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PARTNERSHIPS, S CORPORATIONS, & LLCs

Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K

Author: By Sheldon I. Banoff, Paul Carman, and John R. Maxfield

SHELDON I. BANOFF, P.C., is a partner in the law firm of Katten Muchin Rosenman LLP, Chicago, and co-editor of the Shop Talk column. PAUL CARMAN is a partner in the Chicago law firm of Chapman and Cutler. Both are frequent contributors to The Journal. JOHN R. MAXFIELD is a partner in Holland & Hart LLP in Denver, and chairs the subcommittee on LLCs and LLPs of the ABA Tax Section's Committee on Partnerships & LLCs.

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Existing partnerships as well as those in the planning stage face difficult choices because of the new approach taken by Treasury and the IRS to grants of partnership interests (including options) in return for services. By making Section 83 the principal authority for determining the tax treatment of the partnership, the service provider, and the historic partners, the new rules create significant issues with respect to capital accounts and the substantial economic effect rules, among other problems.

Recently issued Proposed Regulations (REG-105346-03, 5/24/05), accompanied by a draft Revenue Procedure in Notice 2005-43, 2005-24 IRB 1221, provide long-awaited guidance as to the treatment of equity interests and options issued by partnerships[1] ("Partnership Equity") in exchange for services. By eliminating some previously existing uncertainties, the new rules if finalized in substantially the same form as proposed should facilitate the issuance of Partnership Equity for services. Nevertheless, the new proposals themselves raise important questions in need of clarification.

OVERVIEW

The Proposed Regulations eliminate the risk of gain recognition by the partnership (and thereby its partners) in connection with both (1) the issuance or vesting of capital interests, and (2) the issuance, vesting, and exercise of compensatory options. They also would effectively preserve the favorable tax treatment afforded service providers who receive compensatory partnership profits interests, but only if their partnership validly elects the liquidation value approach (currently applicable in IRS Revenue Procedures). Election of the liquidation value approach, however, likely will increase the ordinary income recognized by recipients of compensatory capital interests and options (and generally increase the corresponding deduction to the remaining partners). Thus, the Proposed Regulations may create tax-driven tension between service providers who receive profits interests and service providers who receive capital interests and options,

because the choice of valuation elections that the partnership must make potentially will result in greater income recognition for one group or the other.

Moreover, where a partnership following the capital account maintenance rules of the Section 704(b) Regulations does *not* choose the liquidation value election, the partnership may find it difficult in some situations to maintain the partners' intended economic deal because of questionable capital accounting requirements—and the solution may lead to unforeseen and undesirable special allocations of taxable income or gain, or deductions or losses, to the service partner and/or the other partners. As a result, some partnerships may feel compelled to not follow the capital account maintenance rules in the Section 704(b) Regulations in order to preserve their economic deal.

Consistent with compensatory transfers of other property governed by Section 83, the Proposed Regulations would penalize many recipients of unvested profits and capital interests who fail to make timely Section 83(b) elections, by requiring them to recognize ordinary income when their interests subsequently vest. Finally, the Proposed Regulations may create a problem (under Sections 168, 470, and 514(c)(9)(E)) where one or more partners are tax-exempt entities and the partnership issues unvested capital or profits interests.

Prior to the Proposed Regulations, there had been no guidance as to whether the tax treatment of Partnership Equity for services should be covered by Section 83, by Subchapter K, or by some conglomeration of the principles that have evolved under both systems. The Proposed Regulations provide that the transfer of Partnership Equity in connection with the performance of services is subject to Section 83. They also provide that generally no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. The Proposed Regulations provide a default rule that the gross income of the recipient of the interest will include an amount based on the FMV of the interest at the time of the transfer or vesting. Notice 2005-43, however, describes a proposed Revenue Procedure that would, subject to some limitations, permit the amount included in the gross income of the recipient of the interest to be based on the liquidation value of the interest issued (sometimes referred to herein as the "liquidation value election"). The latter is consistent with Subchapter K principles evidenced in existing case law and IRS Revenue Procedures.

PARTNERSHIP INTERESTS AND OPTIONS FOR SERVICES

Pass-through entities—including joint ventures, general and limited partnerships, and LLCs taxable as partnerships (collectively referred to herein as "partnerships")—are becoming the business entity of choice for nonpublicly traded business organizations. The growth in the use of partnerships has led to a similar growth in the use of equity and equity-based compensation for partnership employees, independent contractors, and existing partners. [2]

Typically, a service provider's compensation will include a "capital" or "profits" interest in the partnership, [3] or (less frequently) an option to acquire such interests. Just as for operating businesses organized in corporate form, many partnerships will only grant the service provider an equity interest subject to a vesting requirement (e.g., service for a specified period of time or the attainment of stated performance goals).

What are the tax consequences to the service provider, the partnership, and the other partners in connection with the issuance (and, in the case of unvested interests, the vesting) of the service provider's interest in the partnership?

The Issues

Prior to the Proposed Regulations, there was little guidance on the tax treatment of the issuance and vesting of partnership profits and capital interests, and exercise of compensatory partnership options. No Code provision, legislative history, Regulations, or Rulings explicitly dealt with these issues. The more significant of these [4] include:

- Does the service provider recognize taxable compensation income on receipt of the profits or capital interest, on its vesting, or not at all?
- If the service provider does recognize income, how much? (That is, is the amount zero, liquidation value, going-concern value, or FMV?)
- Is the partnership (as the issuer of the profits or capital interest) entitled to claim a deduction for payment of compensation to the service provider and, if so, when and in what amount?
- Is the service provider able to make a valid Section 83(b) election with respect to unvested profits or capital interests?
- If the service provider cannot or does not make a valid Section 83(b) election, will she nonetheless be recognized as a partner of the issuing partnership before her interest vests, thereby being required to include in income her distributive share of partnership income and gain and being entitled to claim her share of partnership losses and deductions?
- If the service provider recognizes taxable income on the receipt of her profits or capital interest, can she obtain a corresponding deduction for the amount of the inclusion if she subsequently forfeits her interest?
- If a partnership allocates taxable income to a service provider holding an unvested interest (an "unvested service partner"), thereby increasing her basis in her partnership interest (her "outside basis"), and she subsequently forfeits her interest, is she permitted to claim a loss in an amount equal to the prior income inclusions (and, if so, what is the character of the loss)?
- What is the proper manner for determining the service provider's capital account at grant and vesting of the profits or capital interest for purposes of, and associated consequences under, the capital account maintenance rules of Reg. 1.704-1(b)?
- If the unvested service partner disposes of, but does not forfeit, her interest before vesting, what are the tax consequences to her and her transferee?
- If the service provider is taxed on the value of the compensatory profits or capital interest (whether at grant or at vesting), will the *partnership* also recognize gain or loss as a result of the transfer? [5]
- Does the partnership have a withholding tax obligation with respect to the income recognized by the service provider on the issuance or vesting of the partnership interest and, if so, when and in what amount?
- Will the partnership's cash distributions to a service partner holding an unvested profits or capital interest constitute distributions under Section 731(a) (i.e., not taxable except to the extent they exceed her outside basis, and generally taxable as capital gain to the extent of such excess), or rather as ordinary compensation income (because she may not be the "owner" of the partnership interest for tax purposes until the interest vests, absent a valid Section 83(b) election)?
- Similarly, what are the tax consequences to those parties in connection with the issuance and exercise (and vesting) of vested (and unvested) options to acquire partnership interests in exchange for services?

The answers to these questions ultimately may turn on which regime governs these issues: Subchapter K, Section 83, or, possibly, some new order that blends the principles of both. Prior to the Proposed Regulations, Treasury and the IRS had not developed a

comprehensive approach to reconciling the Subchapter K/Section 83 overlaps and incongruities. Instead, two Revenue Procedures, Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191, answered some of the questions raised above, but only with respect to vested and unvested profits interests.

Some answers are found in the Proposed Regulations, which are the product of joint efforts by Treasury, the Service's Tax-Exempt and Government Entities group (well-versed in the intricacies of Section 83), and the Service's Passthroughs and Special Industries group (most knowledgeable in Subchapter K). A useful background for understanding the positions reached in the Proposed Regulations, and the need for an alternative approach reflected in Notice 2005-43 and its draft Revenue Procedure, can be found in a brief review of the sparse guidance that existed prior to promulgation of the Proposed Regulations.

Prior Guidance

If property is issued in connection with the performance of services, Section 83(a) generally requires that the excess of the value of the property over the amount paid for the property is included in the gross income of the service provider in the first year the rights of the recipient of the property are transferable or not subject to a substantial risk of forfeiture. Special rules in Section 83(b), in respect of property subject to a substantial risk of forfeiture, allow an election to recognize income in the year the property is transferred rather than the year of vesting. [6] Other special rules provide for the general treatment of the income in respect of options without a readily ascertainable FMV [7] as arising at the time of exercise rather than the time of transfer or vesting. [8]

Partnerships issue a variety of equity-related interests in connection with the performance of services, including Partnership Equity. The question of how such Partnership Equity should be treated in a variety of situations has been subject to substantial controversy. In *Diamond,* 56 TC 530 (1971), *aff'd* 33 AFTR 2d 74-852, 492 F2d 286 (CA-7, 1974), Partnership Equity that was shown to have determinable value through a sale of the Partnership Equity shortly after issuance was treated as taxable to the service provider on receipt in the amount of the interest's value. By contrast, in *Campbell,* 68 AFTR 2d 91-5425, 943 F2d 815 (CA-8, 1991), a service partner was not taxable on the receipt of a profits interest where the interest had only speculative value at the time of its issuance. [9]

Treasury issued Proposed Regulations in 1971 that would have applied Section 83 to the issuance of partnership interests, but those rules were never finalized. [10] To reduce the level of controversy in this area, and after thoughtful consideration of *Campbell* and other case law, the IRS issued Rev. Proc. 93-27, which provided generally that the receipt of a partnership profits interest for services provided to, or for the benefit of, a partnership is tax free to the recipient. [11]

For the purposes of Rev. Proc. 93-27, a "profits interest" is defined as an interest that would not give the holder a share of the proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership at the time of the receipt of the partnership interest. This Procedure did not apply, however, if (1) the profits interest related to a substantially certain and predictable stream of income from partnership assets, (2) the partner disposed of the profits interest within two years of receipt, or (3) the profits interest was a limited partnership interest in a "publicly traded partnership" (within the meaning of Section 7704(b)).

Although Rev. Proc. 93-27 was widely applauded, substantial questions remained, particularly in regard to the relationship of Rev. Proc. 93-27 with Section 83. For example, Rev. Proc. 93-27 measured the taxability of the interest at the time of issuance. In contrast, as mentioned above, Section 83 measures the taxability of a transfer of property at the later of the time of the transfer or the vesting of the property. Thus, if an unvested partnership interest were issued which was a profits interest under Rev. Proc. 93-27 on the date of issuance but a capital interest on the date of vesting, Rev. Proc. 93-27 and Section 83 could be interpreted to directly conflict as to the tax result.

To resolve this particular conflict, the IRS issued Rev. Proc. 2001-43. [12] Under that Procedure, if a partnership grants an interest to a service provider, the time for testing whether the interest qualifies as a profits interest is, under certain circumstances, when the interest is granted (rather than at the time of vesting). To qualify for such treatment, (1) the service provider must be treated as a partner from the time of grant, (2) neither the partnership nor the other partners could deduct any amount in respect of the vesting of the interest, and (3) the interest otherwise must qualify as a profits interest under Rev. Proc. 93-27.

On 1/22/03, Treasury and the IRS published Proposed Regulations (REG-103580-02, 1/22/03) (the "Noncompensatory Proposed Regulations") regarding the income tax consequences of noncompensatory partnership options, convertible equity, and convertible debt. [13] In the Preamble, the government requested comments on the 1971 proposed amendment to Reg. 1.721-1(b)(1) and on the income tax consequences of the issuance of partnership capital interests in connection with the performance of services and options to acquire such interests.

Around that time the IRS also issued Ltr. Rul. 200329001, its first—and only—letter ruling regarding the tax treatment of service providers who receive unvested partnership profits interests for services. The ruling confirms that service providers who meet all of the requirements of Rev. Proc. 2001-43 may avoid income recognition on both the receipt and the vesting of the profits interest—even absent a Section 83 election. [14] The letter ruling left unanswered several questions involving the tax treatment of the service provider and the partnership. Moreover, in deference to the Proposed Regulations project, the IRS issued no further rulings under either Rev. Proc. 93-27 or Rev. Proc. 2001-43. [15] Little did the tax bar know then that the IRS would later propose to revoke those Revenue Procedures in conjunction with finalizing the Proposed Regulations and the draft Revenue Procedure. [16]

Another unanswered question under existing law relates to the proper valuation of a service provider's receipt of a capital interest for services. The proper valuation of that interest likely will determine (1) the income reportable by the recipient, (2) the partnership's deduction (or capitalized cost, possibly subject to amortization or depreciation), in connection with the transfer of value, and (3) the payroll and withholding taxes, if any, that must be remitted by the partnership (if the service provider was its employee immediately before the issuance). [17] Such valuation also may determine the capital account credited to the service provider.

Under current law (i.e., prior to application of the Proposed Regulations) there are at least four ways to measure the value of a capital interest issued for services:

- The "relinquishment of capital" approach.
- The "value added" approach.
- The "cost of services" approach.
- The "discounted value" approach.

Support exists under current law for each of these approaches.

Example: A and B each contribute $10,000 to newly formed LLC, in exchange for 50% capital interests in LLC. Shortly thereafter, SP is issued a 331/3% vested capital partner interest solely in exchange for services being rendered to the partnership at that time. A's and B's capital interests are each reduced to 331/3% to reflect this change. What is the proper amount for SP to include in compensation income (and LLC to deduct for SP's services)?

