based on the hypothetical Section 83 regulation, C would report no income upon the receipt of the profits interest. However, if the partnership (or one or more of the partners) successfully challenged the validity of the regulation, they might take the position that the profits interest has value for purposes of Section 83 and that the partnership is entitled to claim a deduction based on that value.

The Proposed Rules address the statutory authority and whipsaw issues by creating a regime in which Section 83 generally governs the taxation of compensatory partnership interests, including the valuation of such interests, but the use of liquidation value is expressly authorized under the terms of a "safe harbor." This safe harbor is available only if both the partnership and the partners execute a binding agreement (which may be the partnership agreement itself) to use liquidation value and a litany of other requirements are satisfied. The Proposed Rules seem premised on the expectation that the safe harbor will be relatively easy for most partnerships to elect and to continue to comply with and that most partnerships that issue compensatory partnership interests will in fact elect into the safe harbor. We note, in this regard, that the Proposed Rules do not provide an express rule for determining the fair market value of compensatory partnership interests where the safe harbor does not apply.

Part III. Proposed Rules Governing the Amount of Income and Deduction upon the Transfer of a Compensatory Partnership Interest.

A. Detailed Description.

The Proposed Regulations would effectively revoke the Existing Revenue Procedures and expressly provide that the term "property" for purposes of Section 83 includes a partnership interest. Accordingly, Section 83 would govern the transfer, holding and forfeiture of a compensatory partnership interest.

Under the Proposed Rules, unless the safe harbor applies, a compensatory partnership interest would be subject to the valuation rules generally applicable under Section 83. However, the Proposed Regulations provide that, subject to such additional conditions, rules and procedures that the IRS may prescribe, a partnership and all of its partners may elect to report the fair market value of a partnership interest transferred in connection with the performance of services at its liquidation value (the "Safe Harbor Election"). In order to qualify for and maintain a Safe Harbor Election, the Proposed Regulations require that:

a) The partnership prepare a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply with respect to all partnership interests transferred in connection with the performance of services while the election remains in effect.

b) The partnership attach the document to the tax return of the partnership for the taxable year that includes the effective date of the election.

c) Either (i) the partnership agreement itself contains provisions that are legally binding on all of the partners, stating that (A) the partnership is authorized and directed to elect the safe harbor and (B) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agree to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective; or (ii) each partner executes a document containing provisions that are legally binding on that partner stating that (A) the partnership is authorized and directed to elect the safe harbor and (B) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.

d) The partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement and, if applicable, the <u>original</u> of each document submitted to the partnership by a partner under c).

The Proposed Revenue Procedure imposes further limits on the availability of the safe harbor:

e) The safe harbor would apply only to a "Safe Harbor Partnership Interest" transferred by a partnership, defined as a partnership interest that (i) is transferred by such partnership to a service provider in connection with services provided to the partnership (either before or after the formation of the partnership) and (ii) is not (a) related to a substantially certain and predictable stream of income from partnership assets, (b) transferred in anticipation of a subsequent disposition or (c) an interest in a publicly traded partnership. Unless it is established by clear and convincing evidence that a partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest would be presumed to be transferred in anticipation of a subsequent disposition (and therefore ineligible for safe harbor treatment) if the interest were sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or were the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). Moreover, an interest would only be considered a Safe Harbor Partnership Interest if at the time at which the interest is transferred the partnership and each partner are legally bound by the provisions contemplated by the safe harbor.

f) A partnership would cease to meet the requirements described in (c)(i) above upon any transfer of an interest in the partnership unless the transferee assumes the transferring partner's obligations under the partnership agreement.

g) A partnership would satisfy the requirements described in (c)(ii) above only if each person classified as a partner executes the document and, in the case of a transfer, the transferee executes an effective document prior to the transfer.

h) A Safe Harbor Election would terminate automatically if (i) the partnership failed to satisfy any of the requirements set forth above or (ii) the partnership, a partner, or the newly admitted service provider reports income tax effects of a safe harbor partnership interest in a manner inconsistent with the requirements of the Proposed Revenue Procedure, including a failure to provide appropriate information returns. The reporting requirements appear to include the rules relating to: (1) the amount and timing of the compensation income recognized by the recipient of a Safe Harbor Partnership Interest upon the issuance and vesting of the interest, (2) the amount and timing of the corresponding deduction to the partnership, (3) the requirement that the recipient of the partnership interest recognize additional ordinary income in certain cases where the partnership does not have sufficient gross income or gain to make certain Forfeiture Allocations, and (4) special rules relating to when a partnership interest will be considered substantially vested.

i) If a partnership has made a Safe Harbor Election but the election terminates, the partnership is not eligible, absent the consent of the Commissioner, to make another Safe Harbor Election for any taxable year that begins before the fifth calendar year after the calendar year during which such termination occurs.

B. Comments.

1) Comments on the Safe Harbor Election.

We believe that it will be difficult, time-consuming and expensive for many partnerships to comply with the Safe Harbor Election, and that it will be a practical impossibility for many partnerships to comply. Moreover, we expect that many partnerships will undertake significant efforts to make and maintain the election but inadvertently violate (or find that one of its partners has inadvertently violated) one or more of the technical requirements. As a result, we believe that the Safe Harbor Election will be unavailable to a substantial percentage of the partnerships formed each year and an even higher percentage of the partnerships currently in existence.

Need for the Binding Agreement of each Partner. For most partnerships, the biggest obstacle to making the Safe Harbor Election would be the requirement that either

(i) the partnership agreement contain certain provisions that are legally binding on all of the partners or (ii) each partner execute a document containing certain provisions that are legally binding on that partner. Although the preamble to the Proposed Regulations indicates that the IRS expects that the use of a separate document generally will not be necessary, we believe that many partnerships will not be able to conclude with reasonable certainty that language included in the partnership agreement is (and will continue to be) legally binding upon all of the requisite persons. As a result, we expect that partnerships will frequently be able to make the safe harbor election only if they receive a binding document from each partner.

Rationale for the Requirement. We understand that the need to obtain a binding agreement from each partner, as opposed to having the partnership make an election on behalf of each partner, stems from concerns about the authority under Section 83 to require the use of liquidation value. Specifically, we understand that Treasury and the IRS are concerned that if a partnership issued a compensatory profits interest and the regulations purported to permit the partnership to elect on behalf of all of its partners to use liquidation value, the recipient of the interest would include no amount in income and the partnership would claim no deduction, but a partner of the partnership might file inconsistently with the partnership, assert that the regulations permitting the election (and therefore the election itself) is invalid, and claim a deduction based on traditional valuation principles applicable under Section 83 (rather than based on the zero liquidation value of the profits interest).

As discussed in greater detail below, we believe that Treasury and the IRS have the authority to require that compensatory partnership interest generally be valued based on their liquidation value.[31] We similarly believe that Treasury and the IRS have authority to issue regulations allowing a partnership to elect to use this valuation methodology. In numerous other areas, a partnership is permitted to make elections that are binding on all of its partners without requiring that each partner authorize a legally binding document allowing for the election. In most cases, the general partner is authorized pursuant a general grant of authority included in the partnership agreement to make any and all tax elections available to the partnership (other than in many cases an election to change the classification of the entity). For instance, without any specific authorization, a general partner typically may choose the method of allocating built-in gain or loss, including the "remedial method",[32] make decisions about the partnership's accounting methods, make a QEF election,[33] and make an election under Section 754.

"Partner" for Tax Purposes vs. "Partner" for Local Law Purposes. Although not entirely clear, the Proposed Rules indicate that the requisite language must be binding on each person who is treated as a partner of the partnership for Federal income tax

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[31] See Part III.B. below.

[32] Treas. Reg. 1.704-3(a)(2) ("A partnership may use different methods [of allocating precontribution gain or loss] with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property…") and T.D. 8585, 59 Fed. Reg. 66724, 66725 (Dec. 28, 1994).

[33] Treas. Reg. 1.1295-1(d)(2)(i)(A).

purposes, not just on persons who are treated as partners for local law purposes.[34] It is not uncommon for partnerships to have persons treated as "partners" for Federal income tax purposes who are not partners for "corporate" purposes and who are not necessarily bound by language included in the partnership agreement. For example, it is quite common for an investor to hold a partnership interest through an entity that is disregarded for U.S. federal income tax purposes (a "DRE"), such as a single member LLC, a qualified Subchapter S subsidiary, a qualified REIT subsidiary or a grantor trust. Since the owner of the DRE is the "partner" of the underlying partnership for Federal income tax purposes, language included in the partnership agreement in these cases generally will not be binding upon all of the persons treated as "partners" of the partnership for Federal income tax purposes. Accordingly, a partnership will need to obtain a separate binding document from each owner of any DRE that has invested in the partnership. Similarly, under the Section 736, a "retired partner" who is entitled to one or more remaining payments from a partnership is treated as a partner of the partnership for Federal income tax purposes even if he or she is treated as a creditor rather than as a partner for corporate purposes. Since language included in the partnership agreement will not be enforceable against these retired partners, they similarly will need to sign a separate binding document in order for the partnership to make the Safe Harbor Election.

In many cases a partnership will have no way of knowing whether one or more of its partners is a DRE, and most partnerships have no ability to prevent an existing partner

[34] Although this is expressly provided in the Proposed Rules only where a partnership has relied upon a separate document executed by a particular partner and the partner transfers its partnership interest, we assume it is also required in other cases as well.

from transferring its partnership interest to an affiliated DRE. Accordingly, we believe it will be difficult for many partnerships to conclude that the included language in the partnership agreement will be effective to make it legally binding upon all of the "partners." We note, in this regard, that even if a partnership determines which partners hold through a DRE as of any given date, a disqualifying transfer could occur in a variety of routine transactions, such as where an exiting partner transfers its partnership interest to a wholly owned DRE, where a single member LLC that holds a partnership interest elects to change its tax classification from corporate status to DRE status, where the stock of a corporation that holds a partnership interest is acquired by an S corporation and becomes a qualified subchapter S subsidiary, or where a corporation holding a partnership interest is acquired by another corporation by merging into a DRE owned by the acquirer. We expect that most taxpayers undertaking such transactions will not anticipate that they will terminate the Safe Harbor Election made by a partnership held by the taxpayer, particularly where the transfer is made in connection with a larger transaction involving the taxpayer's other assets.

An obvious solution to the problem caused by DREs would be to treat the owner of the DRE as bound by any obligations of the DRE. However, as discussed above, the requirement that each partner enter into a binding agreement to report the tax effects of each issuance of a compensatory partnership interest in the manner contemplated by the election is predicated upon concern that an agreement by the partnership to such reporting may not be binding upon the partners. If a two-member LLC cannot bind its members in this area, a single member LLC may similarly not be able to bind its sole member.

Moreover, it is not uncommon for a partnership to permit transfers of economic interests in the partnership but not admit the transferee as a substitute partner. Depending on the circumstances, the transferee may be treated as a partner of the partnership for Federal income tax purposes even though the provisions of the partnership agreement may not be legally binding upon the transferee.[35] Accordingly, these transactions would similarly disqualify a partnership from the Safe Harbor Election if the partnership had assumed that language included in the partnership agreement was (and would continue to be) binding on all of the "partners." Again, many existing partnerships are not able to prevent disqualifying transfers, and even if a newly created partnership attempted to address these concerns in its partnership agreement, there can be no assurance a limited partner would not inadvertently transfer its partnership interest in violation of the agreement. Moreover, we believe that the potential effect of such a transfer on the partnership will simply not occur to many if not most taxpayers who transfer an economic interest in a partnership.