1. Relinquishment of capital: Reg. 1.721-1(b)(1) provides authority for concluding that SP recognizes $6,666.66 of income. That Regulation provides that to the extent that a partner relinquishes any part of her right to be repaid contributions of capital in favor of another partner as compensation for services, Section 721 does not apply. In that event, the receipt of an interest in the capital of a partnership is income to the partner who provides the services, and the amount of such income is the FMV of the interest in capital so transferred.

If the service partner is entitled on liquidation to a share of the capital contributed by the other partners, a shift in capital has occurred, and the service partner has received an interest in the capital of the partnership for which she did not make a contribution of property. [18] If LLC had been liquidated at the time SP received her 331/3% interest, LLC would have had $20,000 cash. Of that amount, A and B each would have been entitled to a 331/3% share (i.e., $6,666.67) and SP would have been entitled to a 331/3% share, i.e., $6,666.66. Thus, A and B each would be viewed as transferring $3,333.33 of capital contributions to SP. [19]

2. Value added: SP's capital interest could be valued based on the other partners' willingness to contribute $20,000 (total capital) in exchange for capital interests aggregating 662/3% of LLC. Under this approach, the value of SP's 331/3% interest would be $10,000 (proof: if 662/3% = $20,000, the total value of the partnership would be $30,000; SP's 331/3% of $30,000 equals $10,000). This method has greater attraction conceptually when SP's services are viewed as "adding value" to LLC's assets. Even without such a finding, the IRS convinced the Tax Court to apply this type of valuation approach in *Johnston,* TC Memo 1995-140, RIA TC Memo ¶95140 (absent evidence from the taxpayer to the contrary).

3. Cost of services: The value of SP's capital interest could be based on the value of SP's services (measured by what SP would ordinarily charge unrelated parties in an arm's-length transaction). Support for this approach can be found in *Hensel Phelps Construction Co.,* 74 TC 939 (1980), *aff'd* 51 AFTR 2d 83-1006, 703 F2d 485 (CA-10, 1983). There, the taxpayer received a portion of its partnership interest for capital and a portion for its contractor's profit in constructing a building. The taxpayer did not dispute the fact that it had received a capital interest in exchange for its profit; it merely disputed the timing of its receipt.

The decision is noteworthy for the court's holding that the FMV of the capital interest could be determined by the value of the contractor's services (measured by its average profit margin). Thus, if SP ordinarily charged $9,000 (payable in cash) for the same services rendered to LLC, under *Hensel Phelps* her capital interest would be valued at $9,000, regardless of the book capital credited her by LLC, and regardless of the liquidating distribution proceeds SP would receive if the partnership were to liquidate at the time she received her interest.

4. Discounted value: Finally, the value of the interest SP receives could be discounted to reflect such factors as lack of marketability (i.e., illiquidity), lack of control (if appropriate), and other factors taken into consideration in valuing equity interests. If valuation principles frequently applied for gift and estate tax purposes to interests in nonpublicly traded partnerships and LLCs are applicable, the value of SP's interest would be substantially lower than the amounts described in some of the alternatives above—perhaps in the $6,000 to $8,000 range. [20]

Section 83(a) and Reg. 1.83-1(a) require the FMV of property transferred to an employee or independent contractor in connection with the performance of services by such employee or independent contractor to be included in income when the property is substantially vested. At such time, the excess of the FMV of such property (determined without regard to any lapse restriction, as defined in Reg. 1.83-3(i), at the time that the property becomes substantially vested) over the amount (if any) paid for such property, is includable as compensation in the employee's or independent contractor's gross income. The FMV of the property (i.e., the partner's capital interest) arguably would reflect the aforementioned substantial discounts, for purposes of Section 83.

To date, the cases and rulings dealing with compensatory partnership capital interests have not adopted the discount valuation approach. In *Johnston,* the court acknowledged in footnote 16 of its opinion that the FMV of the capital interest in question was not necessarily the same as the amount of capital to which the service partner could have been entitled if the partnership had been liquidated immediately after the limited partners shifted that interest to him. Factors might exist that could affect FMV, such as anticipated gains or losses of the partnership and material restrictions on transferability of the partnership interests. Although the *Johnston* court observed that neither the IRS nor the taxpayer argued the applicability of Section 83, and it ostensibly decided the case under Reg. 1.721-1(b)(1), the court did not indicate it would have substantially reduced the value of Johnston's capital interest had Section 83 applied.

In the examples which follow, your authors have not determined which of these four (or other) valuation methods should be applied. For argument's sake, however, we have assumed that the discounted value approach would be appropriate under Section 83.

With all of these unanswered questions lurking, bar associations, accounting societies, practitioners, and industry groups submitted comments to Treasury in regard to Partnership Equity transferred for services. In response, Treasury and the IRS withdrew the 1971 proposed amendment to Reg. 1.721-1(b)(1) as part of the issuance of the Proposed Regulations.

THE PROPOSED REGULATIONS

Section 83 generally applies to a transfer of property in connection with the performance of services. Although there is much less authority on the application of Section 83 to partnerships than to corporations, courts have held that a partnership capital interest is property for the purposes of Section 83. [21] Consistently with such cases, the Proposed Regulations provide that a partnership interest is property within the meaning of Section 83 and that the transfer of a partnership interest in connection with the performance of services is subject to Section 83. [22]

In contrast to Rev. Proc. 93-27 and Rev. Proc. 2001-43, the Proposed Regulations apply Section 83 to all Partnership Equity, without distinguishing between partnership capital interests and partnership profits interests. Although Treasury recognized that the application of Section 83 to partnership profits interests has been the subject of

controversy, the Preamble to REG-105346-03 indicates that Treasury and the IRS do not believe that there is a substantive basis for distinguishing the treatment of capital interests and profits interests under Section 83.

The Preamble notes that all partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Treasury also observed in the Preamble that some commentators have suggested that the same tax rules should apply to both partnership profits interests and partnership capital interests. It indicated that such commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests.

Accordingly, the Proposed Regulations and the accompanying draft Revenue Procedure generally would apply equally to partnership capital interests and partnership profits interests. But a right to receive allocations and distributions from a partnership that is treated under Section 707(a)(2)(A) as a disguised payment of compensation to the service provider is not a partnership interest under the Proposed Regulations. [23]

Section 83(b) allows a person who receives property subject to a substantial risk of forfeiture in connection with the performance of services to elect to include in gross income the difference between (1) the FMV of the property at the time of transfer (determined without regard to a restriction other than one that by its terms will never lapse) and (2) the amount paid for such property. Under Section 83(b)(2), the election under Section 83(b) must be made within 30 days of the date of the transfer of the property to the service provider.

The Section 83(b) election also will affect the amount and timing of the service recipient's deduction. Except as otherwise provided in Reg. 1.83-6(a)(3), [24] Section 83(h) provides that any deduction allowable to the person for whom the services are provided will equal the amount included in the service provider's income. The amount will be deductible in the tax year of the person for whom the services are provided, in which or with which ends the tax year in which the amount is included in the gross income of the service provider.

In contrast with the timing rules just described under Section 83, under Section 706(a) and Reg. 1.707-1(c) guaranteed payments described in Section 707(c) are included in the partner's income in the partner's tax year within or with which ends the partnership's tax year in which the partnership deducted the payments. Under the current Regulations, an interest in partnership capital issued by the partnership as compensation for services rendered to the partnership is treated as a guaranteed payment under Section 707(c). [25]

In order to clarify the relationship of Subchapter K to the rules of the Proposed Regulations, the new rules also contain proposed changes to the Regulations under both Subchapter K and Section 83. Among these changes are:

> (1) Conforming the Subchapter K rules to the Section 83 timing rules.
> (2) Revising the Section 704(b) Regulations to take into account the fact that allocations with respect to an unvested interest may be forfeited.
> (3) Providing that a partnership generally [26] recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership.

In addition (as noted above), Notice 2005-43 contains a draft Revenue Procedure that, when finalized, will render obsolete Rev. Procs. 93-27 and 2001-43. The Preamble to

REG-105346-03 indicates that Treasury and the IRS intend for the Proposed Regulations and the draft Procedure to become effective at the same time.

The Proposed Regulations change the result just described under the current Regulations in two ways. First, under Prop. Reg. 1.721-1(b)(4)(i) all partnership interests (and not merely capital interests) issued to partners for services rendered to the partnership are treated as guaranteed payments. Also, Prop. Reg. 1.707-1(c) provides that the Section 83 timing rules override the timing rules in Section 706(a) and Reg. 1.707-1(c) to the extent that they are inconsistent. Accordingly, under the Proposed Regulations, if a partnership transfers a partnership interest to a partner in connection with the performance of services, the timing and the amount of the related income inclusion and deduction are determined by Section 83 and the Regulations thereunder. [27]

Consistent with the current treatment of S and C corporation shareholders, the Proposed Regulations provide that if a partnership interest that was transferred in connection with the performance of services is subject to a substantial risk of forfeiture, and if a valid election under Section 83(b) is not made, then the holder of the partnership interest is not treated as a partner for federal tax purposes until the interest becomes substantially vested. At that time, the recipient would recognize ordinary compensation income.

Under such an approach, the testing point for the amount of income reportable by the service provider in respect of the issuance of the interest is at the time the interest becomes substantially vested. If the partnership interest has appreciated in value between the grant and the vesting, the service provider may include a greater amount in income than the service provider otherwise might have included in income had a Section 83(b) election been timely made—depending in part on the value of the interest when it vests compared with the service provider's allocable share of income over the period of vesting and the FMV at the time of grant.

ILLUSTRATIONS

The following seven examples are derived from or illustrate the anticipated impact of the Proposed Regulations and draft Revenue Procedure, if they are finalized in substantially the same form as proposed.

Example 1: *Vested profits interest.* In year 1, A and B each contribute $10,000 cash to newly formed LLC, which is classified as a partnership for federal tax purposes, in exchange for 100 units in LLC and $10,000 of capital account credit. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-income-producing, nondepreciable property (X) for $20,000. X is the sole asset of LLC; LLC has no liabilities.

Also in year 1, when X is still valued at $20,000, LLC issues 100 units (a profits interest) to SP solely in exchange for services to LLC. (Thus, SP would not share in the first $20,000 of proceeds should LLC be liquidated, its assets sold, and the cash proceeds distributed under the terms of LLC's operating agreement.) If LLC had paid SP cash for such services, the payment would have been deductible. For state law purposes, SP is admitted as a member of the LLC in year 1. The FMV of SP's interest at the date of issuance (without taking into account the risk of forfeiture) is $1,000.

Under Rev. Proc. 93-27, assuming (1) the income of the partnership was not substantially certain and predictable, (2) SP held on to her interest for at least two years, and (3) LLC is not a publicly traded partnership, SP would have no income recognition in the year of the receipt of the interest in respect of the issuance of the interest. LLC would

not have a deduction in respect of the issuance. SP would start with a zero capital account, and the capital accounts of A and B remain at $10,000 each.

As mentioned above, the draft Procedure in Notice 2005-43 would obsolete Rev. Proc. 93-27 on finalization. Under the Proposed Regulations, absent the liquidation value election, the result just described under Rev. Proc. 93-27 is substantially changed. SP would recognize $1,000 of income in the year of the receipt of the interest in respect of the issuance of the interest. LLC would have a $1,000 deduction in respect of the issuance. SP would start with a capital account of $1,000, and the capital accounts of A and B would be reduced to $9,500 each. [28]

In contrast, if the liquidation value election is made under the Proposed Regulations and Notice 2005-43, the result provided by Rev. Proc. 93-27 is maintained. SP would have no income recognition in the year of the receipt of the interest in respect of the issuance of the interest. LLC would not have a deduction in respect of the issuance. SP would start with a zero capital account, and the capital accounts of A and B would remain at $10,000 each.

Thus, for partnerships that wish to maintain the basic treatment provided by Rev. Proc. 93-27, the liquidation value election will be required.

Example 2: *Unvested profits interest, no Section 83(b) election.* The facts are the same as in Example 1 except that if SP does not continue to render services to LLC until the beginning of year 4, she will forfeit all rights to her interest in LLC on termination of her employment. SP does not make a valid Section 83(b) election. Once again, the FMV of SP's interest at the date of issuance and without taking into account the risk of forfeiture is $1,000.

When X has a value of $30,000 and a basis of $20,000, SP's interest becomes fully vested. After taking into account applicable valuation discounts with respect to SP's interest, the FMV of SP's interest (i.e., 100 units with a liquidation value of $3,333.33) at the time of vesting is $2,000. Absent the liquidation value election discussed below, it appears that (1) SP would recognize $2,000 of compensation income in the year of vesting, (2) the LLC would have a $2,000 deduction in the same year (assuming SP's services are not subject to capitalization), and (3) SP will be first recognized as a partner for federal income tax purposes (a "tax partner") in year 4, [29] having a $2,000 capital account.

If the liquidation value election is made, SP would include $3,333.33 in income, the LLC would have a $3,333.33 deduction, and SP would become a tax partner in year 4 with a beginning capital account of $3,333.33. A's and B's capital accounts each would be adjusted to $13,333.33.

Example 3: *Unvested profits interest, Section 83(b) election, no liquidation value election.* The facts are the same as in Example 2, except that SP makes a valid Section 83(b) election in year 1 and the liquidation value election is not made. In these circumstances SP would be treated as a tax partner when she receives the units, i.e., year 1 (rather than commencing in year 4, as in Example 2). [30] SP would include in her year 1 income $1,000, i.e., the FMV of her profits interest determined without regard to any lapsing restrictions (such FMV exists by virtue of the fact that SP's profits interest is entitled to one-third of the upside and none of the downside of the LLC's assets).

If both the liquidation value election and the Section 83(b) election had been made, SP would not recognize *any* income either on receipt or vesting, even though the FMV of the

interest was $1,000 on receipt. In comparison, in Example 2 SP would have $3,333.33 more of income in year 4 (the year of vesting) than would have been recognized if SP had made a valid Section 83(b) election on the grant in year 1, assuming that a liquidation value election had been made in respect of the grant of SP's interest. [31]

In our Example 3, it appears that the Proposed Regulations direct that SP should, on receipt of her profits interest as a result of the Section 83(b) election, begin with a capital account of $1,000 (i.e., the FMV of the profits interest received by her). [32] The problem here is what happens if, immediately following the issuance of the profits interest to SP in Example 3, LLC sells X for its FMV of $20,000 and liquidates. The economic deal between A, B, and SP is that A and B are to get their money back (i.e., $10,000 each) and that SP only shares in appreciation of the partnership's assets above $20,000. The fact that the Proposed Regulations would prescribe a $1,000 opening capital account for SP seems to conflict with the agreement reached by the parties, and therefore departs from economic reality. A better answer here would seem to be that SP begin with a zero capital account, even though she has recognized $1,000 of income (i.e., the FMV of her profits interest) and LLC has a corresponding $1,000 deduction (subject to capitalization).

Similarly, with respect to A and B, the Proposed Regulations seem to prescribe that LLC's compensation deduction of $1,000 [33] be allocated to the historic partners, A and B. This would cause A and B's capital account to be adjusted to $9,500 each, which is also contrary to their economic deal that if LLC were to liquidate with $20,000 of liquidation proceeds immediately following SP's admission, A and B would each receive $10,000 and SP would receive zero.

One possible approach to this problem would be for the Proposed Regulations to mandate corrective allocations of some type which are designed to bring the capital accounts into conformance with the economic deal (the "corrective allocations approach"). Such allocations would be complex, however, and at best ultimately would accomplish only what could be achieved much more simply. The easier approach would be to require that, in connection with the issuance of a profits interest by a partnership which has not made the liquidation value election, SP starts with a zero capital account for Section 704 capital account maintenance purposes (even though she has recognized the FMV of her interest pursuant to Section 83(a)), and the historic partner's capital accounts are adjusted to the amounts that would be distributed to such partners if the partnership were liquidated immediately after the issuance of the profits interest to SP (the "capital account adjustment approach"). Therefore, as between these two alternatives, the capital account adjustment approach seems preferable.

Example 4: *Unvested profits interest, Section 83(b) election, no liquidation value election, Section 704(b) allocations prior to vesting.* The facts are the same as in Example 2, except that X generates $1,200 of net income per year (exclusive of any deduction attributable to LLC's issuance of SP's member interest), and SP files a valid Section 83(b) election. SP would include in income in the year of grant either the FMV of the interest determined without regard to any lapsing restrictions (which may be a positive amount—assume here it is $1,500—by virtue of the fact that SP's profits interest is entitled to one-third of the upside and none of the downside from LLC's assets) or, if the liquidation value election has been made, the liquidation value—which presumably would be zero if the parties correctly described the interest as a profits interest.

LLC may be entitled to a deduction of $1,500, i.e., the amount included in SP's gross income in respect of the grant of the interest. SP, who is a tax partner in year 1 (having made a valid Section 83(b) election), is allocated $400 of income per year under Section 704(b) (i.e., one-third of LLC's annual income of $1,200), even prior to the vesting of her interest. Thus, the total LLC income allocated to SP under Section 704(b) is $1,200

during the three-year unvested period. The character of SP's share of income will be the same as that recognized by the partnership under Section 702(c).

If SP did not make a valid Section 83(b) election in year 1, SP would not be a tax partner prior to vesting in year 4 and would not be allocated any share of LLC's income (rather than the $1,200 of income allocated in Example 4). Rather, SP would report as ordinary compensation income under Section 61 any distributions paid by LLC to SP with respect to her LLC interest, pursuant to Reg. 1.83-1(a)(1), and LLC would have corresponding compensation deductions (subject to capitalization).

In year 4, when X has a value of $30,000 and a basis of $20,000, SP's interest becomes fully vested. In contrast to the result in Example 2, SP would recognize $1,500 as income in year 1 under Section 83(b), would take the $1,200 allocation into income during the vesting period under Section 704(b), and would recognize no additional amount in year 4 arising from the vesting of SP's interest. LLC also would have no compensation deduction in the year of vesting.

As in Example 3, this simplified example raises an interesting question about the relationship of capital accounts to the economic agreement of the parties in regard to a profits interest for which a liquidation value election has *not* been made. Assuming that SP's profits interest has an FMV of $1,500 on the date of issuance, A and B's capital accounts will each be reduced by $750 as a result of their allocable shares of the deduction attributable to SP's valid Section 83(b) election. The facts of the example, however, indicate that X has a value in year 1 of $20,000. If the capital accounts of A and B total $18,500 (i.e., $9,250 each) after the allocation of the deduction, it would appear that SP has received a capital interest (assuming LLC liquidates in accordance with capital accounts) because, unless LLC finds a valid way to drive A and B's capital accounts back up to a total of $20,000 *and* drive SP's capital account back down to zero, SP effectively will have an interest in $1,500 of LLC's assets.

Although there is no authority directly on point, LLC mathematically could solve this problem in one of three ways:

(1) By special allocations in the year of receipt.
(2) By adjustments in accordance with Section 704(c) principles.
(3) By adjustments on the sale of assets on final liquidation of the partnership.

Use of the corrective allocation approach by effectively reversing the allocation under the Proposed Regulations would require both (1) $1,500 of additional gross operating income to be split solely between A and B (i.e., $750 each) before SP shares in the profits, *and* (2) allocating $1,500 of gross deductions or items of expense or loss to SP, all in the year of SP's receipt of her LLC profits interest. That would restore A's and B's capital accounts in year 1 to $10,000 each and SP's capital account to zero, which matches the parties' business deal with respect to the first $20,000 of cash liquidating distributions under LLC's agreement.

Alternatively, using the capital account adjustment approach, LLC also might treat the $1,500 in SP's book capital account (but intended to be zero under the economic deal at such time) as being an amount for which principles akin to those in Section 704(c) apply, allowing the disparity to be remedied over time or when X is sold.[34] Finally, the adjustment theoretically could be made by reconciling any book-economic disparity on the ultimate sale of LLC's assets and/or LLC's liquidation.

As noted above, the approach of the Proposed Regulations differs markedly from that of Rev. Proc. 2001-43. Under Rev. Proc. 2001-43, if an unvested partnership profits interest is transferred in year 1 in connection with the performance of services, then the holder of the partnership interest may be treated as a tax partner on issuance in year 1 even if no Section 83(b) election is made, provided that certain conditions are met, and the holder will have a zero capital account on the grant of her profits interest.

Vested Capital Interests

Under Prop. Reg. 1.704-1(b)(2)(iv)(*b*)(*1*), the service provider's capital account is increased by the amount the service provider takes into income under Section 83 as a result of receiving the interest, plus any amounts paid for the interest. According to the Preamble to REG-105346-03, some commentators have suggested that the amount included in the service provider's income under Section 83, plus the amount paid for the interest, may differ from the amount of capital that the partnership has agreed to assign to the service provider. (As discussed earlier, the Tax Court, in footnote 16 of *Johnston,* made this same observation.) The Preamble indicates that such commentators have recommended that the substantial economic effect safe harbor in the Section 704(b) Regulations should be amended to allow partnerships to reallocate capital between the historic partners and the service provider to accord with the economic agreement of the parties.

Nevertheless, Treasury concluded that the reallocation of partnership capital in these circumstances is not consistent with the policies underlying the substantial economic effect safe harbor and the capital account maintenance rules. As indicated by Treasury in the Preamble, the purpose of the substantial economic effect safe harbor is to ensure that, to the extent that there is an economic benefit or burden associated with a partnership allocation, the partner to whom the allocation is made receives the economic benefit or bears the economic burden. According to Treasury, under Section 83 the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount paid for the interest. Thus, Treasury limited the amount by which the service partner's capital account should be increased to be the amount included in the service partner's income.

As mentioned above, the draft Revenue Procedure in Notice 2005-43 would allow a partnership, its partners, and the service provider to elect to treat the FMV of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.

Nevertheless, as illustrated above in connection with compensatory profits interests where no liquidation value election is made, the tax and capital accounting consequences remain uncertain with respect to compensatory capital interests if the liquidation value election is *not* made.

Example 5: *Vested capital interest, no liquidation value election.* In year 1, A and B each contribute cash of $10,000 to LLC in exchange for 100 units in LLC and $10,000 capital account credit. Under the LLC agreement, each unit is entitled to share equally in the profits, losses, and distributions of LLC. LLC uses the cash contributions to purchase property X for $20,000. At the beginning of year 4, when A and B still have capital accounts of $10,000, LLC issues 100 units (a capital interest) to SP in exchange for services. At that time, X is the sole asset of LLC, with an FMV of $30,000; LLC has no

liabilities. If LLC had paid cash for the services, such payment would have been deductible. The units are not subject to a risk of forfeiture by SP. LLC does not make the election to value SP's units in accordance with their liquidation value. The FMV of the 100 units issued to SP (after taking into account applicable minority and liquidity discounts) in year 4 is $7,000.

In this example, the economic agreement between the parties is that A, B, and SP are equal members in all profits, losses, and *distributions.* Therefore, if immediately after SP received her interest LLC were to sell X for $30,000 and liquidate, each of A, B, and SP would receive $10,000. A willing buyer, however, would pay only $7,000 for SP's units at the time of issuance because of applicable minority and liquidity discounts, and because there is no binding obligation or intention to liquidate LLC or sell LLC's assets (which may increase or decrease in value) in the near future.

The Proposed Regulations seem to require that SP recognize $7,000 of income on receipt of the 100 units (i.e., their stipulated FMV) and to require that SP take a capital account in LLC equal to $7,000 (i.e., the amount of income she recognizes). But assigning SP a capital account of $7,000 is inconsistent with the deal between A, B, and SP (to share all distributions equally), unless A's and B's capital accounts are each also adjusted down (from $10,000) to $7,000. Otherwise, A, B, and SP will not share equally in all future profits, losses, and distributions. Since LLC has no other assets and has no liabilities, adjusting each of A's, B's, and SP's capital accounts to $7,000 will mean that the value of X in the capital accounts would be adjusted to $21,000, even though its FMV is $30,000. It is not clear whether the Regulations permit these capital account adjustments to be made at other than liquidation value (i.e., $10,000 each for A, B, and SP and $30,000 for X). Nevertheless, Reg. 1.704-1(b)(2)(iv)(*f*), which governs partnership revaluations on, among other things, admission of new partners in exchange for rendering services, provides in relevant part that "the adjustments are *based on* the FMV of partnership property." (Emphasis added.)

Is there support for a "book-down" of A's and B's capital accounts to $7,000? In arriving at a decision of what he is willing to pay for 100 units in LLC, a willing buyer presumably would start with an evaluation of LLC's assets and liabilities and then (after taking all relevant facts and circumstances into consideration) would determine the value of the 100 units in LLC. It seems clear that the $7,000 FMV of the 100 units issued to SP is derived from the FMV of LLC's assets. What is not clear is whether the $7,000 is "based on" the FMV of LLC's assets.

Some might argue that in connection with this issuance of 100 units to SP in Example 5, adjusting each of A's, B's, and SP's capital accounts to $7,000 after allocation of the $7,000 deduction attributable to the issuance to SP is "*based on* the FMV of LLC's property...." [35] This initially would require booking A's and B's capital accounts up to $10,500 each and adjusting X to $21,000. Then, on allocation of the $7,000 compensation deduction, A's and B's capital accounts would be reduced to $7,000 each. Those who support this argument also point out that the practicality of adjusting capital accounts with reference to the FMV of the equity interest issued to an incoming partner/member is highlighted by the typical admission of a new partner entirely for cash (and not in connection with services).

The Proposed Regulations do not have a mechanism to permit or require LLC to "book up" SP's capital account to $10,000 (so that the three members' total capital accounts will equal $30,000, which reflects the amount that would be available for distributions to A, B, and SP if LLC sold its assets and liquidated immediately following SP's admission). Indeed, as stated above, the Preamble to REG-105346-03 expressly excludes that alternative.

The dilemma faced by Treasury and the IRS with respect to the FMV approach (as opposed to the liquidation approach) appears to be grounded in the taxpayer-favorable treatment of profits interests issued for services that meet the requirements set forth in Rev. Proc. 93-27.

Treasury has chosen to preserve the taxpayer-favorable treatment of profits interests issued in connection with services to the issuing partnership, but understandably proposes to condition such treatment on a requirement that the profits interest continue to be determined with reference to the liquidation value of the partnership's assets. Choosing this path, however, meant that Treasury had to reconcile the treatment of profits interests issued in connection with services with the treatment of a capital interest in exchange for services.

In the latter circumstance, taxpayers understandably point to Section 83(a), which determines the amount of compensation income with reference to the FMV of the property received for services. Since the FMV of a capital interest is often less than its liquidation value (see Example 5, above), taxpayers have a strong argument that SP's income on receipt of a capital interest should not be liquidation value, because to do otherwise taxes SP on more than the value of what she received in exchange for her services. Taxing SP on an amount greater than the FMV of what she has received seems contrary to the plain language of Section 83(a) and to the fundamental accession-to-wealth principle of Section 61. Therefore, absent an election by the partnership to which SP is bound, taxing SP on more than the FMV of what she receives would seem difficult to justify.