Additional Self-Imposed Requirements. In light of these possibilities, we expect well-advised partnerships would seek representations from partners about their tax status and express covenants from partners prohibiting them from undertaking any transaction or making any election that would disqualify the partnership from the election. Moreover, some partners who receive compensatory partnership profits interests will

[35] See Rev. Rul. 77-137, 1977-1 CB 178.

seek indemnities from the other partners if they violate the requirements of the safe harbor or do anything else that causes the partnership's Safe Harbor Election to terminate.[36] Reaching agreement with each partner about which of these provisions is appropriate and what remedies should exist if they are breached may be time consuming, expensive and controversial.

Foreign Check the-Box Partnerships. In the case of certain types of non-US entities that elect to be treated as partnerships for U.S. federal income tax purposes, including the requisite language in the organizational document may not create an obligation enforceable against any holder of an interest in the entity. We expect that this issue will arise in many cases where a foreign corporate-type entity elects to be treated as a partnership for U.S. federal income tax purposes. As a result, these types of entities will only be able to make the election if they obtain a separate binding document from each "partner."

Existing Partnerships. The need for language that is binding upon each partner will be especially problematic for an existing partnership, which will need to obtain (i) an amendment of its partnership agreement and/or (ii) a legally binding document from each partner. In the typical case, this will require counsel to the partnership to draft the amendment and/or document and prepare a letter to each partner explaining what it does and why it is needed. Although the language required by the Proposed Rules may appear benign, most taxpayers are very careful in entering into any agreements relating to U.S. taxes, and (as discussed above) in many cases the partnership (or its service partners) will

[36] Such indemnities have already begun to appear in the private equity area.

want to obtain additional representations, covenants and indemnities from each partner. As a result, we expect that many partners upon the receipt of a request for such an amendment or binding document will have separate counsel review and comment on the language. Moreover, as discussed above we expect that many partnerships will need to obtain a separate binding document from one or more of its partners. In these cases, the partners who need to sign the separate binding document will have tremendous hold-up value, which one can expect at least some to try to exploit. This hold-up potential is particularly acute in the case of a service provider who has been terminated from a partnership, but still is a partner for Federal income tax purposes because the service provider's interest was partly vested at the time of termination. In this situation, the need for the terminated partner's acquiescence and the likely bad blood between the partner and partnership may result in time-consuming and acrimonious negotiations. Given the countless number of partnerships in existence and that many partnerships have hundreds or even thousands of partners, we believe this requirement will represent a substantial burden.

Partnership Agreement as the Separate Document. In some cases, language included in the partnership agreement will be binding upon some partners but not other partners. It would be helpful if the Proposed Rules confirmed that in these cases a separate document is only needed from those partners upon which the partnership agreement is not legally binding.

What Exactly Are the Partners Agreeing To? As noted above, each partner is effectively required to agree to "comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective." In light of the numerous requirements to make the Safe Harbor Election and the numerous additional requirements to maintain the election, it is not altogether clear what obligations this language is intended to impose on each partner. We recommend that this required language be modified to make it clear that the partner will be considered to satisfy its obligation so long as it reports items associated with the partnership consistent with the manner in which the partnership reports the item to the partner (whether on a Form K-1 or otherwise).[37] This would seem to further Treasury's goal of requiring all of the relevant taxpayers to report the transaction in a consistent manner. By contrast, the language currently contemplated by the Proposed Rules would seem to require each partner to determine the appropriate tax treatment required under the Proposed Rules in order to ensure that it is complying with the terms of the required language. However, as discussed below, compliance with the safe harbor requires certain valuations, which are inherently factual, and adherence to various allocation and reporting provisions. It will not always be clear how to apply some of these provisions. We are not sure what a partner should do in cases where the partner and the partnership each want to comply with the safe harbor but, due to a genuine disagreement between the partner and the partnership, the partner believes that it is appropriate to report a particular item differently than the partnership. We believe it

[37] Note that in some cases a partner may report items from a partnership before receiving an IRS Form K-1 from the partnership.

would be appropriate and helpful if the Proposed Rules did not terminate the Safe Harbor Election in this context.

We note that the language contemplated by the safe harbor would require each partner to comply with all of the requirements of the safe harbor with respect to "all partnership interests transferred in connection with the performance of services" even though the safe harbor only applies to such a partnership interest if it meets certain other requirements and is therefore considered a so-called "safe harbor partnership interest." It would be helpful if the language contemplated by the Proposed Rules were modified to clarify that it does not impose any obligations with respect to compensatory partnership interests that are not Safe Harbor Partnership Interests.[38]

Meaning of "Legally Binding." The Proposed Rules require that the relevant provisions be "legally binding on all the partners." Legal opinions concerning the enforceability of partnership agreements (even those formed under Delaware law, the most common jurisdiction of formation and the one with the most well-developed case law) are universally subject to various exceptions, including exceptions for the effects of (i) bankruptcy, insolvency, and similar laws and principles, (ii) general equitable principles (whether considered in a proceeding in equity or at law), (iii) an implied covenant of good faith, reasonableness and fair dealing, and concepts of materiality, and (iv) limitations on the enforceability of rights to indemnification, contribution or

[38] We note in this regard that Section 3.04 of the Proposed Revenue Procedure provides that a Safe Harbor Election terminates if the partnership, a partner, or a service provider reports income tax effects of a safe harbor partnership interest in a manner inconsistent with the Proposed Revenue Procedure.

exculpation under federal, state or local securities laws or regulations or to the extent such indemnification, contribution or exculpation would violate public policy. We assume that limitations on enforceability in these traditional cases are not intended to terminate the Safe Harbor Election. It would be helpful if the Proposed Rules clarified this point.

Tiered Arrangements. It bears noting that if a partnership is not able to bind its partners in this area, the Proposed Rules would not eliminate the potential whipsaw concern in a variety of typical situations. For example, suppose that a partnership (the "lower-tier partnership") includes the requisite language in its partnership agreement, that the language is in fact legally binding on all of the partners of the lower-tier partnership, and that one of the partners of the lower-tier partnership is in another partnership (the "upper-tier partnership"). If a partnership generally cannot bind its partners in this area, the partners of the upper-tier partnership would not be required to comply with the requirements of the safe harbor elected by the lower-tier partnership. Similar concerns may be applicable in cases where a partnership interest is held by an S corporation or a subsidiary member of a consolidated group. We are not suggesting that the Proposed Rules be amended to cover these situations as this would cause the Safe Harbor Election to be beyond the reach of even more partnerships,[39] but rather to point out that the framework of the Proposed Rules does not address Treasury's concerns in a number of common situations.

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[39] We note that if such an amendment to the Proposed Rules were made, it would also need to cover the situation in which one of the partners in the upper-tier partnership is also a partnership.

Reporting Requirements. A Safe Harbor Election would terminate automatically if the partnership, a partner, or a service provider reports the income tax effects of a safe harbor partnership interest in a manner inconsistent with the requirements of the Proposed Revenue Procedure, including a failure to provide appropriate information returns. The fact that the Proposed Rules explicitly state that a Safe Harbor Election terminates if the partnership fails to provide appropriate information returns seem to confirm that Treasury intends that a technical foot fault will disqualify the partnership and prevent the partnership from being entitled to make the Safe Harbor Election for another five years. This aspect of the Proposed Rules seems to assume, in our view incorrectly, that reporting in a manner consistent with the requirements of the Safe Harbor Election will be a relatively straightforward matter in most cases. However, correct reporting will depend on whether the IRS agrees with the partnership's determination of the value of its assets (which is inherently factual but an obviously key component in determining liquidation value) and the manner in which the partnership (and the partner) reports Forfeiture Allocations and allocations with respect to compensatory partnership interests subject to vesting. Thus, for example, if a partnership reports under the assumption (which the partnership may well have tried to confirm) that all of its partners have made valid elections under Section 83(b), but it turns out that one such election was filed one day late (or the recipient mistakenly failed to file it altogether), the partnership will not have complied with the requirements of the Safe Harbor Election and the partnership's Safe Harbor Election would automatically terminate. In this and other cases neither the partnership nor the other partners may have any reason to know that the partnership, a partner or the service provider failed to report in the required manner and that the election therefore terminated.

We think that terminating a Safe Harbor Election on such technical grounds will create substantial uncertainty for taxpayers. In addition, it will effectively allow a partner to retroactively disavow a prior Safe Harbor Election by pointing out a technical foot fault made in a prior year and recreate the whipsaw possibility that the Proposed Rules are designed to eliminate. Moreover, in light of the significance of the safe harbor under the Proposed Rules and the importance it would have to many partnerships and their partners, we think it is simply bad tax policy to give a single recalcitrant partner the ability to defeat a partnership's use of the safe harbor or to extort concessions from the partnership (and its partners).

<u>Need to File a Tax Return</u>. The Proposed Rules indicate that a partnership may not make the Safe Harbor Election unless the partnership files a Federal income tax return for the year the election is to be made and the partnership attaches the election statement to the tax return. We believe this requirement will effectively prevent many (and probably most) foreign partnerships that are not otherwise required to file a U.S. tax return from making the Safe Harbor Election. Although such partnerships could voluntarily choose to file a U.S. tax return for the sole purpose of making the Safe Harbor Election, we expect very few such partnerships will do so. If a non-US partnership is not otherwise required to file a U.S. tax return, it is probably the case that most of the partners are non-US persons who will have a strong preference for the partnership to avoid filing a U.S. tax return unless absolutely necessarily. Nevertheless, many such

partnerships (such as non-US based private equity funds) issue compensatory partnership profits interests to U.S. taxpayers (or partnerships held in part by U.S. taxpayers). For these partnerships, we recommend that they be permitted to make a Safe Harbor Election, without filing a Federal income tax return, by mailing an election to the applicable Service Center.

Newly-Formed Partnerships. New partnerships that issue compensatory partnership interests are formed on a routine basis, often without any tax advice. As a result, we expect that many compensatory partnership interests issued in connection with the formation of a partnership or early in the life of a partnership will be ineligible for the safe harbor. Moreover, for the reasons discussed above, we believe that many well-advised partnerships will unknowingly fail to qualify for or maintain a Safe Harbor Election despite substantial efforts to comply.

Who Must File. The Proposed Rules require that the Safe Harbor Election be executed by "a partner who has responsibility for Federal income tax reporting by the partnership." It is not clear whether this requires that the election be executed by a person who is a partner of the partnership in a corporate sense (as appears to be the requirement for filing partnership tax returns in general) or requires that the person also be considered a partner of the partnership for Federal income tax purposes. In some cases, the partner authorized to file the partnership tax return does not actually have an economic interest in the partnership (such as a managing member of an LLC that does not have an economic interest) and therefore is generally not considered a partner for income tax purposes. It is not entirely clear what such a partnership needs to do in order to make the election. We recommend that the Proposed Rules be modified to permit any person authorized to sign and file the partnership's tax return to execute the election statement and clarify that this person does not need to be a partner for Federal income tax purposes.

Safe Harbor Partnership Interests. As noted above, the Safe Harbor Election applies to compensatory partnership interests only if the interest qualifies as a "Safe Harbor Partnership Interest," and an interest will not satisfy this requirement if it is transferred to the service provider "in anticipation of a subsequent disposition."[40] An interest that is sold or disposed of during the two years following the receipt of the interest or that is subject, at any time within two years of the date of receipt, to a right to buy or sell (other than a right triggered by death or disability of the service provider) is presumed to be transferred "in anticipation of a subsequent disposition," and therefore presumed to be outside of the safe harbor. In practice, many (and perhaps most) compensatory partnership interests are subject to buy/sell rights if the holder ceases to provide services to the partnership. These buy/sell rights are typically motivated by the wholly non-tax purpose of removing the service partner from the partnership because, for example, the partner may have left on less than amicable terms or may now be working for a competitor. We believe that these buy/sell rights should not create any negative presumption under the safe harbor, at least in cases where they are commercially reasonable and not entered into with a primary purpose of tax avoidance.

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[40] Notice 2005-43.

However, even if the IRS were to conclude that a right of the service provider to sell his or her interest should create the presumption, on the theory that the unilateral ability of the service recipient to eventually obtain liquidity with respect to his or her interest in the partnership is inconsistent with the ability to use liquidation value, we recommend that, in the case of a call option in favor of the partnership or the general partner, the presumption should not apply unless the call option is substantially certain to be exercised by the partnership or the general partner. While we understand that the IRS may be concerned with the unilateral ability of a service partner to obtain liquidity, in the case of a call option in favor of the partnership, a service partner has no ability to sell the interest.

We also request that the Proposed Rules clarify that a liquidation of a partnership is not treated as a sale or disposition of a partnership interest and that the right of a partner to trigger a liquidation is not treated as a right to buy or sell for these purposes, because a liquidation has much broader tax and non-tax implications than the sale or disposition of a single partner's compensatory partnership interest.

2) Comments on the Application of the General Rules.

If a compensatory partnership interest is not governed by the safe harbor, the interest will be subject to the general rules applicable under Section 83. Accordingly, the recipient will have income (and the partnership will generally have a deduction) equal to the "fair market value" of the interest on the date it is treated as transferred.[41] However,

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[41] Although the preamble to the Proposed Regulations notes that rights to receive allocations and distributions described under Section 707(a)(2)(A) are not partnership interests, no similar mention is made about rights to receive future

as the Preamble to the Proposed Regulations observes, some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest may have only a speculative value (meaning it is effectively without fair market value) or that the value should be determined by reference to the liquidation value of the interest, whereas other courts have determined, under particular facts and circumstances of their case, that a compensatory partnership profits interest may have a determinable fair market value above its zero liquidation value.

In light of this case law and the history of compensatory partnership interests in general, we expect that recipients of a compensatory partnership profits interest would generally continue to report no income upon the receipt of the interest even if the interest is not governed by the Safe Harbor Election. In the much less frequent case in which a capital interest is issued, depending on the circumstances, we expect that recipients will report income based on either the interest's liquidation value or based on traditional fair market value principles applicable under Section 83. As is the current custom, we expect that the recipient and the partnership would typically agree (either formally or informally) on what value would be ascribed to the interest for tax purposes and report in a consistent manner. We would similarly expect the partners of the partnership to continue to report

guaranteed payments described under Section 707(c). If the final regulations do not require that compensatory partnership interests be valued based on their liquidation value, we believe they should clarify whether rights to future guaranteed payments are taken into account in valuing a compensatory partnership interest under Section 83. We believe that such rights should not be taken into account since they essentially represent fixed compensation for services rather than an interest in property.

the transaction in the same manner as the partnership, as reflected on the IRS Form K-1 sent to the partner.

However, the Proposed Rules would create considerable uncertainty surrounding the issuance of compensatory partnership interests that are not governed by the safe harbor since it would no longer be clear when such interests should be valued based on their liquidation value and when they should be valued under traditional Section 83 principles. The fact that liquidation value is expressly authorized under a "safe harbor" seems to confirm that in some cases the use of liquidation value would be permitted in valuing compensatory partnership interests that fall outside of the safe harbor and in other cases the use of liquidation value may not be permitted. However, the Proposed Rules provide no guidance (and may actually remove the existing guidance) as to which valuation method is applicable in any given case.[42] The Proposed Rules would thus resurrect the uncertainty in valuing profits interests that was created by the Tax Court's decisions in *Diamond* and *Campbell* and eliminated by Rev. Proc. 93-27 and maintain the existing uncertainty in valuing capital interests.

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[42] Since the use of liquidation value is expressly authorized under a "safe harbor," it seems clear that the use of liquidation value is also permitted in at least certain circumstances under the general rule. However, by expressly subjecting compensatory partnership interests to Section 83 but not providing any specific guidance as to how such interests should be valued when the safe harbor is not applicable, the Proposed Rules could be read (by taxpayers or the courts) to limit the circumstances in which a partnership profits interest may be considered to have only "speculative" value or in which it is appropriate to use the liquidation value of the interest as a proxy for fair market value.

In addition, if compensatory partnership interests could be valued under Section 83 at something other than their liquidation value, additional regulations would be necessary to further coordinate Subchapter K and Section 83. As discussed in Part VII.A.-C., these regulations would be needed in order to ensure that the opening Section 704(b) capital account of the recipient of a compensatory partnership interest equals the capital account assigned to the recipient under the parties' economic arrangement.

Moreover, in light of the almost universal practice today of following the tax treatment prescribed in the Existing Revenue Procedures, the fact that this treatment conforms to the long-understood treatment of compensatory partnership interests in general, the fact that neither Treasury nor Congress has indicated any desire to modify this treatment, and the fact that this treatment is consistent with the general framework in Subchapter K of taxing partnership operations, we believe that it simply does not make sense at this point to abolish the current system of effectively allowing almost all compensatory partnership profits interests to be valued based on their liquidation value due to a concern that the current system is somehow prohibited by a Code provision enacted over thirty-five years ago.

Furthermore, the Proposed Rules would replace the very simple set of rules found in the Existing Revenue Procedures with a very complicated set of regulations. This seems hard to justify in light of the fact that the system seems to work quite well under the Existing Revenue Procedures and the fact that Proposed Rules are generally designed to allow taxpayers to maintain the results available under the Existing Revenue Procedures.[43]

Accordingly, we believe the Proposed Regulations should be revised to provide for a simple rule of general application that generally requires compensatory partnership interests be valued based on their liquidation value.

Authority to Require the Use of Liquidation Value.

As we indicated in our Second Report, we believe that Treasury and the IRS have the authority to and should issue regulations that generally require compensatory partnership interests to be valued based on their liquidation value.[44] In considering this question, we believe that Section 83 cannot be viewed in isolation but rather must be viewed both in its historic context and in the context of the Internal Revenue Code as a

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[43] We also note that, notwithstanding the lack of any express rules governing compensatory partnership interests over the last fifty years and notwithstanding the vast number of compensatory partnership interests issued each year, we are not aware of a single instance in which the whipsaw concern identified by Treasury has in fact occurred. Moreover, by expressly providing that compensatory partnership interests are subject to Section 83 but not providing any guidance as to how they should be valued when the safe harbor does not apply, we think that the Proposed Rules may in fact elevate the whipsaw potential, as compared with the potential that exists today or that would exist if regulations were issued requiring liquidation value to be used.

[44] As discussed in the Second Report, we believe that Treasury has authority to issue such regulations 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). Cf. *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.

whole and Subchapter K in particular. The fact that at the time Section 83 was enacted there was a long-established practice of not currently taxing the recipient of a compensatory partnership profits interest and that the legislative history of Section 83 does not mention compensatory partnership interests or any intention to change this long-established practice together support the conclusion that Treasury and the IRS have authority to and should issue regulations (either under Section 83 or under Subchapter K) that maintain this treatment.[45] Further, the fact that during the thirty-five year period since Section 83 was enacted, Treasury and the IRS have (expressly or implicitly) continued to interpret Section 83 to allow this treatment, and that during this time Congress has amended Section 83 eight times and amended the Internal Revenue Code countless times without revising Section 83 to reverse this treatment, similarly supports the conclusion that Treasury and the IRS have the authority to and should maintain this treatment.[46]

It is also important to keep in mind, in light of the large and growing number of partnerships, the important function of Subchapter K in providing a comprehensive framework for taxing partnership arrangements. As a general matter, Subchapter K is an

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45 *See generally Chisom v. Roemer*, 501 U.S. 380 (1991) (under the "dog that didn't bark" canon, if there is no discussion of a major change to longstanding common law or administrative practice in the legislative history of a statute, there may be a presumption against finding that Congress intended to change the historical treatment).

46 *See generally Bob Jones University v. U.S.*, 461 U.S. 574, 699 (1983) (failure of Congress to modify the IRS rulings of which Congress has been constantly reminded for over twelve years make out an unusually strong case of legislative acquiescence and ratification).

intricate, sealed system in which a seemingly simple transaction can trigger numerous ancillary tax consequences. For example, provisions in Sections 704(b), 704(c), 737 and elsewhere are designed to ensure that the taxable income, gain, loss, deduction and loss will be allocated to the partner who received the economic benefit or burden of the item, and provisions in Sections 705, 707, 722, 723, 731, 732, 733, 734, 743, and 754 and elsewhere are designed to ensure that income, gains, deductions and losses will be taken into account only once by the partners.

As we discussed in the Second Report, valuing compensatory partnership interests at something other than their liquidation value would undermine certain fundamental Subchapter K objectives. For example, if compensatory partnership profits interests were valued taking into account the right to future distributions of profits and the partnership's deduction were not allocated under Section 704(b) to the recipient, then the recipient would effectively be taxed twice on these profits—once upon the receipt of the interest and then again as the partnership actually recognizes the profits—with the double taxation being reversed (if at all) only upon a complete liquidation of the partnership, the sale of the interest (both presenting character mismatches) or to the extent (if any) the income realized upon the receipt of the interest resulted in tax benefits pursuant to a Section 754 election. Similarly, the historic partners in this situation would effectively receive a double deduction.

Moreover, under the Proposed Regulations, if a compensatory partnership interest were valued at something other than its liquidation value, it would create a discrepancy between the recipient's Section 704(b) capital account and the recipient's economic capital account. The Section 704(b) capital account would equal the value ascribed to the interest[47] whereas the economic capital account (that is, the amount the recipient would actually receive under the terms of the partnership agreement if the partnership sold all of its assets and then liquidated) would equal the liquidation value. As discussed in greater detail below,[48] left uncorrected this would undermine a central tenet of Subchapter K—that the Section 704(b) capital account of each partner will equal the amount the partner would receive if the partnership sold all of its assets for book value and then liquidated. Since Subchapter K is generally designed to operate as a sealed system, we believe that Subchapter K principles would need to be applied to eliminate that discrepancy. See Part VII A.-C. below.