The Proposed Regulations attempt to resolve this dilemma by allowing partnerships a choice of either (1) continuing to enjoy the favorable tax treatment of profits interests in connection with services at a cost of valuing *all* partnership interests (including capital interests) with reference to liquidation value, or (2) taxing profits and capital interests at their true FMV, at a cost of discontinuing the favorable tax treatment accorded to profits interests. It appears that the liquidation valuation approach is more favorable than the FMV approach to the service performer who receives a profits interest, and less favorable to the service performer who receives a capital interest. An additional price for not electing the liquidation value approach appears to be substantial uncertainty as to how to make the capital accounts reflect the economic deal of the parties.

In Example 5, the deal between A, B, and SP is that on issuance of the 100 LLC units (representing a one-third "straight up" or "vertical" interest in partnership capital, profits, and losses) to SP, SP is an equal one-third partner with A and B in all profits, losses, and distributions. The Proposed Regulations and Preamble seem reasonably clear that SP should recognize as ordinary income the FMV of the property she received (i.e., the FMV of the 100 units). The FMV of the 100 units is not the $10,000 liquidation value, but rather, $7,000. Hence, SP should report $7,000 of compensation income. The Proposed Regulations seem to require that SP also take an initial capital account balance of $7,000. [36]

An alternative capital account adjustment approach would be to book all the members' capital accounts to $7,000. Crediting SP's capital account with $7,000 is consistent with the economic deal she has struck with A and B only if A and B also adjust their capital accounts to $7,000 (and necessarily property X is also adjusted to $21,000). As noted above, an argument supporting this treatment as consistent with the Regulations is usage of the words "based on the FMV of partnership property" in the applicable book-up Regulation. [37] Otherwise, applying the requirements of the Proposed Regulations without either variant of the capital account adjustment approaches, SP would take a $7,000

capital account, and A and B would each take a capital account equal to $11,500 (i.e., 50% of (1) $30,000 minus (2) $7,000). This simply is not reflective of the deal.

Moreover, assuming the appraisers value SP's 100 units as though the unit holder is, in fact, entitled to one-third of all profits, losses, and distributions, the fact that SP's capital account started at $7,000 while A's and B's capital accounts started at $11,500 would clearly cause the FMV of SP's units to be less than $7,000 (because such $7,000 valuation was premised on the units issued to SP having the same per-unit entitlement to all distributions to which other outstanding units were entitled). If (as seemingly mandated by the Proposed Regulations) this is not true, then the value of the units to SP must be further adjusted downward.

Under the approach of the Proposed Regulations, such downward adjustment in the FMV of the units would appear to trigger a further downward adjustment in SP's capital account. If A, B, and SP were to agree that as directed by the Proposed Regulations, SP's capital account should be equal to the FMV of her interest, then the FMV of her interest conceivably could suffer this continual downward spiral until it equals the FMV of a profits interest. Under this approach, the net result would be that following the Proposed Regulations would effectively convert a capital interest issued to SP into a pure profits interest in a partnership that does not make the liquidation value election.

As with the above-described treatment of compensatory issuances of profits interests by partnerships that are not subject to the liquidation value election, the Proposed Regulations also need to be modified in order to resolve this capital accounting problem that exists under the Proposed Regulations in connection with the compensatory issuance of a capital interest by a partnership that is *not* subject to the liquidation value election. As with profits interests, one solution would be to mandate corrective allocations until the capital accounts are brought into harmony with the economic deal. But corrective allocations in connection with compensatory issuances of capital interests generally would cause SP to recognize an amount of income that exceeds the amount of her accession-to-wealth and therefore seems contrary to Section 83(a). [38]

The alternative capital account adjustment approach discussed above seems to resolve the capital accounting problem that exists under the Proposed Regulations, while remaining true to the accession-to-wealth principles of Sections 83(a) and 61. As a practical matter, this approach also seems consistent with how capital accounts are customarily adjusted and maintained on the admission of new partners in a noncompensatory context.

Unvested Capital Interests

The tax and capital accounting treatment of unvested *capital* interests, with respect to which a valid Section 83(b) election is not made, is comparable to the tax and capital accounting treatment of an unvested *profits* interest with respect to which a valid Section 83(b) election is not made. As illustrated in Example 2 above, when a profits interest vests in a partnership with appreciating assets, the interest is generally a capital interest at the time it vests.

In both instances, SP (the service performer) is not treated as the tax owner of the interest until it vests. Any distributions received by SP prior to vesting constitute additional compensation and are included in her gross income for the tax year in which such income is received. [39] The service provider recognizes income equal to either the FMV or liquidation value (depending on whether a liquidation value election is in effect) of the capital interest at the time of vesting.

Valuation of Compensatory Partnership Interests

Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the FMV of the property, disregarding lapse restrictions. [40] Some authorities have concluded, however, that in any given case a partnership profits interest might have only a speculative value or that the FMV of a partnership interest should be determined by reference to the liquidation value of that interest. [41]

Prop. Reg. 1.83-3(l)(1) and Notice 2005-43 provide that, if certain requirements are satisfied, partnerships and service providers may value partnership interests based on liquidation value. According to the Preamble, this approach ensures consistency in the treatment of partnership profits and partnership capital interests.

Subject to some additional conditions, [42] the Proposed Regulations permit a partnership and all of its partners to elect a safe harbor under which the FMV of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final Regulations become effective if the conditions discussed in the following paragraphs are satisfied.

To make a liquidation value election, the partnership must prepare a document, [43] 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 irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the liquidation value election remains in effect. The partnership must attach the document to its tax return for the tax year that includes the effective date of the election. [44]

Except as described below, to qualify for the liquidation value election, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (1) the partnership is authorized and directed to elect the safe harbor and (2) 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. [45]

If the partnership agreement does not contain the provisions described in the preceding paragraph, or if the provisions are not legally binding on all of the partners of the partnership, the partnership still may qualify for the liquidation value election if each partner in the partnership that transfers a partnership interest in connection with the performance of services executes a document containing provisions that are legally binding on that partner stating that (1) the partnership is authorized and directed to elect the safe harbor and (2) 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. [46] Each person classified as a partner must execute such document before the transfer occurs for the election to be effective in respect of such transfer. [47] If a partner who has submitted the consent transfers his or her interest, the transferee will be treated as having consented only if the transferee separately consents or assumes the transferor's obligations under the transferor's consent to the election. [48]

Under Notice 2005-43, when a liquidation value election is made an interest issued subject to the safe harbor is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, both of the following conditions apply:

> (1) If the interest terminates, the holder may be required to forfeit the capital account balance equivalent credited to the holder under conditions that would constitute substantial risk of forfeiture.
> (2) The interest is not transferable.

For these purposes, the capital account balance equivalent is the amount of cash that the recipient of the interest would receive if, immediately prior to the forfeiture, the interest vested and the partnership sold all of its assets (including goodwill, going-concern value, or any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets and then liquidated.

The following illustration is adapted from Example 1 in the draft Procedure in Notice 2005-43.

Example 6: *Technically vested profits interest, no Section 83(b) election, liquidation value election.* SP is an individual and PRS is a partnership, both with a calendar tax year. The PRS partnership agreement provides for all partnership items to be allocated to the partners in proportion to the partners' interests in the partnership. The partnership agreement also provides that the partners' capital accounts will be determined and maintained in accordance with Reg. 1.704-1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of the partner's interest must restore that deficit to the partnership. No allocations and distributions to all parties are recast under Section 707(a)(2), and Section 751(b) does not apply to any distribution.

The partnership, its partners, and the service providers elect the safe harbor provided in Notice 2005-43 and file all affected returns consistent with the safe harbor, and each partnership interest transferred constitutes a safe harbor partnership interest under Notice 2005-43. The issuance of the partnership interest in each example is not required to be capitalized under the rules of Section 263 or another Code provision. If the partnership interest transferred to the service provider is not substantially vested, there is no plan that the service provider will forfeit the partnership interest.

PRS has two partners, A and B, each with a 50% interest in PRS. On 3/1/05, SP agrees to perform services for the partnership in exchange for a partnership interest. Under the terms of the partnership agreement, SP is entitled to 10% of the future profits and losses of PRS but is not entitled to any of the partnership's capital as of the date of transfer. Although SP must surrender the partnership interest on termination of services to the partnership, SP will not surrender any share of the profits accumulated through the end of the partnership tax year preceding the partnership tax year in which SP terminates services.

Under section 4.03 of the draft Revenue Procedure in Notice 2005-43, SP's interest in PRS is treated as substantially vested at the time of transfer. Under Notice 2005-43, the FMV of the interest for purposes of Section 83 is treated as being equal to its liquidation value (zero). Therefore, SP does not recognize compensation income under Section 83(a) as a result of the transfer, PRS is not entitled to a deduction, and SP is not entitled to a capital account balance.

SP in this example is entitled to the capital account accumulated through the end of the partnership tax year preceding the forfeiture. SP is not entitled to the capital account balance equivalent under Notice 2005-43—the capital account resulting from a deemed sale of assets—but the example still concludes that the interest is substantially vested. Because the interest is viewed as substantially vested to begin with, no Section 83(b) election would be required, and SP in this example would not be subject to the forfeiture allocation rules described herein, even if the income is distributed or losses are allocated to SP prior to forfeiture.

For service partnerships that make the liquidation value election, the result in this example may make the application of Section 83 to the issuance of compensatory partnership interests much more manageable. Many of such partnerships provide for the payment of the capital account to a departing partner. Under the example, no Section 83(b) election would be necessary in respect of interests with a right to a return of the capital account, if the liquidation value election were made.

The specified effective date of the liquidation value election of any partnership may not be prior to the date on which the liquidation value election is executed. 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 original of each document submitted to the partnership by a partner. If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. [49]

The liquidation value election terminates automatically if the partnership fails to satisfy any of the conditions or requirements of the election or the partnership, a partner, or a service provider reports the federal income tax consequences of the transfer of the relevant partnership interest inconsistently with the election. [50] The liquidation value election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the liquidation value election on the stated effective date. The document must be attached to the tax return for the tax year that includes the effective date of the revocation. [51]

If a liquidation value election is terminated, then, absent the Service's consent, the partnership and any successor partnerships are not eligible to make a liquidation value election for any tax year that begins before the fifth calendar year after the calendar year during which such termination occurs. [52] For such purposes, a successor partnership is any partnership that (1) on the date of the termination is related (within the meaning of Section 267(b) or Section 707(b)) to the partnership whose election has terminated (or, if the partnership whose election has terminated does not exist on the date of termination, it would have been related if it existed on such date), and (2) acquires (either directly or indirectly) a substantial portion of the assets of the partnership whose election has terminated. [53]

Application of Section 721 to the Partnership

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. [54] According to the Preamble to REG-105346-03, Treasury and the IRS are still analyzing whether an exception to this general rule is appropriate on the transfer of an interest in the capital or profits of a partnership to satisfy certain partnership obligations (such as the obligation to pay interest or rent).

The Preamble nevertheless indicates that Treasury and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. The Preamble further states that such a rule is more consistent with the policies underlying Section 721—to defer recognition of gain and loss when persons join together to conduct a business—than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests.

Accordingly, Prop. Reg. 1.721-1(b)(2) provides that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Although the new rules do not propose any changes to Reg. 1.704-1(b)(4)(i) (dealing with allocations to reflect revaluations of capital accounts), the Preamble indicates that it is the Treasury's view that under existing Reg. 1.704-1(b)(4)(i) the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized. [55]

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in a disregarded eligible entity, as defined in Reg. 301.7701-3(a), that becomes a partnership under Reg. 301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest. [56]

Revaluations of Partnership Property

The Noncompensatory Proposed Regulations contained special rules regarding the revaluations of partnership property while noncompensatory partnership options were outstanding. [57] While a noncompensatory option was outstanding, the Noncompensatory Proposed Regulations required that any revaluations of partnership property take into account the value of any noncompensatory options outstanding.

The new Proposed Regulations do not contain similar provisions. In Treasury's view as reflected in the Preamble, under recent modifications to Reg. 1.704-1(b)(2)(iv) the obligation to issue a partnership interest in satisfaction of an option agreement is a liability that is taken into account in determining the FMV of partnership assets as a result of a revaluation. As support for this interpretation, the Treasury refers to REG-106736-00 (6/24/03; recently finalized in TD 9207, 5/26/05) relating to the assumption of certain obligations by partnerships from partners.

Neither the proposed nor final version of REG-106736-00 directly makes any change to Reg. 1.704-1(b)(2)(iv)(*f*) or (*h*), which deal with the valuation of property for the purpose of book revaluations. Reg. 1.752-7(c)(1)(ii) provides, however, that if there is a change in the value of a Reg. 1.752-7 liability for the purposes of Reg. 1.704-1(b)(2)(iv)(*f*), the amount of the decrease or increase constitutes an item of income or loss for the purposes of Section 704(b) and Reg. 1.704-1(b). [58]

For these purposes, a Reg. 1.752-7 liability is an obligation, including contingent obligations and options, to the extent such obligation does not (1) create or increase the basis of any asset, (2) give rise to an immediate deduction, or (3) give rise to an expense (that is neither deductible nor capitalizable). [59] An obligation to issue a partnership interest pursuant to a compensatory option or on the vesting of an interest that is subject to a substantial risk of forfeiture may satisfy this definition because the tax consequences are generally deferred until the option is exercised or the interest vests.

Under Reg. 1.752-7(b)(3)(ii), the amount of a Reg. 1.752-7 liability is the amount of cash that a willing assignor would pay to a willing assignee to assume that liability in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted

to the obligor under that contract, and that contract is contributed to the partnership in connection with the partnership's assumption of the contractual obligation, then the amount of the Reg. 1.752-7 liability is the amount of cash, if any, that a willing assignor would pay to a willing assignee to assume the entire contract.

It is unclear how the Reg. 1.752-7 valuation rules are intended to apply in the context of Partnership Equity issued in exchange for services. On a theoretical level, assuming all parties priced the services and the equity on an FMV basis, at the outset of the contract the net value of the entire contract should equal zero. That is, the value of the services contributed to the partnership should equal the total value of consideration to be paid to the service provider, including the Partnership Equity to be issued. As time passes, however, an increased likelihood of exercise or vesting, plus the increased present value of the future payment because of a shortened time span, might cause the value of the Reg. 1.752-7 liability to approach the value of the partnership interest that would be received on exercise or vesting.

This would mean that adjustments to capital accounts under Reg. 1.704-1(b)(2)(iv)(*f*) would tend to reflect increases in the partners' shares of the Reg. 1.752-7 liability associated with an option or a nonvested interest as the time for exercise or vesting approached. For these purposes, a partner's share of a partnership's Reg. 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the Reg. 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than the Reg. 1.752-7 liabilities), and paid an unrelated person to assume all of its Reg. 1.752-7 liabilities in a fully taxable arm's-length transaction (and assuming such a payment would give rise to an immediate deduction to the partnership).

The value generated for an obligation of a partnership in respect of Partnership Equity under Reg. 1.752-7 may or may not equal the liquidation value attributable to the interest. Although not stated expressly in Notice 2005-43, [60] presumably Treasury intended for an electing partnership to use the liquidation value for all purposes—otherwise, an electing partnership could use liquidation value for purposes of Section 83 and the value calculated under Reg. 1.752-7 for other purposes. That often would result in understating or overstating the capital accounts of the historic partners when compared with the economic agreement of the parties while the option is outstanding or prior to the vesting of the interest.

Characterization/Timing Rules

The Noncompensatory Proposed Regulations contain a rule (Prop. Reg. 1.761-3) providing that the holder of a noncompensatory option might be treated as a partner under certain circumstances. According to the Preamble to REG-105346-03, however, Treasury and the IRS have concluded that the Proposed Regulations should not contain a similar rule for partnership options transferred in connection with the performance of services.

This is because of the possibility that constructive transfers of property, subject to Section 83, may occur under circumstances other than those described in the proposed rules for treating the holder of a noncompensatory option as a partner. Treasury and the IRS have requested comments on whether anti-abuse rules are necessary to prevent taxpayers from using the Proposed Regulations or the rules in Notice 2005-43 to inappropriately shift items of partnership income or loss between the service provider and the other partners.

In general, the absence of such rules in the Proposed Regulations would mean that the historic doctrine of constructive receipt would apply to issuances of Partnership Equity. Reg. 1.451-2 requires taxpayers to take into account income, although not actually reduced to a taxpayer's possession, if the income is set apart for the taxpayer or otherwise made available so that the taxpayer may draw on it at any time. Income is not constructively received, however, if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

It is currently unclear the extent to which new Section 409A will apply to the issuance of Partnership Equity in exchange for services. Section 409A requires the early inclusion in gross income of amounts payable under certain deferred compensation plans, and, in some instances, imposes a 20% additional tax on the amounts required to be included in income under the section. [61] Neither the statute nor the legislative history of the section refers to partnerships, but Notice 2005-1, 2005-2 IRB 274, provides that the application of Section 409A is not limited to employers and employees. Notice 2005-1 also provides that, until further guidance is provided, partnerships and partners may apply the same rules as are applicable to corporations in the application of Section 409A.

Because the extent of the application of Section 409A to partnerships is currently unclear, the interrelationship between Section 409A and the Proposed Regulations is also unclear.

Retroactive Allocations

Section 761(c) generally allows a partnership to modify its agreement at any time on or prior to the due date for the partnership's return for the tax year (without regard to extensions), provided that the agreed-on allocations satisfy the requirement of Section 704(b). It is not uncommon for service partnerships to amend their agreements after the year has closed (but before the return is filed) to reflect the contributions or production of the firm's partners during the year. Thus, for example, a partnership could, at the end of its tax year, amend its partnership agreement to provide that a service provider who was a partner at the beginning of the year was entitled to a substantially vested or nonvested interest in partnership profits and losses from the beginning of the partnership's tax year.

The Preamble to REG-105346-03 indicates that a retroactive grant of a nonvested partnership interest can be made to a service provider who was not a partner at the date of the retroactive grant. This seems to be an expansive reading, given the general restrictions of Section 706(d). The legislative history of that section provides for the right of persons *who are partners for the entire year* to retroactively adjust their distributive shares under Section 761(c) as long as the adjustments are not attributable to additional capital contributions. [62] Nevertheless, general principles of tax law are unlikely to recognize the retroactive grant of partnership interests to nonpartners. [63] It is unclear whether retroactive grants of compensatory partnership interests to nonpartners will be respected on audit.

The Proposed Regulations provide guidance regarding the allocation of the partnership's deduction for the transfer of property in connection with the performance of services. The Preamble states that some commentators had suggested that the Proposed Regulations require that the partnership's deduction be allocated among the partners in accordance with their interests in the partnership prior to the transfer. The Preamble also states, however, that Treasury and the IRS believe that Section 706(d)(1) adequately ensures that partnership deductions attributable to the portion of the partnership's tax year prior to a new partner's entry into the partnership are allocated to the historic partners.

Section 706(d)(1) provides generally that, if, during any tax year of a partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for that tax year is determined by the use of any method prescribed by Regulations that takes into account the varying interests of the partners in the partnership during that tax year. No Regulations have been issued providing the rules for taking into account the varying interests of the partners in the partnership during a tax year—other than if a partner's entire interest is transferred. [64]

Reg. 1.706-1(c)(2)(ii) provides that, in the event of a sale, exchange, or liquidation of a partner's entire interest in a partnership, [65] the partner's share of partnership items for the tax year may be determined by either:

> (1) Closing the partnership's books as of the date of the transfer (the "closing of the books method").
> (2) Allocating to the departing partner that partner's pro rata part of partnership items that the partner would have included in the partner's taxable income had the partner remained a partner until the end of the partnership tax year (the "proration method").

Section 706(d)(2), however, places additional limits on how cash-method partnerships may allocate these deductions. Payments for services are treated as allocable cash-method items. [66] Under Section 706(d)(2)(A), if during any tax year of a partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in the Regulations) each partner's distributive share of any allocable cash-method item must be determined by assigning the appropriate portion of such items to each day in the period to which it is attributable. The portion assigned to any such day is allocated among the partners in proportion to their interests in the partnership at the close of that day. [67]

To allow partnerships to allocate deductions with respect to property transferred in connection with the performance of services under a closing of the books method, Prop. Reg. 1.706-3(a) provides that Section 706(d)(2)(A) does not apply to such a transfer.

Information Reporting to Nonpartners

The Preamble indicates that Treasury expects that, if a substantially vested compensatory partnership interest is transferred to an employee or independent contractor (or an election under Section 83(b) is made with respect to the transfer of an unvested compensatory partnership interest to an employee or independent contractor), the partnership will report the transfer, on Form W-2 or Form 1099-MISC as appropriate. [68] The Form W-2 or Form 1099-MISC would be issued to the service provider by the partnership by January 31 of the year following the calendar year in which the partnership interest is transferred.

The service provider would be required to report any income recognized on the transfer of the partnership interest on the service provider's return for the tax year (of the service provider) in which the transfer occurs. Presumably the partnership would be subject to payroll and withholding tax obligations if the taxable interest were issued to an employee of the partnership.

Because the partnership tax year may be other than a calendar year, the partnership may not have the information necessary to issue Form W-2 or Form 1099-MISC to the service provider by the January 31 deadline. Treasury and the IRS requested comments

on the timing, for Section 83 purposes, of retroactive transfers of partnership interests and on any actions that may be appropriate to address the associated administrative concerns. The request does not distinguish between interests retroactively transferred to partners and nonpartners.

Information Reporting to Partners

The Proposed Regulations treat the transfer of a partnership interest to a partner in connection with the performance of services as a guaranteed payment. To ensure that the service-provider partner has the information necessary to include the transfer in income for the tax year in which the transfer occurs (rather than the tax year in which or with which ends the partnership tax year in which the transfer occurs), Treasury and the IRS are considering the possibility of amending the Section 6041 Regulations.

Any such possible amendment would provide that this type of guaranteed payment must be reported by the partnership on Form 1099-MISC, which is required to be issued to the service provider on or before January 31 of the year following the calendar year of such transfer. Treasury and the IRS have requested comments on whether such a requirement is appropriate. Any interest issued after January 31 but before April 16 (but effective with respect to the preceding calendar year, pursuant to Section 761(c)) may prevent the partnership from having the information necessary to issue the Form 1099-MISC to the service partner receiving such guaranteed payment.

Forfeiture of Certain Compensatory Partnership Interests

If an election under Section 83(b) has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership items that may later be forfeited. Under the Proposed Regulations, for this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect. [69] Under Prop. Reg. 1.704-1(b)(4)(xii)(*b*), such allocations will be deemed to be in accordance with the partners' interests in the partnership if both of the following conditions are met:

> (1) The partnership agreement requires that the partnership make forfeiture allocations (described below) if the interest for which the Section 83(b) election is made is later forfeited.
> (2) All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a Section 83(b) election has been made are recognized under Section 704(b).

This safe harbor does not apply if, at the time of the Section 83(b) election, there is a plan that a substantially nonvested interest will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is such a plan. If that is the case, the partners' distributive shares of partnership items will be determined in accordance with the partners' interests in the partnership under Reg. 1.704-1(b)(3). [70]

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. Forfeiture allocations may be made out of the

partnership's items for the entire tax year, whether or not the forfeiting partner was a partner for the entire tax year. [71]

The formula for forfeiture allocations of income is (1) the excess (which cannot be less than zero) of (a) the amount of distributions (including deemed distributions and the adjusted tax basis of any property distributed) to the partner with respect to the forfeited interest (to the extent such distributions were not taxable under Section 731) over (b) the amount paid for the interest (including any deemed contributions) and the adjusted basis of property contributed, minus (2) the cumulative net income or loss allocated to the partner with respect to the forfeited partnership interest. [72]

Such allocations are designed to offset any partnership income (or loss) that was allocated to the service provider prior to the forfeiture by new allocations triggered by the forfeiture of the interest. [73] The Preamble indicates that the formula for forfeiture allocations was intended to carry out the prohibition under Section 83(b)(1) on deductions with respect to amounts included in income under Section 83(b) by causing a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under Section 83(b).

The reference to a prohibition under Section 83(b)(1) on deductions with respect to amounts included in income by the forfeiting partner under Section 83(b) presumably alludes to the flush language of Section 83(b)(1), which provides: "If such election is made..., and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture." Reg. 1.83-2(a) has interpreted Section 83(b)(1) to allow a deduction equal to the excess (if any) of the amount paid for the property with respect to which the Section 83(b) election was made over the amount realized on the forfeiture of such property.

The following illustration is adapted from new Example 29 in Prop. Reg. 1.704-1(b)(5).

Example 7: *Unvested profits interest, no Section 83(b) election, liquidation value election, complete forfeiture.* In year 1, A and B each contribute cash to newly formed LLC, which is classified as a partnership for federal tax purposes, in exchange for equal units in LLC. Under LLC's operating agreement, each unit is entitled to participate equally in the profits and losses of LLC. The operating agreement also provides that the partners' capital accounts will be determined and maintained in accordance with Reg. 1.704-1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in that partner's capital account following the liquidation of the partner's interest must restore the amount of that deficit to LLC.

At the beginning of year 3, SP agrees to perform services for LLC. In connection with the performance of SP's services and a payment of $1,000 by SP to LLC, LLC transfers a 10% interest in LLC to SP. SP's interest in LLC is substantially nonvested (within the meaning of Reg. 1.83-3(b)).

At the time of the transfer of the LLC interest to SP, LLC's operating agreement is amended to provide that, if SP's interest is forfeited, SP is entitled to a return of SP's $1,000 initial contribution. Also, SP's distributive share of all partnership items (other than forfeiture allocations under Reg. 1.704-1(b)(4)(xii)) will be zero with respect to that interest for the tax year of the partnership in which the interest is forfeited. The operating agreement is further amended to require that LLC make forfeiture allocations if SP's interest is forfeited. Additionally, the operating agreement is amended to provide

that no part of LLC's compensation deduction is allocated to the service provider to whom the interest is transferred.

SP makes an election under Section 83(b) with respect to SP's interest in LLC. On receipt, the FMV of SP's interest in LLC is $10,000. [74] In each of years 3 through 6, LLC has operating income of $10,000 (consisting of $20,000 of gross receipts and $10,000 of deductible expenses), and makes no distributions. SP forfeits SP's interest in LLC at the beginning of year 6. At the time of the transfer of the interest to SP, there was no plan for SP to forfeit her interest in LLC.

Because a Section 83(b) election is made, SP recognizes compensation income in the year of the transfer of the LLC interest. Therefore, SP recognizes $9,000 of compensation income in the year of the transfer of the LLC interest (the excess of the $10,000 FMV of SP's interest in LLC over the $1,000 SP paid for the interest). Under Reg. 1.704-1(b)(2)(iv)(*b*)(*1*), in year 3 SP's capital account is initially credited with $10,000, the amount paid for the interest ($1,000) plus the $9,000 included in SP's compensation income under Section 83(b) on the transfer. Under Regs. 1.83-6(b) and 1.721-1(b)(2), LLC does not recognize gain on the transfer of the interest to SP. LLC is entitled to a compensation deduction of $9,000 under Section 83(h). Under the terms of the operating agreement, the deduction is allocated equally to A and B.