Accordingly, we believe that Treasury and the IRS have authority to and should revise the Proposed Regulations to provide for a simple rule of general application that generally requires compensatory partnership interests be valued under Section 83 based on their liquidation value.

Alternative Recommendations.

If Treasury and the IRS continue to have some concern about the authority to issue such a regulation under Section 83 and about a whipsaw situation arising if such a

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[47] *See* Proposed Regulation § 1.704-1(b)(2)(iv)(b)(1). Since the Section 704(b) capital account is credited with the value of property contributed to a partnership (rather than the value of the partnership interest issued in return), we assume that the analytical framework here would be that the opening capital account equals the value of the recipient's services and that value is assumed to equal the value of the compensatory partnership interest being issued in exchange.

[48] See Part VII.A. below.

regulation were issued but held invalid, we recommend that Treasury and the IRS consider either:

a) Issuing Comprehensive Regulations under Subchapter K. For the reasons outlined above, we believe there is ample authority for Treasury and the IRS to issue comprehensive regulations under Subchapter K governing compensatory partnership interests and for such regulations to generally require that compensatory partnership interests be valued based on their liquidation value.

b) Issuing Additional Coordinating Subchapter K Regulations that Eliminate the Whipsaw Potential. Treasury and the IRS could also issue regulations under Section 83 and Subchapter K that would together effectively result in the recipient of a compensatory partnership interest having net income (and the other partners of the partnership having a deduction) equal to the liquidation value of the interest. For example, regulations could be issued under Section 83 that would require compensatory partnership interests to be valued based on their liquidation value[49] and, as a backstop to any authority concerns, Treasury and the IRS could still issue additional regulations (described in Part VII.B and C below) [50] (i) under Section 707(c) that treat as an additional "guaranteed payment" to the service provider in the year of transfer any excess of the liquidation value of a compensatory partnership interest over its fair market value for purposes of Section 83 and (ii) under Section 704(b) that require the partnership's deduction for transferring a compensatory partnership interest be allocated to the recipient partner to the extent the deduction exceeds the

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[49] It bears noting, however, that we would recommend this approach only if Treasury either required (or made it easy to elect) that compensatory partnership interests, or at least compensatory partnership profits interests, be valued based on their liquidation value rather than based on traditional principles applicable under Section 83. We believe that, consistent with the long-understood treatment of compensatory partnership interests, the recipient of a profits interest generally should not recognize any income upon the receipt of the interest and we do not believe it makes sense to adopt a regime in which, upon the issuance of any compensatory partnership profits interest, the recipient is forced to value the interest, recognize gross income and then claim a deduction. Moreover, in some cases the issuance of the interest may be subject to employment taxes and in some cases the corresponding deduction may be limited.

[50] As discussed in Part VII.B and C. below, we believe that these Section 704(b) and 707(c) regulations should similarly be issued if the Proposed Regulations are finalized without requiring the use of liquidation value.

> liquidation value of the interest, thus ensuring that the allocation can have economic effect under the Section 704(b) regulations.[51]

In the event that Treasury and the IRS do not believe there is authority to adopt a simple rule of general application that generally requires compensatory partnership interests be valued based on their liquidation value (such as those described above), we believe they should allow the area to continue to be governed by the Existing Revenue Procedures. Alternatively, in this event Treasury and the IRS could seek a legislative change.[52]

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[51] If a capital interest were issued, the regulations under Section 707(c) would effectively prevent the recipient from including less income than the liquidation value of the interest, and ensure that the income and deduction associated with the issuance of a capital interest coincide and equal the liquidation value of the interest. If a profits interest were issued, the Section 704(b) regulations would prevent an existing partner from claiming a deduction that exceeds the partner's share of the liquidation value of the interest, and would similarly ensure that the net income and deduction associated with the issuance of a profits interest coincide and equal the zero liquidation value of the interest.

[52] In this regard, Treasury could seek a statutory change to Section 83 that would expressly grant Treasury the authority to issue regulations applicable to compensatory partnership interests, including regulations that would (i) allow compensatory partnership interests to be valued based on their liquidation value, (ii) effectively reverse the default rule for Section 83(b) elections so that an unvested compensatory partnership interest would be treated as transferred for tax purposes on the date of grant (rather than on the vesting date) unless the recipient elects otherwise (See Part V.A.), and (iii) allow for special rules in the case of traditional service partnerships that regularly admit and promote service partners without ascribing any value to the partnership's assets, including its goodwill and going concern value. Alternatively, Treasury could seek a statutory change that would overturn the decision in *Robinson v. US*, 335 F.3d 1365 (Fed. Circ. 2003), and require that the deduction claimed by the service recipient (here the partnership) equal the amount actually included by the service provider. *Robinson* held that an employer's deduction under Section 83(h) for property issued in exchange for services was the amount includible in the employee's income, without regard to the amount that the employee actually includes. Accordingly, this may alleviate Treasury's whipsaw concern.

C. Comments on the Potential Application of the Proposed Rules to Traditional Service Partnerships.

Traditional service partnerships, such as law, accounting, consulting and investment management firms, regularly admit new partners and reshuffle the interests of existing partners. Typically, a partner is required to invest a certain amount of capital upon admission to the firm and receives his or her capital back upon exiting the firm.[53] Traditional service partnerships rarely if ever value their goodwill or going concern value for any purpose, including upon the admission, promotion or withdrawal of partners. Rather, the new or promoted partner merely receives his or her share of the income recognized by the partnership. Retired or withdrawn partners sometimes continue to receive a reduced share of distributions from the firm, often capped at a percentage of the average distributions they received prior to exiting the partnership. As far as we are aware, it is the universal practice for the new or promoted partner not to report any income associated with the receipt of the interest and for the other partners not to claim any deduction associated with the issuance of the interest.

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[53] In many cases, the partner is required to invest additional capital as the partner becomes more senior and the partner's expected share of partnership profits grows. However, since traditional service partnerships are not capital intensive, the amount of capital required to be invested in any year is typically much less than the amount of distributions received by the partner in that year.

In General

The application of Section 83 to traditional service partnerships would raise a variety of issues:[54]

First, it is not clear how the liquidation value of many traditional service partnerships should be determined, particularly where (i) the partnership's goodwill and other intangible assets have never been valued, (ii) the business has no value unless the service partners continue to provide services to the partnership as such, (iii) the potential for a sale of the partnership's business is remote (or prohibited under applicable law), or (iv) there are no comparable sales because like partnerships have never been sold. We note in this regard that many traditional service partnerships operate on a largely informal basis and many do not even have a written partnership agreement. Even if a traditional service partnership has some kind of written understanding, it is often limited to governance and retirement matters and does not otherwise set forth any specific economic arrangement. Moreover, in light of how rare it is for a traditional service partnership to sell its business, even if such a partnership were to have a clear understanding about the economic arrangement of the partners, it would typically be limited to how income in any year is shared and would not address what would happen if the partnership sold its assets and liquidated.[55] These issues would create similar

[54] The application of Section 83(d) to traditional service partnerships is discussed below and, except as noted, this Report assumes that an interest in a traditional service partnership would not be subject to Section 83(d).

[55] It bears noting that qualification for the Safe Harbor Election will raise additional issues for traditional service partnerships. As noted above, many traditional service partnerships do not have a written partnership agreement at all, and these

difficulties if an interest in such a partnership had to be valued using traditional principles under Section 83.

Second, the amount entitled to be received by a service partner for any year is often determined by a group of managing partners in their discretion and is often based in significant part on the perceived contribution of the partner to the firm for the year. As a result, a partner's share of profits may be increased or reduced in any given year, as compared with the prior year.[56] Although not entirely clear, we assume that such adjustments would not be treated as "transfers" or "forfeitures" of property under Section 83 (or for purposes of the effective date).[57]

Third, in cases where the share of distributions to be made with respect to a particular partnership interest is discretionary and will be based in part on the perceived contributions of the recipient for the year, it is not clear how one can meaningfully determine the liquidation value of the interest immediately after the interest is issued, as

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partnerships will therefore need to obtain a binding document from each partner in order to make the election. In the case of an existing traditional service partnership that is a general partnership (as is often the case), amending the partnership agreement to include the requisite language may require the consent of each partner. Moreover, many traditional service partnerships are organized as a domestic partnership but with separate partnerships (and partnership agreements) in some countries due to local bar restrictions. Although the local partnerships are typically treated as disregarded entities, it may not always be clear in what agreement the requisite language must be included in order to be "legally binding" on all of the "partners".

[56] This is true apart from any adjustments caused by the admission or withdrawal of other partners to the firm.

[57] See Part VII.D.

contemplated by the Safe Harbor Election.[58] The fact that the distributions to be received in respect of the interest are discretionary and based on the perceived contribution of the service provider will similarly make it difficult to value the interest on the date of grant in cases where the safe harbor is not applicable. Moreover, it would appear that if two new partners are admitted on the same day, the value of their respective interests should differ if one of the new partners is likely to receive more distributions than the other. We are not aware of any other situation where the fair market value of the property subject to Section 83 is disproportionately affected by the perceived contribution by the service provider.

Fourth, assuming a Section 83(b) election is made for an interest, it is not clear what assumption should be made in valuing the interest as to how long the interest will generate distributions. Although it might seem sensible to base this on whatever expectation exists at the time of the transfer, this is tantamount to taking into account the risk of forfeiture, which is generally prohibited under Section 83.

Fifth, if the "fair market value" ascribed to an interest in a traditional service partnership materially exceeds the "capital" associated with the interest (and therefore exceeds the buy-in and buy-out price), it is not altogether clear (i) whether the interest would be treated as having been "transferred"[59] at all for purposes of Section 83 and

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[58] If the liquidation value of an interest is determined by reference to what the holder is legally entitled to receive, the interest could well be viewed as having a zero liquidation value or a liquidation value equal to the capital contributed in respect of the interest.

[59] A Section 83(b) election is available only for property that is treated as having been "transferred" for purposes of Section 83. See Treas. Reg. § 1.83-2(a).

(ii) if the interest were treated as having been transferred, whether it would be treated as subject to a substantial risk of forfeiture. Factors suggesting that no transfer has occurred would include the fact that the recipient would be required to return the interest in all events (generally when the recipient ceases to provide services) and the fact that the amount paid to the partner would be based on the capital account of the partner (plus perhaps a reduced share of distributions for some period) rather than the "fair market value of the interest". [60]

Assuming that an interest in a traditional service partnership were treated as "transferred", the interest might be considered subject to a substantial risk of forfeiture since the partnership would generally have the right to have the partner removed from the partnership in exchange for the partner's invested or accrued capital. However, if normal adjustments (up or down) to the share of profits associated with a particular interest are not treated as new transfers or forfeitures, we would think that a reduction in the partner's share in connection with the partner ceasing to provide services would similarly not be treated as a forfeiture. Under Section 736, the partner would continue to be treated as a "partner" for Federal income tax purposes and these payments to the partner would be

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[60] Treas. Reg. § 1.83-3(a) provides that (i) for purposes of Section 83 and the regulations thereunder, a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any lapse restriction), (ii) no transfer may have occurred where property is transferred under conditions that require its return upon the happening of an event that is certain to occur, such as the termination of employment (in which case whether a transfer has occurred depends on all of the facts and circumstances) and (iii) an indication that no transfer has occurred is the extent to which the consideration to be paid to the transferee upon surrendering the property does not approach the fair market value of the property at the time of surrender.

treated as either guaranteed payments or a distributive share. This would suggest that an interest in a traditional services partnership might not be considered subject to a substantial risk of forfeiture if the partner were entitled from the outset to receive a certain minimum share even if the recipient stopped providing services. Alternatively, an interest might be considered to "vest" for purposes of Section 83 if the recipient became entitled to that minimum share after providing services for some period.