As a result of SP's election under Section 83(b), SP is treated as a partner starting from the date of the transfer of the LLC interest to SP in year 3, under Reg. 1.761-1(b). In each of years 3, 4, and 5, SP's distributive share of partnership income is $1,000 (10% of $10,000). A's and B's distributive shares of partnership income are $4,500 each (45% of $10,000). In accordance with the operating agreement, SP's capital account is increased (to $13,000) by the end of year 5 by the amounts allocated to SP, and A's and B's capital accounts are increased by the amounts allocated to A and B. Because LLC satisfies the requirements of Reg. 1.704-1(b)(4)(xii), LLC's allocations in years 3, 4, and 5 are deemed to be in accordance with the partners' interests in the partnership.

As a result of the forfeiture of the LLC interest by SP in year 6, LLC is required to recognize $9,000 of income (the amount of the allowable deduction on the transfer of the LLC interest to SP under Reg. 1.83-6(c)). LLC repays SP's $1,000 capital contribution to SP, reducing SP's capital account to $12,000. Under the terms of the operating agreement, because SP forfeited SP's interest, SP's distributive share of all partnership items (other than forfeiture allocations) is zero for year 6.

To reverse SP's prior allocations of LLC income, LLC makes forfeiture allocations to SP in year 6 of $3,000 of deductions (zero, the difference between the $1,000 distributed to SP and the $1,000 contributed to LLC by SP, minus $3,000, the cumulative net LLC income allocated to SP). Notwithstanding Sections 706(c) and (d), these allocations may be made out of LLC's partnership items for the entire tax year of the forfeiture.

Thus, in year 6, $3,000 of deductions are allocated to SP, and the remaining $22,000 of net operating income ($20,000 of gross receipts and $9,000 of income under Reg. 1.83-6(c), less $7,000 of remaining deductions) are allocated to A and B equally for tax purposes. In accordance with the last sentence of Section 83(b)(1), SP does not receive a deduction or capital loss for the $9,000 previously included in SP's compensation income. Because LLC satisfies the requirements of Reg. 1.704-1(b)(4)(xii), LLC's allocations in year 6 are deemed to be in accordance with the partners' interests in the partnership.

If there are sufficient losses or deductions of the partnership in the year of forfeiture to allocate to SP, applying the forfeiture allocation formula potentially treats the amounts of

income previously allocated to SP (without offsetting distributions or allocations of loss) similarly to "amounts paid" for the purposes of Reg. 1.83-2(a). Although, strictly speaking, the forfeiture allocation is not part of the loss limited to the amount paid by Reg. 1.83-2(a), the net result often may be indistinguishable to the forfeiting partner. In each event, she will have a reduction of income in calculating taxable income. [75]

In some instances, however, the partnership may not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider. The Preamble to REG-105346-03 suggests that, in those circumstances Section 83(b)(1) may prohibit the forfeiting partner from claiming a loss with respect to such partner's basis in her partnership interest attributable to partnership net income that was previously allocated to the service provider. The Proposed Regulations do not treat such excess amounts as literally being "amounts paid" for the purposes of the limitation on the recognition of losses on the forfeiture of property under Reg. 1.83-2(a). A forfeiting partner still would be entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. [76]

In other instances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The draft Procedure in Notice 2005-43 proposes a rule that would require the recapture of losses taken by the service provider prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider, if the safe harbor for using liquidation value is elected.

Specifically, section 4.04 of the draft Procedure would require that if a liquidation value election has been made with respect to a forfeited interest, the service provider must include as ordinary income in the tax year of the forfeiture the excess, if any, of (1) the income or gain that the partnership would be required to allocate to the service provider under Prop. Reg. 1.704-1(b)(4)(xii) if the partnership had unlimited items of gross income and gain, over (2) the income or gain that the partnership actually allocated to the service provider under Prop. Reg. 1.704-1(b)(4)(xii). The proposed rule does not allow the other partners in the partnership to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service provider.

Treasury has requested comments about whether partnerships should be allowed or required to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make such allocations. It also has requested comments on whether Section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction, and if so whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the loss claimed by the service provider. [77]

In addition to making forfeiture allocations to reverse previous allocations, the partnership generally will have gross income in the tax year of the forfeiture equal to the amount of the deduction allowed to the service recipient partnership on the transfer of the interest as a result of the service provider's making the Section 83(b) election. [78]

Proposed Effective Date

These rules are proposed to apply to transfers of property on and after the date final Regulations are published in the *Federal Register.* The Proposed Regulations do not indicate whether taxpayers who transfer property prior to the proposed effective date may elect to have the final Regulations apply to such transfers.

QUESTIONS, ISSUES, AND PRACTICAL APPLICATIONS

Given the nature of the task of the Proposed Regulations—to provide an equity compensation regime in which Section 83 coordinates with Subchapter K—there inevitably are many points that require additional consideration.

1. Capital account as FMV for purposes of determining whether an interest is subject to a substantial risk of forfeiture. It appears clear under section 4.03 and Example 1 of the draft Revenue Procedure that if the liquidation value election is made, the service partner's right to receive a return of her capital account will cause her interest to be treated as substantially vested. Reg. 1.83-5 provides that for the purposes of Section 83 and the Regulations thereunder, in the case of property subject to a nonlapse restriction, [79] if stock in a corporation is subject to a nonlapse restriction that requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings, or a reasonable combination thereof, the price so determined ordinarily will be determinative of the FMV of such property for purposes of Section 83.

The Proposed Regulations do not modify Reg. 1.83-5 to clarify that the presumptions relating to a formula price based on book value also would apply to a formula price based on a partner's capital account. Nevertheless, it would not appear to be a great stretch of the current language to come to the conclusion that, if Section 83 applies equally to partnerships and corporations, the presumptions established in Reg. 1.83-5 also should apply equally to partnerships and corporations.

If such an interpretation is correct, a partnership in which partners were entitled to their capital accounts on leaving the partnership would not be issuing interests subject to a substantial risk of forfeiture, whether or not the partnership made the liquidation value election.

2. Capital account of partners when profits interest is issued and liquidation value election is not made. If the liquidation value election is not made, it is possible that the profits interest may have a positive FMV. If so, the capital accounts of the historic partners will be reduced by the amount of the deduction, potentially below the liquidation value of the assets of the partnership. If the capital accounts of the historic partners are reduced below the liquidation value of the assets, is the interest really a profits interest? The service partner will have a positive capital account value reflecting the FMV of the profits interest at the time of issuance.

If the economic deal is that the interest is intended to only share in the profits and growth after the issuance of the interest, the capital accounts of the historic partners must in some way be corrected to bring them back up to the value of the assets of the partnership and drive down the capital account of the service partner. The Proposed Regulations do not provide a clear answer to how to approach this question.

3. Capital account of service partner receiving a capital interest when liquidation value election is not made. If a service partner receives a capital interest and the liquidation value election is not made, the FMV of the interest may appropriately reflect various discounts from the liquidation value. The discounts taken will reduce the amount the service partner must take into income in respect of the interest issued.

The Proposed Regulations provide that the capital account of the service partner will equal the amount the service partner takes into income. The result is the reverse of the situation described in the previous point in regard to the historic partners: The service partner's capital account may be understated when compared with the economic arrangement of the parties. The Proposed Regulations do not provide a clear answer to how to approach the disparity between the capital accounts and the economic agreement.

4. Valuation of interests: past vs. future services. The Proposed Regulations also do not answer questions as to proper valuation of partnership interests for purposes of Section 83 under the liquidation value approach.

Assume SP is receiving her "profits" interest for services already rendered and (as in Example 1, above) the parties (A, B, and SP) have agreed to value SP's "profits" interest as of the date of A's and B's capital contributions. In that event, the value of her services presumably has increased the value of the partnership's assets (or reduced its liabilities). By being required to take the measurement of liquidation value at the time of the grant, however, SP effectively is taxed on that portion (in Example 1 above, a one-third share) of the increase in value that her services generate. In essence, this is a variant of the "cheap stock" problem that arises under Section 83(a) (whereby stock has to be issued to service providers on formation of a corporation before substantial value is created in order to avoid compensation income to the service providers).

Compare this with SP's receipt of the same one-third profits interest issued to her in exchange for *future* services. Applying the liquidation approach at the time of receipt of her interest, the partnership is legally entitled to have her provide such future services. Is that contract right properly includable in determining liquidation value? If so, in Example 1 and subsequent examples the value of the partnership's assets is greater than the $20,000 reflected for property X.

Presumably, this valuation dilemma also exists under the existing Revenue Procedures, any time the putative profits interest is issued in part or whole for future services. If, however, the entity were to liquidate and sell its assets, under the liquidation value approach should there be an assumption that the services still will be provided (and thereby add value)? Stated differently, if liquidation were to occur, is SP's promise to render future services relieved (as an impossibility) or instead assignable (like other assets owned by the partnership) in a bulk sale of the going concern? If the latter, is it in SP's best interest to provide in the partnership agreement that, notwithstanding her obligation to render future services, such obligation lapses if the partnership were to liquidate and sell its assets in bulk (with SP *still* being entitled to retain her profits interest and corresponding share of the sales proceeds)?

5. Reg. 1.752-7 liabilities and Section 83(b) elections. It appears from the Preamble to REG-105346-03 that options and unvested partnership interests may be treated as Reg. 1.752-7 liabilities for the purposes of determining the value of the assets of the partnership on certain book-up or book-down events. In general, the Section 83(b) election causes unvested interests to be treated as vested interests for most purposes. The Proposed Regulations, however, do not clarify whether the Section 83(b) election will be effective to cause an unvested interest to be treated as not being a Reg. 1.752-7 liability.

Although probably not contemplated by the drafters of the Proposed Regulations, an unvested profits interest in respect of which a liquidation value election has been made would appear to meet the definition of a Reg. 1.752-7 liability even if a Section 83(b) election has been made in respect of the interest (because no deduction results from the

Section 83(b) election). The result of the lack of coordination of the provisions could be interpreted to mean that the capital accounts continue to reflect the unvested interest as a Reg. 1.752-7 liability (depressing the capital accounts) until the vesting of the interest.

6. Forfeiture allocations. The premise of the forfeiture allocations is that allocations to a partner who may later forfeit her interest cannot have economic effect.

Section 704(b) provides that if the allocation to a partner, under the partnership agreement, of income, gain, loss, deduction, or credit (or items thereof) does not have substantial economic effect, such allocation instead will be made in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). The legislative history of the Tax Reform Act of 1976 indicates, among other things, that "substantial economic effect" depends on whether the allocations may actually affect the dollar amount of the partner's share of the total partnership income or loss independently of tax consequences. [80] A special allocation will be given effect only if the partner to whom such allocation is made also bears the economic benefit or cost of such allocation. [81]

Under the legislative history, case law, and current Regulations, it would seem that if the allocations of the partnership otherwise had substantial economic effect and the service partner's allocable share of net income was distributed to the partner, allocations to a partner who later forfeited his or her interest would have economic effect. Prop. Reg. 1.704-1(b)(4)(xii) would require offsetting allocations if a service partner, in fact, forfeits her interest after receiving allocations. If distributions at least equal to the allocations of net income have been made to the service partner, the policy justification for such forfeiture allocations is unclear. Unless the service partner is required to pay back any such distributions on leaving the partnership, it would seem that the service partner has had a partial vesting of the interest as distributions were made. Ordinarily, this would suggest that the service partner would be entitled to rely on the statutory Section 83(b) election to fix her tax consequences in relation to the election at the time of the original transfer of the interest to the partner.

No such allocation is required under current law for S corporation shareholders who file a Section 83(b) election and then later forfeit their interests.

7. Liquidation value elections. One of the practical problems presented by the liquidation value election is the requirement of either amending the partnership agreement or getting all of the partners to agree to the election. Setting aside the fact that it is often difficult to get all the partners to agree on anything, "partners" for tax purposes may be broader than "partners" for state law purposes. For example, without clarification that the partners who have to agree are only state law partners, retired partners who still receive distributions from the partnership as K-1 partners would have to consent to the election. For most partnerships, it will be easier to amend their existing partnership agreement rather than to try to obtain the consent of all the partners.

But amending a partnership agreement has its own problems. For one thing, it usually takes time. To have an amendment in place when the Proposed Regulations become effective, most partnerships would need to start the process of amending their partnership agreements well in advance. At the present time, however, we are only working with Proposed Regulations and a Notice that contains a draft Revenue Procedure. Both obviously are still subject to change, so starting the process too early, before the landscape is clear, may result in the process (or at least significant portions of it) having to be undertaken twice.

It also is unclear whether partnerships that are trying to anticipate how the Proposed Regulations will look in final form will be able to hedge their bets, e.g., by making the election but also granting their managing partners the authority to not apply the election. To properly make the election, the partnership agreement must provide that the partnership is authorized and directed to make the election and that each partner agrees to comply with all of the conditions of the election. Directing a managing partner to disregard the election would seem to conflict with the conditions of the election.

8. Two-year no-transfer safe harbor for profits interests. Under Rev. Procs. 93-27 and 2001-43 (both of which will be rendered obsolete on the effective date of the draft Revenue Procedure), the safe harbor for the tax-free treatment of profits interests is conditioned, among other things, on the service partner's retaining such interest for two years. In contrast, the draft Procedure conditions such tax-free treatment on, among other things, the profits interest not being transferred to the service provider "*in anticipation of a subsequent disposition.*"

The draft Procedure also provides that unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition (e.g., by death or disability), a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for this purpose if the partnership interest is either transferred by the service partner within two years of issuance, *or* is 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 death or disability).

This language creates a problem for many partnerships and LLCs. Many partnership and LLC agreements provide that if the service partner ceases performing services, the partnership or LLC has an option to purchase such interest. The purchase price in such event is often at a nominal or low price (in relation to FMV) before vesting, and at FMV or liquidation value after vesting. Such a provision generally is contained in the partnership or LLC agreement at all times from the date of issuance. Therefore, it would seem to violate the prerequisite that the compensatory profits interest not be subject, at any time within two years of the date of receipt, to a right to buy or sell regardless of when the right is exercisable (other than by virtue of death or disability or if it can be proven by clear and convincing evidence that such interest was not issued in anticipation of a subsequent disposition).

There is no indication in the Proposed Regulations, the draft Revenue Procedure, or their Preambles that the ability to qualify for the liquidation value election was intended to be made materially more difficult than under the existing Revenue Procedures. This result does not seem appropriate, and should be modified when the draft Procedure is issued in final form.

9. Revocation of liquidation value elections. The liquidation value election is easily terminated under the draft Revenue Procedure. Among other things, a liquidation value election terminates *automatically* in the event that the partnership, a partner, or a service provider reports income tax effects of a compensatory partnership interest received from a partnership with a liquidation value election in effect in a manner inconsistent with the requirements of the draft Procedure. Such inconsistency includes a failure to provide appropriate information returns.

It would seem, therefore, that almost any foot-fault by the partnership or *any* partner in this regard would automatically terminate the liquidation value election with respect to any compensatory partnership interest issued after the date of such foot-fault

(termination). For example, if a partnership with a liquidation value election in effect determines that the liquidation value of the partnership assets is $10,000 and such value on audit is actually $10,100, it is possible that the Service would successfully assert that the partnership has reported in a manner inconsistent with the requirements of the Revenue Procedure. Similarly, if a single service partner ever reports in a manner inconsistent with the Procedure, then—without notice to the partnership or the other partners—the liquidation value election may be terminated for the partnership and all of its partners. This seems unnecessary and draconian, and creates a huge potential trap.

10. Valuation on retroactive allocations. Treasury has indicated that it is considering treating an interest issued retroactively for the prior year as being issued on the date of the amendment of the partnership agreement. Although, as discussed above, Treasury has pointed out some valid questions pertaining to compliance with the current treatment, moving the deemed date of issuance to the date of amendment raises additional problems.

For example, if the amendment is made after the close of the tax year for which the interest is granted, will the deemed date of issuance be the date of amendment for both Section 83 and Section 704 purposes? The Preamble raises the question of whether the retroactive date should be treated as the date of issuance for purposes of the Code outside of Subchapter K. If, however, an interest is issued in respect of a tax year that already has closed, the partnership income already would have been earned for the year. Application of either the FMV approach or the liquidation value approach potentially could cause the service provider to take into income her allocable share of the value of the net income of the partnership for the relevant tax year under Section 83 at the deemed time of grant, then take her allocable share of the income of the partnership into income *again* under Section 704—essentially double taxing the service provider on the same income.

11. Tax-exempt use property and debt-financed property. Do the Proposed Regulations inadvertently cause partnerships that issue unvested profits or capital interests for services to run afoul of Sections 168(h), 470, and 514(c)(9)(E)?

Both Section 168(h) (dealing with the definition of tax-exempt use property for the purposes of the alternative depreciation system) and Section 514(c)(9)(E) (dealing with qualified allocations for the purposes of determining unrelated debt-financed income of exempt organizations) provide exceptions to the generally taxpayer-unfriendly treatment of those sections if the allocations of a partnership meet certain requirements. Section 168(h) requires all allocations to be straight-up (strictly in proportion to percentage interests) and have substantial economic effect. [82] (Violation of Section 168(h) also can have unexpected and adverse consequences under Section 470.) Section 514(c)(9)(E) requires that income allocations to an exempt partner (1) cannot, subject to certain exceptions, be in percentages greater than the smallest percentage of loss allocated to the partner in any year and (2) have substantial economic effect or be deemed to be in accordance with the partners' interests in the partnership. [83]

Prop. Reg. 1.704-1(b)(4)(xii)(*a*) explicitly provides that the allocations to a partner in respect of an interest that is substantially nonvested cannot have substantial economic effect. If this conclusion is interpreted to mean that none of the allocations to any partners have substantial economic effect during the period that an interest in the partnership is substantially nonvested, allocations to exempt partners would fail the exception under Section 168(h) for qualified allocations, and the property held by the partnership would be tax-exempt use property. In addition, as discussed above the Proposed Regulations would adopt forfeiture allocations to cause the allocations of the partnership to be deemed to be in accordance with the partners' interests in the partnership. Forfeiture allocations also would cause the allocations of the partnership to

fail the requirement that the allocations be straight-up for a partnership that has an exempt partner.

By failing the requirements for qualified allocations under Section 168(h), the property of the partnership generally would be subject to longer depreciation periods. In addition, the partnership may unexpectedly find itself subject to the limitations on deductions imposed by Section 470.[84]

The Regulations under Section 514(c)(9)(E) allow allocations that are deemed to be in accordance with the partners' interests in the partnership, so a partnership with forfeiture allocations would not fail the requirements of Section 514(c)(9)(E) simply because the allocations do not have substantial economic effect. Nevertheless, Section 514(c)(9)(E) generally does not permit disproportionate allocations. Reg. 1.514(c)-2(e) allows for certain chargebacks without violating the disproportionate prohibition, such as minimum gain chargebacks, qualified income offsets, and other certain chargebacks that are required outside of Subchapter K, but the Proposed Regulations do not add forfeiture allocations to the permitted list of chargebacks.

Unless forfeiture allocations are added to the permitted chargebacks under Reg. 1.514(c)-2(e), an exempt organization could have unrelated business taxable income from a partnership in the year of a forfeiture allocation even if the partnership otherwise complies with the rules of Section 514(c)(9)(E). Such results are unduly harsh and likely were never contemplated by the drafters. Appropriate modification of the applicable provisions is in order.

12. Partnership Equity issued to service providers of affiliated partnerships. The Preamble to REG-105346-03 also notes that the draft Revenue Procedure and certain parts of the Proposed Regulations only apply to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership. Treasury and the IRS have requested comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier (operating) partnership in exchange for services provided to the upper-tier partnership.

Many sophisticated business structures involve incentivizing employees of the general partner (or of the managing member of an LLC) with Partnership Equity in the operating partnership. In Ltr. Rul. 200329001, the sevice providers receiving partnership profits interests were employees of the lower-tier (operating) partnership, the upper-tier partnership, and the general partner of the upper-tier partnership. The IRS ruled favorably that all of those service providers qualified under Rev. Proc. 2001-43 to avoid income recognition on both the receipt and the vesting of the profits interests. By contrast, the Proposed Regulations do not apply so broadly. Therefore, absent favorable modifications or administrative relief, the Proposed Regulations and draft Procedure may provide no or limited relief to such service providers.

CONCLUSION

The Proposed Regulations attempt to resolve the bedrock question that has existed since promulgation of Section 83 in 1969: Should the tax treatment of Partnership Equity for services be governed by Section 83, by Subchapter K, or by some amalgamation of the principles that have evolved under both systems and their underlying Regulations?

Under the Proposed Regulations, Section 83 principles generally control, with a nod to Subchapter K in two important respects—the nonrecognition of gain by the issuing

partnership under Section 721, and the ability to use the elective liquidation value approach that has evolved under Subchapter K in case law and the 1993 and 2001 Revenue Procedures. Reading the Proposed Regulations and draft Revenue Procedure together, one might conclude that taxpayers generally can choose their course of action, with relatively predictable results, depending on whether the Section 83 FMV approach or the liquidation value approach is selected.

Reality is far from being so simple or easy, however. As a result of permitting Section 83 to control, the "planned" obsolescence of Rev. Procs. 93-27 and 2001-43 (on finalization of the Regulations) will throw numerous partnerships and their partners into uncharted waters with respect to vested and unvested profits interests where the liquidation value approach has *not* been validly elected.

The Proposed Regulations adhere to the long-standing convention that a compensatory profits interest may be received without income recognition. Nevertheless, this taxpayer-favorable treatment is conditioned on the liquidation value election. If made, the liquidation value election will often cause a service provider who receives a capital interest to recognize more income than the FMV of such interest. Absent the liquidation value election, the measure of the service performer's income on the receipt of a compensatory profits or capital interest would be the FMV of such interest (i.e., the amount of the service performer's accession to wealth).

Reconciling these alternative approaches in the partners' capital accounts in a manner that accurately reflects the economic deal is no mean feat. The Proposed Regulations need clarification to address this issue. Such clarification appears attainable without violence to the existing capital accounting rules of Section 704(b) or the tax consequences described in the Proposed Regulations. Can the capital accounts simply be booked, immediately on the issuance of a profits interest (or capital interest), at amounts that are consistent with the economic deal?[85]

The Proposed Regulations anticipate that taxpayers will follow the safe harbors in Reg. 1.704-1(b), but this leads to a basic fallacy: The latter Regulation does *not* contemplate issuance of profits interests having a value other than zero. Indeed, the only case to hold that profits interests can have a positive value (*Diamond*) was decided many years before the Service's capital account maintenance Regulations were promulgated.[86] There is no authority as to proper capital account maintenance (and allocations of profits and losses) immediately following the taxable issuance of a profits interest.

To the extent the deduction under Sections 83(h) and 162 must be specially allocated to the other (pre-existing) partners, their capital accounts are reduced, but by definition the service provider could not have received a *profits* interest if, immediately after receipt of such interest, a sale of all of the partnership's assets, payment of liabilities, and distribution of cash (the liquidation approach) in accordance with the partners' capital account balances would result in the service partner's receiving any cash distributions.

Does this require a special allocation of the first items of deduction to the service provider (and/or of the first items of gross income to the other partners), to bring their Section 704 capital accounts back into equilibrium (i.e., a zero capital account for the service provider and liquidation value capital accounts for the other partners)? Alternatively, can the adjustment be made under Section 704(c) or reverse Section 704(c) principles with any remaining disparity being adjusted on ultimate sale of the assets and/or liquidation of the partnership?

Similarly, with respect to the issuance of capital interests, if the liquidation value election is not in effect, capital account disparities again arise, as illustrated in Examples 3 and 4 in this article. The Proposed Regulations provide no guidance or solution.

Many partnerships will choose to make the liquidation value election not because it will be in everybody's best interest in any particular circumstance but because under the proposed rules the only way to be assured of reflecting the business deal is through the liquidation value election. On the assumption that the Proposed Regulations and draft Revenue Procedure will be finalized (in substantially similar form), tax advisors to existing partnerships that may issue Partnership Equity for services might consider teeing up an amendment to the partnership agreement that allows the liquidation value election and adds the forfeiture allocations. Practitioners drafting new partnership agreements may want to incorporate the consent to the liquidation value election from the outset.

Such a course of action is not risk free, especially for those partnerships that issue capital interests. Further, the final Regulations and Revenue Procedure might be substantially different from those proposed. Unless the tax tail is wagging the business dog, however, the proposed rules (which implicitly assume that the partnership is complying with the capital account maintenance rules of Reg. 1.704-1(b)) provide only one clear path to achieving the business agreement—making the liquidation value election.

Alternatively, if the liquidation value election is *not* made, the partners' business deal (e.g., that the agreed-on cash distributions should control, as opposed to liquidating distributions being made in accordance with and controlled by the partners' ending capital account balances) can be preserved only at the cost of falling out of the safe harbors of Reg. 1.704-1(b), and having all of the partnership's allocations governed by the partners' interests in the partnership (PIP) under Reg. 1.704-1(b)(3) (and subject to uncertainties and IRS challenges).

The draft Revenue Procedure precludes the liquidation value election if, among other things, the partnership has an option to purchase (or the service provider has the option to sell back to the partnership) the service provider's interest, if that partner ceases to perform services. As described above, [87] this may preclude many partnerships from qualifying from the liquidation value election. This restriction, not found in Rev. Proc. 93-27 or Rev. Proc. 2001-43, should be modified accordingly.

Consistent with the Noncompensatory Proposed Regulations, the Proposed Regulations provide that the partnership itself will not recognize gain or loss in connection with the issuance, transfer, or vesting of a partnership interest for services (or the exercise of an option to acquire a compensatory partnership interest). Regulations currently provide that there is nonrecognition of gain by a corporation on the issuance of its stock for services; all other transfers of property for services (which presumably includes a partnership's issuance of its interests) result in potential recognition of gain by the transferor. The Proposed Regulations would, when adopted, result in similar nonrecognition of gain by partnerships that issue interests for services (including those issued on exercise of compensatory options). This is both a correct result and potentially significant for many partnerships and their partners.

Issuance of partnership equity for services is driven by the parties' intention to incentivize the service provider—not to create a tax shelter. Thus, the focus traditionally has been on the income taxation of the service provider, in optimizing her potential after-tax return. To the extent that the service provider recognizes income under the Proposed Regulations, there often is a silver lining: The partnership's deductions will increase, either immediately or over time (if the services are subject to capitalization). Those

deductions are generated without cash payments by the partnership or the remaining partners, and effectively constitute a tax windfall.

Whether those partners are willing to reimburse the service provider for her (increased) taxes under the Proposed Regulations is the subject of negotiation by the parties and conjecture by your authors. Given the array of types of partners and their respective tax profiles, we doubt that partnerships will readily gross-up compensation income recognized by service providers under the Proposed Regulations. Therefore, tax planning to minimize the service providers' income still remains an objective worth pursuing, should the Proposed Regulations and draft Revenue Procedure be adopted in final form.

Practice Notes

If the Proposed Regulations and draft Revenue Procedure are finalized in substantially the same form, partnerships and LLCs should consider the following in connection with granting partnership equity interests and options ("Partnership Equity") for services.