Sixth, it is really not clear what result would follow if none of the service partners were treated as having received an interest in the partnership, either because the interests were not treated as having been transferred to begin with or because they were considered subject to a substantial risk of forfeiture but none of the service partners made a Section 83(b) election.[61] Obviously somebody must be considered to own the partnership for Federal income tax purposes, but it is not clear who that would be in this case.

Seventh, assuming that a Section 83(b) election were made and the service provider therefore included income upon the receipt of the interest, Section 83(b) would presumably disallow any corresponding loss to the recipient upon the partner's withdrawal from the partnership if the withdrawal were treated as a forfeiture of the interest. It seems somewhat punitive for Section 83(b) to cause the recipient to recognize income upon the receipt of property but disallow a corresponding loss upon the forfeiture of the property when the property was issued under terms that required its eventual forfeiture.

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[61] This could well occur on a regular basis following the finalization of the regulations, particularly when new service partnership are formed without tax advice.

Eighth, international service partnerships typically have numerous partners who are nonresident aliens and who are subject to U.S. federal income tax and withholding under Section 1446. It is not clear whether the admission of such a partner would give rise to Section 1446 withholding in cases where the admission is treated as a taxable transfer under Section 83. We also note that analysis of whether such partners are better off making a Section 83(b) election may be quite complicated and very difficult for such partners to understand.

Ninth, since all of the partners in a traditional service partnership are typically individuals and since all (or substantially all) of the income is typically ordinary in character, any income inclusion associated with the issuance of an interest in a traditional service partnership would, in general, merely shift income from partner to another without any net revenue to the Treasury. We believe that the current taxation of traditional service partnerships allows for a clear reflection of each partner's income and that applying Section 83 in this context to create a temporary shift in taxable income is arguably at odds with the basic Subchapter K principle articulated in Treas. Reg. § 1.701-2 that the tax consequences to each partner must accurately reflect the partners' economic agreement and must clearly reflect each partner's income.

Tenth, Section 83 only applies in cases where property is transferred to one person in connection with that person's performance of services to another person. By contrast, in the typical traditional service partnership context, the service partners are not really providing services to the partnership or even to the other partners. Rather, they have joined together in a collective effort to provide services to clients. Under this aggregate view, Section 83 would seem wholly inapplicable when a new service partnership is formed or a new service partner is admitted because the interests in the partnership are not transferred in connection with the performance of services to another person.

For these and other reasons, we would expect that many individuals who become partners in a traditional service partnership would continue the historic practice and report no income upon the recipient of their partnership interest and would litigate any challenge to this treatment.

<u>Application of Section 83(d)</u>.

The historic treatment of compensatory partnership interests in traditional service partnerships is consistent with the treatment applicable under Section 83 when property is transferred subject to a so-called nonlapse restriction under Section 83. Specifically, Section 83(d) provides that in the case of a restriction that by its terms will never lapse, and that allows the transferee to sell such property only at a price determined under a formula, the price so determined shall be deemed to be the fair market value of the property unless established to the contrary by the Secretary, and the burden of proof shall be on the Secretary with respect to such value. Example (1) of Treas. Reg. § 1.83-5(c) illustrates the type of situation that Section 83(d) is designed to address:

> On November 1, 1971, X corporation whose shares are closely held and not regularly traded, transfers to E, an employee, 100 shares of X corporation stock subject to the condition that, if he desires to dispose of such stock during the period of his employment, he must resell the stock to his employer at its then existing book value. In addition, E or E's estate is obligated to offer to sell the stock at his retirement or death to his employer at its then existing book

> value. Under these facts and circumstances, the restriction to which the shares of X corporation stock are subject is a nonlapse restriction. Consequently, the fair market value of the X stock is includible in E's gross income as compensation for taxable year 1971. However, in determining the fair market value of the X stock, the book value formula price will ordinarily be regarded as being determinative of such value.

The admission and withdrawal of partners in traditional service partnerships work in largely the same manner. A new partner effectively purchases an interest in the partnership based on the partner's share of partnership capital, and the partnership effectively repurchases the partnership interest based on the partner's share of partnership capital. Moreover, partners in traditional service partnerships are generally prohibited from transferring their interest.

As with Section 83 in general, there are no regulations applying Section 83(d) to partnerships and such application raises a variety of issues.[62] For example, after a partner retires (or withdraws) from a traditional service partnership and receives a return of his or her capital, the partner is often entitled to continue to receive distributions of profits or other payments from the partnership as a retirement or similar benefit.[63] Regardless of whether such a partner continues to be treated as a partner for state law purposes, under Section 736 he or she continues to be treated as a partner for Federal income tax purposes. It is not clear whether the taxpayer's continued status as a partner

[62] The second sentence of Treas. Reg. § 1.83-5(a) refers to corporate stock. We assume this reference is illustrative only and is not intended to confine the application of Section 83(d) to corporate arrangements.

[63] In some cases, these distributions are capped at a percentage of the partner's share for some period prior to retirement.

or the right to these distributions undermines the requirement in Section 83(d) that the property (here the partnership interest) be purchased at a particular formula.[64]

In some partnerships, each partner's share of capital is required to be maintained in proportion to the partner's share of partnership profits. In other partnerships, particularly those which retain discretion over profit allocations, the required capital may not be proportionate to profits. It is not clear whether Section 83(d) can apply in this context, although we believe that it should be able to apply so long as the same formula is applied to a partner's admission to the partnership and his or her withdrawal from the partnership. However, some partnerships do not require any capital to be invested by the partners and do not pay anything to a withdrawing partner. It is not clear whether these arrangements can properly be viewed as a formula buyback arrangement under Section 83(d).

<u>Recommendation</u>.

In light of the issues discussed above, the long-understood tax treatment of traditional service partnerships, the lack of any indication that Congress intended to change this treatment in 1969 when it first enacted Section 83 and the lack of any indication that Congress disagrees with the manner in which the IRS has applied and interpreted Section 83 in this context over the thirty five years since Section 83 was enacted, we believe Treasury and the IRS have authority to and should exclude interests in traditional service partnerships from Section 83. Alternatively, we recommend that

64 In the corporate context, the holder may be entitled to equivalent distributions but in the holder's capacity as an employee. In the partnership context, a partner is generally not considered to have a dual status.

Treasury and the IRS issue additional guidance in this area before subjecting all traditional service partnerships to the general rules applicable under Section 83, and, if the more general regulations are finalized in advance of that additional guidance, we recommend that interim guidance be issued providing that a service partnership and its partners will not recognize income, gain, loss or deduction in connection with the granting or vesting of an interest in the partnership, so long as the partnership does not claim a deduction and the service partner does not report income. It may be appropriate to incorporate other aspects of the Existing Revenue Procedures as well.

Part IV. Tiered and Affiliated Arrangements.

The Proposed Regulations generally apply only to a "compensatory partnership interest," which is defined as an interest in the transferring partnership that is transferred in connection with the performance of *services for* that partnership (either before or after the formation of the partnership). Similarly, under the Proposed Rules, the Safe Harbor Election would apply to a partnership interest only if, among other things, the interest were transferred by the partnership in connection with *services provided to* the partnership (either before or after the formation of the partnership). By contrast, Rev. Proc. 93-27 generally provides that the receipt of a partnership profits interest is not a taxable event if the interest is received for "*services to or for the benefit of* the partnership in a partner capacity or in anticipation of being a partner."[65]

The Preamble to the Proposed Regulations notes that the Proposed Revenue Procedure and certain parts of the Proposed Regulations apply only to a transfer by a

[65] Rev. Proc. 93-27, Section 4.01.

partnership of an interest in that partnership in connection with the performance of services for that partnership and requests comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership. Similarly, the IRS asks whether additional guidance is needed to address the transfer of an interest in a partnership to a person who is not rendering services directly to such partnership (for example, an upper-tier partnership transfers an interest in a lower-tier partnership to a person for services rendered to the upper-tier partnership).

It is quite common for partnerships to operate in tiered and affiliated arrangements and we believe it is critical for the final regulations to address the treatment of compensatory partnership interests in this context. Typical arrangements include the following:

> Example 3: Upper-Tier LLC provides services to, and is the general partner of, Lower-Tier LLC. Upper-Tier LLC and Lower-Tier LLC are both classified as partnerships for Federal income tax purposes. In exchange for services to be provided by A to Upper-Tier LLC, A receives a profits interest in Upper-Tier LLC and a profits interest in Lower-Tier LLC. A substantial portion of the services that A will provide to Upper-Tier LLC will benefit Lower-Tier LLC through the services provided by Upper-Tier LLC. Alternatively, A might instead receive a profits interest solely in Lower-Tier LLC but not Upper-Tier LLC and provide services to Upper-Tier LLC as an employee.

> Example 4: A and a variety of other individuals provide services to Lower-Tier LLC. Rather than issue A and these individuals' interests in Lower-Tier LLC, the parties form Upper-Tier LLC, issue Upper-Tier LLC a profits interest in Lower-Tier LLC and issue A and the other individuals interests in Upper-Tier LLC. Upper-Tier LLC and Lower-Tier LLC are both classified as partnerships for Federal income tax purposes. No direct services are provided by A

> or the other individuals to Upper-Tier LLC or by Upper-Tier LLC to Lower-Tier LLC.
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> Example 5: Upper-Tier LLC provides services to, is the general partner of, and holds a 20% profits interest in Lower-Tier LLC. Manager LLC provides services to (but is not a partner of) Lower-Tier LLC. Manager LLC, Upper-Tier LLC and Lower-Tier LLC are all classified as partnerships for Federal income tax purposes. A provides services to (and receives interests in) both Manager LLC and Upper-Tier LLC. A substantial portion of the services that A provides to Manager LLC (i) benefits Lower-Tier LLC (through the services provided by Manager to Lower-Tier LLC) and (ii) benefits Upper-Tier LLC, both directly by facilitating the provision of services by Upper-Tier LLC to Lower-Tier LLC, and indirectly by virtue of Upper-Tier LLC's 20% profits interest in Lower-Tier LLC. Alternatively, A might provide services directly to Manager LLC (but not Upper-Tier LLC) and receive an interest in Upper-Tier LLC (but not Manager LLC) in circumstances where A's services to Manager LLC benefit Upper-Tier LLC (as described above).

In each case, A is providing services that, directly or indirectly, benefit the partnership in which A is receiving an interest. Moreover, in each case it would have been possible to restructure the arrangement so that some or all of A's services were provided directly to the Lower-Tier LLC and A received a direct interest in the Lower-Tier LLC. Based on an aggregate view of the Lower-Tier LLC in Example 3, we believe that the tax consequences to A of receiving an interest in Lower-Tier LLC should be the same whether A provides services directly to Lower-Tier LLC or indirectly by virtue of providing services to Upper-Tier LLC, so long as the interest is issued in exchange for services that relate directly to Lower-Tier LLC. For similar reasons, we believe that in Example 5 the tax consequences to A of receiving an interest in Upper-Tier LLC should be the same whether A provides services directly to Upper-Tier LLC (or Lower-Tier

LLC) or indirectly by virtue of providing services Manager LLC, so long as the interest is issued in exchange for services that relate directly to Upper-Tier LLC (or Lower-Tier LLC). As a result, we believe that the partnership interest transferred to A in each of the above examples should be treated as a compensatory partnership interest under the Proposed Regulations and should be eligible for the safe harbor, assuming the other requirements are met. To clarify this point, we recommend that the definition of compensatory partnership interest (and safe harbor partnership interest) be revised so that they apply to any partnership interest that is issued in connection with the performance of services to or for the benefit of the transferring partnership.[66]

We also recommend that the final rules permit the liquidation value of an interest in the upper-tier partnership to be computed by reference to the liquidation value of any interests held by the upper-tier partnership in any lower-tier partnerships.

> Example 6: An upper-tier partnership's sole asset is a 20% profits interest in a lower-tier partnership. The liquidation value of the interest in the lower-tier partnership is $100 and the fair market value (applying traditional principles applicable under Section 83) of the interest is $150. A receives a 10% (capital and profits) interest in the upper-tier partnership. We believe that the liquidation value of A's interest should be $10 (rather than $15).

[66] We would distinguish the case where a taxpayer received an interest in a partnership but the taxpayer's services did not benefit the partnership, as would be the case, for instance, in Example 3 if Upper-Tier LLC was not providing services to Lower-Tier LLC. In these cases, we believe that A should be treated as having received the partnership interest from someone other than the issuing partnership and the interest should not be eligible for the Safe Harbor Election.

Part V. Requirement that the Recipient of an Unvested Compensatory Partnership Interest Make a Section 83(b) Election in Order to be Treated as the Current Owner.

A. Appropriate Default Rule for Section 83(b) Elections.

Under the Proposed Regulations, the recipient of a substantially nonvested compensatory partnership interest would be treated as the current owner of the interest for Federal income tax purposes only if the recipient makes a timely election under Section 83(b). In the Second Report, we recommended that regulations be issued, consistent with Rev. Proc. 2001-43, to treat the recipient of an unvested compensatory partnership interest as the owner of the interest from the date of grant, without the need to make a Section 83(b) election, unless the recipient affirmatively elected otherwise. We continue to believe that most compensatory partnership interests are issued in the form of profits interests and that (assuming such interests continue to be valued based on their zero liquidation value) most recipients (and likely substantially all recipients) of such interests would choose to be treated as having received the interest on the date of grant rather than the date of vesting. Accordingly, we believe that this should be the default rule.

> Example 7: A receives a 10% profits interests in a partnership that will vest in one year. If A is entitled to value the interest based on its zero liquidation value, A would have no income upon the making of a Section 83(b) election and no income upon the vesting of the interest. By contrast, if A does not make a section 83(b) election, A would have income upon the vesting of the interest equal to the liquidation value of the interest at that time.

Moreover, in our experience the recipient of a compensatory partnership is generally more surprised by the need to make a Section 83(b) election than is a recipient of corporate stock. This may partially be attributable to the fact that partnerships are often formed as, and compensatory partnership interests issued in, informal arrangements among business persons.[67] Given the greater informalities of many partnership arrangements, including the fact that it often is not entirely clear when a transfer of a partnership interest has occurred, the risk of missing the 30-day deadline is much greater in the partnership context than in the corporate context. As a result, we believe that affirmatively requiring Section 83(b) elections in this context creates a tremendous trap for the unwary.

Accordingly, we believe that Treasury and the IRS should consider issuing regulations that reverse the default rule (either under Section 83 or under Subchapter K) for compensatory partnership interests[68] and, if they do not believe there is authority to do so, they should seek a legislative change.

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67 It is simply not intuitive to most people that if three people form a general service partnership and, under the agreement, any two partners can force out the third partner for no consideration, then all three partners need to make a Section 83(b) election. One reason this is not intuitive is that if none of the partners makes a Section 83(b) election then nobody is the owner of the partnership for Federal income tax purposes, which obviously cannot be the case.

68 We note that it may not be appropriate to reverse the default rule for capital interests subject to vesting and doing so may raise authority issues. As a result, Treasury and the IRS may instead wish to reverse the default rule solely for compensatory partnership profits interests. Alternatively, if adjustments (up or down) in a partner's share of profits occurring pursuant to the terms of the partnership agreement are not intended to constitute transfers or forfeitures for purposes of Section 83, we believe it would be appropriate and helpful if the regulations provided that a partnership interest will not be considered substantially nonvested except to the extent that initial capital account (or liquidation value) of the interest at the time of transfer is subject to a substantial risk of forfeiture. This latter approach would allow for a single rule to be applied to both profits interests and capital interests and create an appropriate default rule. Thus, for example, no affirmative section 83(b) election would be

B. Tax Treatment in Cases Where No Section 83(b) Election is Made.

The preamble to the Proposed Regulations explains that:

> "[U]nless an election under § 83(b) is made, the transferor is regarded as the owner of substantially nonvested property transferred in connection with the performance of services until such property becomes substantially vested, and any income from such property received by the service provider … constitutes additional compensation and is included in the gross income of the service provider for the taxable year in which the income is received …. Under this rule, a partnership must treat as unissued any substantially nonvested partnership interest transferred in connection with the performance of services for which an election under § 83(b) has not been made. If the service provider who holds such an interest receives distributions from the partnership with respect to that interest while the interest is substantially nonvested, the distributions are treated as compensation in the capacity in which the service provider performed the services. For example, if a service provider *that is not a pre-existing partner* holds a substantially nonvested partnership interest that the service provider received in connection with the performance of services and the service provider did not make an election under § 83(b) with respect to that interest, then any distributions made to the service provider on account of such interest are treated as additional compensation and not partnership distributions." (emphasis added).

It would be appropriate and helpful for the final regulations to provide additional guidance on how a service recipient would be taxed (including whether Section 409A applies) in cases where no Section 83(b) election is made, but the recipient receives (or

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necessary if a person received (i) a pure profits interest (that is, an interest with no capital component) even if the interest were subject to vesting or (ii) an interest with a profits component and a capital component if the profits component were subject to vesting but the capital component were not subject to vesting. A section 83(b) election would be necessary to the extent a person received a partnership interest with a capital component that was subject to vesting, even if the recipient contributed the underlying capital.

becomes entitled to receive) a distribution from the partnership. This could occur in a variety of different contexts:

> Example 8: On January 1, 2005, A receives a 10% compensatory partnership profits interest and under the terms of the grant A is required to forfeit the entire interest in the event that A ceases to provide services for the partnership prior to January 1, 2008. No Section 83(b) election is made. No income is recognized by the partnership in 2005 but in 2006 the partnership recognizes $100 and makes a pro rata distribution to the partners. Accordingly, A receives $10. We assume that A has $10 of compensation income under Section 61.
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> Example 9: Same as the previous example, except that A receives an in-kind distribution. We assume that A has income under Section 83(a) provided that the property received is substantially vested.
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> Example 10: On January 1, 2005, A receives a 10% compensatory partnership profits interest and under the terms of the grant A is required to forfeit the entire interest in the event that A ceases to provide services for the partnership prior to January 1, 2006, two-thirds of the interest in the event that A ceases to provide services for the partnership prior to January 1, 2007 and one-third of the interest in the event that A ceases to provide services for the partnership prior to January 1, 2008. A Section 83(b) election is not made. No income is recognized by the partnership in 2005 but in 2006 the partnership recognizes $100 of income and makes a pro rata distribution to the partners on December 31, 2006. A is still providing services as of that date and therefore receives $10.
>
> A has income under Section 83(a) (and the partnership has a deduction) on January 1, 2006 equal to the value of the portion of A's partnership interest that vested on that date. Ignoring the guaranteed payments or other tax consequences arising from the vesting of the partnership interest or the payments to A, we assume that for the taxable year ending December 31, 2006: (i) A would be allocated income of $3.33 (one-third of the partnership's income), (ii) $3.33 of the amount distributed to A would be treated as a distribution under Section 731, and (iii) $6.67

of the amount distributed to A would be taxable to A as a guaranteed payment under Section 707(c).

Part VI. Forfeiture of Compensatory Partnership Interests Where a Section 83(b) Election was Made.

A. Loss Attributable to Undistributed Profits.

One question raised in the Preamble to the Proposed Regulations is the extent to which a taxpayer is entitled to claim a loss if the taxpayer receives an unvested compensatory partnership interest, makes a Section 83(b) election, is allocated undistributed taxable income, and the partnership interest is ultimately forfeited.

> Example 11: A acquires a compensatory partnership profits interest on January 1, 2005 and makes a timely election under Section 83(b) for the interest. At grant, the partnership interest has a $1 current liquidation value and A duly makes the Safe Harbor Election. As a result of the 83(b) election, A has $1 of income upon the receipt of the interest. During 2005, A's allocable share of partnership taxable income is $20, so that A's basis in the interest is increased to $21 on December 31, 2005. In January 2006, A forfeits his interest and receives no consideration in exchange for the interest. We believe that A is (and should be) entitled to claim a $20 loss in this circumstance. However, under Section 83(b), A would not be entitled to deduct the tax basis attributable to the $1 that A included in income upon the receipt of the interest as a result of the Section 83(b) election.

Although Section 83(b) literally provides that "no deduction shall be allowed in respect of [the] forfeiture" of property for which a Section 83(b) election has been made, the regulations quite rightly permit a loss equal to the "amount paid" for the property (reduced by any amount received upon the forfeiture of the property). If a partnership recognizes taxable income but does not distribute the income, each partner's tax basis in the partnership is increased by the partner's share of the income, and this increase should similarly be treated as an amount paid for the interest for purposes of Section 83. The tax treatment under Section 83 should not differ depending upon whether a partnership distributes its taxable earnings currently (and then requires the partners to recontribute the earnings) or merely retains the earnings. In either case, the partners have effectively reinvested in the partnership and that reinvestment should be treated as an amount paid for the partnership interest in determining the amount of loss permissible under Section 83.

B. Forfeiture Allocations.

The Proposed Rules generally contemplate that if a Section 83(b) election is made with respect to an unvested compensatory partnership interest, the partnership will allocate book income and taxable income to the holder under the assumption that the interest will ultimately vest.[69] Since these allocations may not reflect the ultimate sharing of partnership income or loss, the Proposed Rules require certain offsetting Forfeiture Allocations in certain cases.

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[69] Prop. Treas. Reg. § 1.704-1(b)(4)(xii) provides that if a Section 83(b) election has been made with respect to a substantially nonvested interest, the allocations with respect to the interest cannot have economic effect because they may ultimately be forfeited, but such allocations will be deemed to be in accordance with the partner's interest in the partnership ("PIP") if (i) the partnership agreement requires that the partnership make Forfeiture Allocations (described below) if the nonvested interest is later forfeited and (ii) all other material allocations with respect to other partnership interests are recognized under Section 704(b). However, such allocations may nevertheless be deemed to be not in accordance with PIP under an anti-abuse rule which applies if, at the time of the Section 83(b) election, there is a plan to forfeit the substantially nonvested interest. Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(e).

Specifically, Prop. Treas. Reg. §1.706-3(b) provides that if an election under Section 83(b) is made with respect to a partnership interest that is substantially nonvested, and that interest is later forfeited, the partnership must make Forfeiture Allocations to reverse prior allocations made with respect to the forfeited interest. See Prop. Treas. Reg. §1.704-1(b)(4)(xii). Forfeiture Allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss, as applicable, for the year of the forfeiture. The amount of required Forfeiture Allocations is equal to (1) the excess (if any) of the (i) amount of distributions (including deemed distributions under Section 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under Section 731); over (ii) amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under Section 752(a)) to the partnership with respect to the forfeited partnership interest; over (2) the cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership interest. Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(c).

If Forfeiture Allocations of gross income and gain are to be made, the allocations are required to consist of a pro rata portion of the partnership's gross income and gain for the year, and if Forfeiture Allocations of gross deduction and loss are to be made, the allocations are required to consist of a pro rata portion of the partnership's gross deduction and loss for the year.

> Example 12: On January 1, 2005, A receives a 10% compensatory partnership profits interest that is valued at zero under the safe harbor. Although the interest is subject to vesting, A makes a Section 83(b) election. For 2005, A is allocated $20 of income (none of which is distributed). On January 1, 2006, A forfeits the interest. During 2006, the partnership has at least $20 of deductions. Accordingly, A would receive a Forfeiture Allocation in 2006 equal to $20 of gross deductions.

Forfeiture Allocations seem designed to serve a variety of functions. First, they can cause the cumulative net taxable income allocated to each partner to more closely reflect the economic arrangement of the parties in light of the forfeiture. Second, they can cause the Section 704(b) capital accounts to more closely reflect the economic arrangement of the partners after the forfeiture. Third, in the event that, contrary to our recommendation above, a loss is not permitted under Section 83(b) in respect of undistributed taxable earnings, Forfeiture Allocations may mitigate the effect to the service provider.

We support all of these goals but believe that various changes should be made to the Proposed Regulations in furtherance of these goals.

1) Book vs. Tax.

In general, each partner is considered to have a book capital account and a tax capital account. The book capital account is essentially governed by the Section 704(b) regulations and is designed to reflect what the partner would be entitled to receive at any point if the partnership sold all of its assets for their "book" basis and then liquidated. Book capital accounts are adjusted by items of book gain and loss (rather than taxable income or loss) and, upon a contribution or distribution of property, by reference to the fair market value of the property. A partner's tax capital account is computed in essentially the same manner, but is based on Federal income tax concepts. Thus, a partner's tax capital account reflects allocations of taxable income or loss (rather than book allocations) and, upon a contribution or distribution of property, is generally adjusted by reference to the tax basis of the property (rather than its fair market value). The primary differences between book income and taxable income relate to Section 704(c) property, reverse Section 704(c) property, and book income attributable to "revaluations."

Although not entirely clear, the Forfeiture Allocations contemplated by the Proposed Rules seem to blend in some respects book concepts and tax concepts. Since the Proposed Regulations actually requiring that Forfeiture Allocations be made would be issued under Section 706, which itself relates to the allocation of tax items rather than book items, we assume that the Forfeiture Allocations will consist of tax items rather than book items. While the amount of required Forfeiture Allocations is similarly determined by reference to the tax basis of contributed and distributed property, the amount of required Forfeiture Allocation appears to be determined based on allocations of book income and loss rather than taxable income and loss.

> <u>Example 13</u>: A and B each receive a 10% profits interest in PRS in exchange for services and a contribution of $100. A contributes $100 in cash, while B contributes Truck with an adjusted tax basis of $0 and fair market value of $100. The profits interests are substantially nonvested. A and B each make a Section 83(b) election. In year 2, PRS sells Truck for $100, resulting in $100 of taxable gain (but no book gain) being allocated to B under Section 704(c). In addition, PRS recognizes $100 of other income, resulting in $10 of taxable income being allocated to each of A and B. In year 3, both A and B cease providing services and forfeit their partnership interests. PRS distributes $100 to each of

> A and B in respect of their initial capital contributions. The other income that was allocated to A and B in year 2 is forfeited.
>
> The Forfeiture Allocation for A is a loss of $10, equal to (i) the excess of distributions to A ($100) over the amount paid by A for the interest ($100), i.e. zero, minus (ii) the cumulative net income allocated to A ($10). The Forfeiture Allocation for B is a *gain* of $90, equal to (x) the excess of distributions to B ($100) over the amount paid by B for the interest and the adjusted tax basis of property contributed by B ($0), i.e. $100, minus (y) the cumulative net income allocated to B ($10). The fact that Section 704(c) taxable gain did not give rise to any book income, combined with the use of tax basis of property contributed, produces an inappropriate result.

We recommend that the provisions relating to Forfeiture Allocations be revised to be based entirely on either tax concepts or book concepts.[70] If Treasury and the IRS believe that the Forfeiture Allocations should serve the dual purpose of harmonizing book and tax capital accounts, we believe that separate Forfeiture Allocations should be required. Except as otherwise noted, the remainder of this report assumes that Forfeiture Allocations will be based on tax concepts, rather than book concepts.

2) Character of Forfeiture Allocations Items.

Under the Proposed Regulations, the Forfeiture Allocations are required to consist of a pro rata portion of each item of gross income and gain or each item of gross deduction and loss, as the case may be, for the taxable year of the partnership in which

[70] We note that, in the analogous Subchapter S area, a service provider who makes a Section 83(b) election with respect to unvested stock in an "S" corporation is treated as an owner of the stock for tax purposes and no Forfeiture Allocations are required if such unvested shares are subsequently forfeited. Treas. Reg. § 1.1361-1(b)(3).

the forfeiture occurs. No attempt is made to match the character of the Forfeiture Allocation with the character of the allocation giving rise to the Forfeiture Allocation.

> Example 14: A acquires an unvested profits interest for services on January 1, 2005 and makes a timely election under Section 83(b) for the interest. During 2005, A is allocated $20 of long-term capital gain. On January 2006, A forfeits his interest and receives no consideration in exchange for the interest. During 2006, the partnership has a $100 long-term capital loss and a $900 ordinary deduction. Under Prop. Treas. Regs. §1.704-1(b)(4)(xii) and §1.706-3(b), A would be allocated $2 of long-term capital loss and $18 of ordinary deduction.

The pro rata rule seems to place a premium on ease of administration and ease of taxpayer compliance and may reflect the fact that in many cases it may be impossible to meaningfully determine the character of the allocation that gave rise to the forfeiting allocations. This could occur, for example, if a partner was allocated numerous items of income, gain, loss and deduction over a number of years and received various distributions from the partnership. Nevertheless, we believe that partnerships should have some flexibility to adjust the makeup of the Forfeiture Allocations in cases where the adjustments are reasonably designed to allow the character of the forfeiting allocation to match the character of the allocations giving rise to the Forfeiture Allocation. We believe that Treasury and the IRS may also wish to consider requiring such adjustments where it would be abusive not to make such adjustments.

3) Distortive Effect of Pro Rata Rule.

The requirement that Forfeiture Allocations consist of a pro rata portion of gross income and gain or gross deduction and loss, as the case may be, for the taxable year of the forfeiture seems to assume that the forfeited partnership interest will revert economically to all of the existing partners in proportion to the manner in which Forfeiture Allocations would have been shared. This assumption can prove incorrect and in these cases the Forfeiture Allocations will further distort the relative tax positions of the existing partners.

> Example 15: A acquires an unvested profits interest for services on January 1, 2005 and makes a timely election under Section 83(b) for the interest. The partnership has two income-producing assets, X and Y. The other partners are B and C. Under the partnership agreement, A is entitled to 10% of the income and loss from Property X and Property Y, B is entitled to 90% from property X and 0% from Property Y, and C is entitled to 90% from Property Y but 0% from Property X. Under the partnership agreement, if A ceases to provide services to the partnership, any amounts otherwise distributable to A attributable to Property X will go to B and any amounts otherwise distributable to A attributable to Property Y will go to C. In 2005, Property X generates $100 of net income and property Y generates no income or loss. Accordingly, A is allocated $10 of net income, B is allocated $90 of net income and C is allocated $0 of net income. On January 2006, A forfeits his interest and receives no consideration in exchange for the interest.[71] During 2006, Property X generates no income or loss and Property Y generates $100 of net income ($1000 of gross income and $900 of gross deductions). Under the proposed forfeiture rules, $10 of deductions would be allocated away from C and be allocated to A, notwithstanding the fact that B will ultimately receive the economic benefit of the $10 allocation to A that gave rise to the need for Forfeiture Allocations in the first place. As a result, the Forfeiture Allocation will merely shift the problem from one between A and B to one between B and C.

[71] Assume that X and Y are still treated as held by the partnership.

4) Insufficient Partnership Items in the Year of Forfeiture.

The Preamble to the Proposed Regulations correctly notes that in some cases a partnership will not have enough items of gross income and gain (or gross deductions and loss) to fully offset prior allocations to the forfeiting service provider and requests comments as to whether the regulations should require or allow partnerships to create notional tax items to make Forfeiture Allocations in this event. We believe that it would be appropriate and helpful for the regulations to allow partnerships to elect to use notional items to make any necessary Forfeiture Allocations. In addition, we believe that notional items should be permitted where (i) the character of the partnership's income, gain, loss or deduction in the year of forfeiture differs from the allocations giving rise to the Forfeiture Allocation (see Section 2 above) and (ii) the use of a pro rata portion of the partnership's income, gain, loss or deduction for the year of the forfeiture would distort the tax position of the existing partners (see Section 3 above). However, consistent with the notional items contemplated by the remedial method prescribed under the Section 704(c) regulations, we believe that a partnership should not be required (either by the final regulations or upon audit) to create notional items.

5) Adjustment to the Book Capital Accounts.

Assuming that the Forfeiture Allocations are generally based on tax concepts rather than book concepts, we would expect that these tax allocations would typically drag along a corresponding book allocation and we believe that the Proposed Regulations should be clarified in this respect. However, there may be cases where the Forfeiture Allocation of tax items does not allow the book capital account to correctly reflect the economic arrangement of the partners in light of the forfeiture.

Example 16: A acquires an unvested profits interest for services on January 1, 2005 and makes a timely election under Section 83(b) for the interest. During 2005, A is allocated no taxable income but, because another partner is admitted at the end of the year, A is allocated $20 of book income after a "book up" to reflect A's share of the unrealized appreciation. On January 1, 2006, A forfeits his interest and receives no consideration in exchange for the interest.

In this example, no Forfeiture Allocation of tax items would be required under Prop. Treas. Reg. §1.706-3(b). However, the Section 704(b) regulations should be revised to permit (or explain)[72] the shift of the $20 from A's capital account to the capital accounts of the other partners. We recommend that this be done either by prescribing a separate set of Forfeiture Allocations for book items and requiring the use of notional items if there are insufficient book items available or simply by allowing the capital to be moved without going through that fiction.

6) Timing and Type of Forfeiture Allocation upon Partial Forfeiture.

As previously noted, there will be many cases where a partner forfeits part but not all of his or her interest in the partnership. In these cases it would seem appropriate to allow Forfeiture Allocations of income or deduction to be made to the other partners using items that would otherwise have been allocated to the forfeiting partner in respect of the retained portion of his partnership interest if the partnership has insufficient items of deduction or income to reduce the capital account of the forfeiting member to the appropriate balance.

[72] Since the example assumes that the economic deal among the parties is for the $20 to be forfeited, the movement will occur regardless of whether (or how) the Section 704(b) regulations expressly permit the movement to occur.

> Example 17: A acquires an unvested profits interest for services on January 1, 2005 and makes a timely election under Section 83(b) for the interest. During 2005, A is allocated $20 of long-term capital gain. On January 2006, A forfeits 50% of his interest and receives no consideration in exchange for the interest but retains the other 50%. Thus, A forfeits only $10 of the $20 in undistributed earnings that have been allocated to A. During 2006, the partnership has $100 of capital gain, of which $10 would (absent any Forfeiture Allocation) be allocated to A in respect of his retained interest in the partnership. We recommend that the regulations be revised so that the Forfeiture Allocation can be made by reallocating to the other partners the $10 of capital gain that otherwise would have been allocated to A.

Similarly, in addition to allowing a partnership to create notional items to make any necessary Forfeiture Allocations, we believe that the Forfeiture Allocations should be permitted in subsequent years to the extent that there were insufficient available items in the year of forfeiture. Thus, if the partnership in the above example had no gain or loss in 2006, but had either gains or losses in 2007, we think it would be appropriate to permit the Forfeiture Allocations in 2007 so long as A continued to be a partner of the partnership during that year.

7) Amount of Required Forfeiture Allocation upon Partial Forfeiture.

We recommend that the final regulations provide guidance as to how the amount of required Forfeiture Allocations should be determined in cases where a partner forfeits part (but not all) of his partnership interest. This is a common circumstance, particularly in the private equity context where service partners often receive compensatory partnership interests, parts of which are fully vested on the date of grant and parts of which vest in installments over time. Accordingly, we recommend that the proposed regulations be modified to make it clear that in computing the required Forfeiture

Allocations, it is appropriate to take into account only contributions, distributions and allocations attributable to the forfeited interest. We note, however, that it may not always be clear what contributions, allocations and distributions are attributable to the forfeited interest and we think it would be appropriate and helpful if the final regulations gave taxpayers a degree of latitude when making such determinations.

Part VII. Additional Issues

A. Initial Capital Account of the Recipient.

The Proposed Regulations contemplate that the opening capital account of the recipient of a compensatory partnership interest would equal the amount of money and the fair market value of property contributed by that partner to the partnership, plus the amount included in the partner's compensation income under Section 83. Unless additional regulations are issued (see Part VII.B.-C. below), the Proposed Regulations would, in the face of a binding agreement between the partner and the partnership about what the partner would receive if the partnership liquidated, potentially force the opening capital account to be based on an entirely different amount. For example, if a partnership issued a compensatory partnership interest and the economic deal reached between the partner and the partnership was that the interest would have an opening capital account of a certain amount (say $10) but the interest was valued at a different amount (say $8) under Section 83, the Proposed Regulations would require that the partner's Section 704(b) opening capital account be $8 even though the recipient's economic capital account (that is, the capital account that would actually reflect what would happen on liquidation) should be $10.[73] We believe that this aspect of the Proposed Regulations would frustrate a central purpose of the Section 704(b) capital account rules, which is to ensure that allocations of partnership items have an economic effect on the partners by requiring that the allocations be reflected on the partner's capital accounts and requiring that the capital account balances reflect what each partner would receive if the partnership were liquidated for tax purposes.

The disconnect between a partner's Section 704(b) capital account and the partner's economic capital account arises only when a compensatory partnership interest is valued at something other than its liquidation value and reflects a need to issue additional regulations that further coordinate Subchapter K and Section 83 in this circumstance. The additional Section 704(b) and 707(c) regulations described below would eliminate the disconnect and ensure that the Section 704(b) capital account of the

[73] Moreover, for partnerships that attempt to keep strict Section 704(b) capital accounts, the rule currently contemplated by the Proposed Regulation would suffer from a circularity problem, since the opening capital account would affect the valuation of the compensatory partnership interest but the valuation of the interest would affect the amount of the opening capital account. This circularity problem could only be solved in cases where the value of the partnership interest and the opening capital account balance were equal, which could only occur if the interest were valued based on its liquidation value. Although it is unclear how this circularity problem would be resolved in other cases, it would seem that any approach taken by these partnerships would potentially cause the partnership not to have complied with the Section 704(b) capital account maintenance rules. This could pose a substantial issue for partnerships that want to comply with the fractions rule or maintain qualified allocations under Section 168(h) and would effectively require them to take whatever action necessary to make and maintain a Safe Harbor Election under the Proposed Rules, as this would be the only way to ensure that compensatory partnership interests issued by the partnership could be valued at their liquidation value and thus the only way to ensure that the partnership complies with the Section 704(b) capital account maintenance rules.

recipient of a compensatory partnership interest always equal the liquidation value of the interest.

B. Application of Section 707(c).

In the event that a compensatory capital interest in a partnership is valued under Section 83 at less than its economic capital account (that is, its liquidation value), we believe that the difference should be considered a guaranteed payment to the service provider under Section 707(c). Although Section 707(c) generally only applies to "payments" to a partner, we think that crediting the book capital account of a partner as compensation for services generally should be treated as a payment for this purpose. The current Section 721 regulations provide that to the extent a partner gives up any part of his rights to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services, Section 721 does not apply and the value of an interest in such partnership capital so transferred to the partner constitutes income to the partner under Section 61 and is a guaranteed payment under Section 707(c). More generally, in cases where capital that is permanently reflected in one partner's capital account is reallocated to another partner as additional compensation for services, we believe it is appropriate to treat the "capital shift" as a guaranteed payment.[74] We believe that the regulations under Section 707(c) should be revised so

[74] We would distinguish this case from a number of other instances where a so-called "capital shift" may arise, such as where (i) at the time a partnership is required to allocate a particular item it is not clear which partner will ultimately be entitled to receive the benefit of the item under the economic arrangement of the parties (as will be the case whenever a partner makes a Section 83(b) election for an unvested partnership interest), (ii) the partnership allocates the item to the partner that it expects will receive the economic benefit, and (iii) it turns out that another partner is

that the timing of the "additional" guaranteed payment always coincides with the transfer of the interest.

> Example 18: A receives a compensatory partnership interest with a $10 liquidation value that is valued at $8 under Section 83. We believe it would be appropriate to treat the recipient as having (i) an $8 guaranteed payment by virtue of the issuance of the partnership interest and the application of Section 83 and (ii) a $2 guaranteed payment by virtue of the additional "capital" that the partnership has unconditionally promised to pay A without regard to the partnership's income.

C. Allocation of Deduction.

The Proposed Regulations contemplate that the partnership's deduction for the issuance of a compensatory partnership interest generally should be allocated to the historic partners.[75] Although we believe this is appropriate in most cases, we believe that it is not appropriate to the extent that the value of the partnership interest for purposes of Section 83 exceeds its liquidation value. From a Section 704(b) perspective, in such a case the deduction in excess of the liquidation value of the interest is being borne by the

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entitled to the benefit of the item and the partnership reallocates capital accordingly. In this case, the movement of the capital does not represent compensation or the satisfaction of a partnership obligation, but is merely a product of our tax system's use of separate accounting periods and the fact that the partnership was required at the time it filed its tax return to report the income to one of its partners, even though it genuinely did not know which partner would ultimately receive the economic benefit of the item.

75 The preamble to the Proposed Regulations notes that "The Treasury Department and the IRS believe that Section 706(d)(1) adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners."

new partner rather than the existing partners and we believe it should be allocated accordingly.

> Example 19: A and B each invest $50 in a partnership that continues to hold the cash. C is granted a 10% profits interest in the partnership with a $0 opening capital account that is valued at $10 under Section 83. C has $10 of income under Section 83 and, under the Proposed Regulations, the $10 of income would increase C's capital account by $10. If the partnership's $10 deduction were allocated to A and B, then each of A's and B's capital account would be $45 and C's capital account would be $10. However, this allocation would seem to violate basic Section 704(b) principles because, upon a constructive liquidation of the partnership, A and B would be entitled to $50 and C would be entitled to $0. In order to achieve this result, it is appropriate to allocate the $10 deduction to C rather than to A and B. Following this allocation, A and B would each have a $50 Section 704(b) capital account and C would have a $0 capital account.

D. When Interests are Considered Transferred.

The Proposed Rules generally apply whenever a compensatory partnership interests is "transferred" and the Proposed Rules are generally only applicable to interests "transferred" after the Proposed Rules are finalized. In many partnership contexts, it will not be clear what is intended to constitute a "transfer" for these purposes. For example, suppose that a partnership interest is transferred to A prior to the effective date but under the terms of the partnership agreement, A's share of partnership capital or profits will (or may at the discretion of senior management) be increased over time or upon certain events, such as the withdrawal or retirement of another partner. Would such an increase in A's interest be treated as a "transfer" of a partnership interest, either for purposes of the effective date provision or for purposes of applying the Proposed Rules more generally? Alternatively, assume that under the partnership agreement, A's share of profits is determined each year at the sole discretion of senior management.

We recommend that Treasury and the IRS issue guidance as to when a transfer of a partnership interest will be considered to occur and that such guidance generally provide that (i) changes (including discretionary changes) in the sharing of the partners that occur pursuant to the terms of the partnership do not constitute transfers of partnership interests, (ii) transfers of compensatory partnership interests generally only occur in cases where a new partner is admitted or there is an actual amendment to the partnership agreement and (iii) if a partner receives a compensatory partnership interest with a retroactive commencement date, the partner will have thirty (30) days from the date of the actual transfer (determined without regard to the retroactive effective date) during which to file a Section 83(b) election.

E. Effective Date.

As noted above, the Proposed Rules would generally be effective for partnership interests (or property) transferred after the date the final regulations are published in the Federal Register. The Existing Revenue Procedures would become "obsolete" on such date. Many existing partnership arrangements were set up under the expectation that the Existing Revenue Procedures would continue to apply and that the partnership would be able to issue compensatory partnership interests in the future without the recipient recognizing gain. As discussed above, it will be difficult, time consuming and expensive for many existing partnerships to make the Safe Harbor Election contemplated by the Proposed Rules and other existing partnerships may well find that, due to the unwillingness of a particular partner or other reasons, it is impossible for them to make the election. These partnerships will generally be forced into the uncertain state of the law that would apply in valuing compensatory partnership interests that do not qualify for safe harbor treatment. We believe that Treasury and the IRS should consider extending the application of the Existing Revenue Procedures to partnerships in existence at the time the Proposed Regulations are finalized until either a certain amount of time has passed or there has been a substantial change in the nature of the partnerships' activities or the partners of the partnership.