If the partnership expects to issue vested and/or unvested *profits* interests, the partnership and its partners will need to evaluate whether to make the liquidation value election safe harbor in the draft Revenue Procedure, which often will be advantageous. The draft Procedure requires unanimous approval of the partners and consistent reporting thereafter by all recipients of partnership equity interests, or else the election will be terminated. Consideration should be given to adding forfeiture allocations and including prophylactic language in partnership agreements currently being drafted, in anticipation of the finalization of the draft Revenue Procedure, so as to avoid the need to obtain subsequent unanimous approval of the safe harbor election (which may be difficult or impossible to obtain later).

If the partnership will be issuing *capital* interests and/or options for services, the liquidation value election safe harbor likely will cause the new capital partners (and optionholders, on exercise of their options) to recognize a greater amount of taxable income than if the safe harbor were not elected.

If the partnership foresees that a combination of (1) profits interests and (2) capital interests and/or options may be issued for services, the partnership and its partners must evaluate whether to make or retain the safe harbor election, as one group or the other of the recipient service providers may be more favorably (or adversely) affected.

If the liquidation value election is *not* made, the FMV (rather than the liquidation value) of the interests received by the partners must be determined at the time of issuance or vesting (pursuant to Section 83 rules) by the partnership, which will report to the IRS and the recipient the amount of income being recognized. If the recipient is an employee, the partnership may have to pay payroll and withholding taxes on the value of the compensation. The partnership should consider whether it will pay a cash "gross up" to the recipient service providers (who generally are receiving illiquid partnership interests) to pay their income taxes; the remaining partners may obtain tax savings from deductions equal to the value of the income reported by the service providers (without making cash payments) attributable to the issuance or vesting of the partnership interests.

If the partnership does *not* have a valid liquidation value election in place when a grant of Partnership Equity is recognized as income, and if the partnership follows the capital account maintenance rules under the Section 704(b) Regulations (with liquidating distributions being made in accordance with ending capital account balances), a disparity

likely will be created in the partners' capital accounts. The partnership should determine whether it needs to modify its capital accounting (or otherwise amend the partnership agreement) to assure that the partners will, on liquidation, receive the distributions intended under their economic deal.

Service providers who receive *unvested* profits or capital interests should consider making timely Section 83(b) elections. It is uncertain whether interests which are issued retroactively (within the rules of Section 761(c)) can be the subject of a timely Section 83(b) election. Accordingly, until the issue is clarified, service providers receiving unvested partnership interests should consider whether retroactive grants are advantageous, after considering the appreciation in value which may have occurred in the interim.

1

Or LLCs or other entities classified as partnerships.

2

Such equity-based compensation includes partnership capital and profits interests, options to acquire partnership interests, phantom equity interests, tracking interests, reverse tracking interests, and stock and options to acquire stock of a corporation that is a partner in the partnership. See, e.g., Banoff, "Partnership Use of Corporate Partner Stock and Options as Compensation Easier Under the 1032 Regs.," 93 JTAX 81 (August 2000).

3

For purposes of this article, a "capital interest" includes an interest in partnership capital and a right to share in partnership profits and losses, while a "profits interest" does not include an interest in partnership capital on the date of grant. A "valid Section 83(b) election" means the service provider has timely complied with the filing requirements of Reg. 1.83-2 *and* the IRS or the courts have accepted the election as effective.

4

Other issues include (1) whether and to what extent the partnership's liabilities are reallocated from the other partners to the service partner under Section 752 at the time of grant and vesting, (2) if the service provider reports taxable income on receipt or vesting of her interest, whether she is allowed to amortize the tax basis during the period she owns the interest, or only to claim a (typically) long-term capital loss on ultimate sale or disposition of her interest, and (3) in a two-person partnership where one partner has received an unvested profits or capital interest (without making a valid Section 83(b) election), whether the partnership fails to qualify as a partnership because the service provider is not recognized as a partner for tax purposes under Section 83.

5

Generally, the transferor of property transferred in connection with the performance of services is required to recognize gain on the transfer of appreciated property to a service provider, and the only explicit exception to such gain recognition is for corporate transferors under Section 1032. Reg. 1.83-6(b).

6

Section 83(c)(1) provides that the rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned on the future performance of substantial services by any individual.

7

The value of an option is ordinarily not treated as having a readily ascertainable value unless the option is actively traded on an established market; Reg. 1.83-7(b)(1). If the option is not actively traded, it does not have a readily ascertainable FMV unless its FMV otherwise can be measured with reasonable accuracy; Reg. 1.83-7(b)(2).

8

Section 83(e)(3).

9

A general discussion of the problems surrounding the issuance of a capital interest for services may be found in Frost, "Receipt of Capital and Profits Interests Continues to Have Uncertain Tax Consequences," 75 JTAX 38 (July 1991).
10

Notice of Proposed Rulemaking, 36 Fed. Reg. 10787 (6/3/71). These remained the oldest Proposed Regulations outstanding—almost 34 years—until their withdrawal by REG-105346-03, 5/24/05. See Shop Talk, "Do Old Proposed Regulations Never Die?," 91 JTAX 60 (July 1999).
11

See, e.g., Egerton, "Rev. Proc. 93-27 Provides Limited Relief on Receipt of Profits Interest for Services," 79 JTAX 132 (September 1993).
12

See Mincey, Sloan, and Banoff, "Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests—the Final Facet of *Diamond*?," 95 JTAX 205 (October 2001); Shop Talk, "Update on Unvested Partnership Profits Interests and Rev. Proc. 2001-43," 80 JTAX 315 (November 2001).
13

See Carman and Banoff, "Proposed Regulations on Noncompensatory Partnership Options: No Gain, Some Pain," 98 JTAX 197 (April 2003).
14

For an extensive analysis of this development, see Banoff, "First IRS Ruling on Unvested Profits Interests: No Income Recognized But Questions Remain," 99 JTAX 133 (September 2003).
15

See Shop Talk, "More on Unvested Partnership Profits Interests, Section 83(b), and Ltr. Rul. 200329001," 100 JTAX 253 (April 2004).
16

See Notice 2005-43, 2005-24 IRB 1221, "Purpose," and section 7 of the draft Revenue Procedure contained therein.
17

See Shop Talk, "What's the Value of a Capital Interest Received for Services?," 96 JTAX 57 (January 2002).
18

See Mark IV Pictures, Inc., 70 AFTR 2d 92-5210, 969 F2d 669 (CA-8, 1992).
19

Accord: Johnston, TC Memo 1995-140, RIA TC Memo ¶95140 .
20

If SP received a mere assignee interest, rather than being admitted as a state-law member of the partnership, even greater discounts may be appropriate. See, e.g., Estate of McLendon, 77 AFTR 2d 96-666, 77 F3d 477 (CA-5, 1995); Shop Talk, "Partnership Assignee Interests Generate Discounts," 90 JTAX 254 (April 1999).
21

Also see Schulman, 93 TC 623 (1989) (Section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); Kenroy, Inc., TC Memo 1984-232, PH TCM ¶84232 .
22

Reg. 1.83-3(e) would be amended by the Proposed Regulations to explicitly provide that "property" includes a partnership interest.
23

See S. Rep't No. 98-169, Vol. 1, 98 Cong. 2d Sess. 226 (1984).
24

Reg. 1.83-6(a)(3) provides two exceptions. First, when property is substantially vested on transfer, an otherwise allowable deduction is allowed to the service recipient according to its method of accounting (in conformity with Sections 446 and 461). Also, in the case of a transfer to an employee benefit plan described in Reg. 1.162-10(a) or a transfer to an employees' trust or annuity plan described in Section 404(a)(5), Section 83(h) does

not apply.
25

Reg. 1.721-1(b)(2). The Regulations actually refer to the transfer of the interest as being a guaranteed payment to the extent that the value of such interest is compensation for services rendered to the partnership. It is through the application of Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191, that the provision in the Regulations effectively becomes applicable only to capital interests.
26

The exceptions are as provided in Section 83(h) (relating to the deduction of the employer) or Reg. 1.83-6(c) (relating to forfeitures).
27

Treasury and the IRS have requested comments on alternative approaches to resolving the timing inconsistency between Section 83 and Section 707(c).
28

This may create substantial problems (with no solutions provided in the Proposed Regulations) for partnerships whose agreements require distributions to be made in accordance with Section 704 capital account balances. See Examples 3-5 in the text, below.
29

Until SP's units in LLC become substantially vested, the transferor (LLC) will be regarded as the owner of such units (i.e., they remain unissued for tax purposes) and any cash received by the employee or independent contractor with respect to the partnership interest constitutes additional compensation includable in SP's gross income for the tax year in which such income is received. See Reg. 1.83-1(a)(1).
30

See Reg. 1.1361-1(b)(3) (after making an election under Section 83(b), the service provider becomes a shareholder for purposes of Subchapter S).
31

The difference between not filing a Section 83(b) election and filing a Section 83(b) election is likely to be less (assuming the interest increases in value) if the liquidation value election is *not* made. There also are other consequences of not filing that election that are discussed in greater detail in the text, below.
32

Reg. 1.704-1(b)(2)(iv)(*b*)(*1*).
33

Assuming such amount is not required to be capitalized under Section 263 or 263A or otherwise.
34

Cf. Regs. 1.704-1(b)(2)(iv)(*f*) and (*q*).
35

Reg. 1.704-1(b)(2)(iv)(*f*)(*1*).
36

Prop. Reg. 1.704-1(b)(2)(iv)(*b*)(*1*).
37

Reg. 1.704-1(b)(2)(iv)(*f*)(*1*).
38

See Example 5 in the text, above. SP recognizes the FMV of the 100 units ($7,000) on receipt (i.e., this is the amount by which her wealth has been increased by virtue of receiving the units and this is the amount she should include in income absent an affirmative election (agreement) of LLC and its members to adopt the liquidation value approach). If, however, the Proposed Regulations were to mandate corrective allocations, then SP would be allocated $3,000 of income as quickly as possible, thereby causing her to recognize more income ($10,000) than the amount of her accession to wealth ($7,000), and thereby effectively departing from the fundamental principle contained in Sections 83(a) and 61 that one is not taxed (at least not involuntarily) on more than the

FMV of what she receives.
39

Reg. 1.83-1(a)(1).
40

See Schulman, *supra* note 21.
41

See Campbell, 68 AFTR 2d 91-5425, 943 F2d 815 (CA-8, 1991), and St. John, 53 AFTR 2d 84-718 (DC Ill., 1983).
42

Such as those provided in Notice 2005-43. The availability of the liquidation value election for unvested profits (and capital) interests is subject to uncertainty for interests callable by the partnership or puttable by the service provider on the latter's termination of employment. See the "Questions, Issues, and Practical Applications" portion of this article, item 8, below.
43

It seems unlikely that Treasury intended the actual preparation of the document by the partnership, as opposed to the attorneys for the service partner, to be a condition for the safe harbor. Nevertheless, this apparent condition is repeated in Notice 2005-43, section 3.03(1) of the draft Procedure.
44

Prop. Reg. 1.83-3(l)(i).
45

Prop. Reg. 1.83-3(l)(1)(ii); Notice 2005-43, section 3.03(2) of the draft Procedure.
46

Prop. Reg. 1.83-3(l)(1)(iii); Notice 2005-43, section 3.03(3) of the draft Procedure.
47

Notice 2005-43, section 3.03(3) of the draft Procedure.
48

Id.
49

Prop. Reg. 1.83-3(l)(2). The language of the Proposed Regulation is unclear as to whether the election is terminated *ab initio* or at the time of the failure to produce the document.
50

Notice 2005-43, section 3.04 of the draft Procedure.
51

Prop. Reg. 1.83-3(l)(2).
52

Notice 2005-43, section 3.04 of the draft Procedure.
53

Id., section 3.05.
54

See, e.g., International Freighting Corp., 30 AFTR 1433, 135 F2d 310 (CA-2, 1943).
55

This reference would suggest that it is the Treasury's view that the book-up of capital accounts on the issuance of a partnership interest in exchange for services provided in Reg. 1.704-1(b)(2)(iv)(*f*)(*5*)(*iii*) is mandatory rather than discretionary, as is suggested by the language of Reg. 1.704-1(b)(2)(iv)(*f*).
56

See McDougal, 62 TC 720 (1974) (the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership).
57

Prop. Regs. 1.704-1(b)(2)(iv)(*f*) and (*s*); see Prop. Reg. 1.704-1(b)(2)(iv)(*h*)(*2*).
58

The Regulations do not state whether the item of income or loss was intended to be book income, taxable income, or both. The reference to Reg. 1.704-1(b)(2)(iv)(*f*) suggests that the intent was book income, but the reference to Section 704(b) might suggest that taxable income or both was intended.
59

Reg. 1.752-7(b)(3).
60

Notice 2005-43 on its face deals with a deemed value only for the purposes of Section 83. Prop. Reg. 1.83-3(l), however, is not so limited.
61

See generally Hirsh and Schoonmaker, "New Section 409A—AJCA's Major Overhaul of Nonqualified Deferred Comp.," 102 JTAX 152 (March 2005).
62

S. Prt. No. 98-169 (Vol. I), 98th Cong., 2d Sess. 219 (1984).
63

Cf. FSA 200128031 (refusing to give effect for federal income tax purposes to a divorce court's retroactive award of a partnership interest).
64

Reg. 1.706-1(c)(4) applies to transfers of less than all of a partnership interest but does not provide a method of allocation.
65

The legislative history indicates that the same methods were generally intended to be used on the sale or exchange of part of an interest. S. Rep't No. 94-938, 94th Cong., 2d Sess. 98 (1976).
66

Section 706(d)(2)(B)(iii).
67

The Preamble to REG-105346-03 refers to the method under Section 706(d)(2)(A) as an application of the proration method.
68

If the recipient is already a partner, she is not an employee for W-2 or other employment tax purposes. See, e.g., Rev. Rul. 69-184, 1969-1 CB 256.
69

Prop. Reg. 1.704-1(b)(4)(xii). This conclusion would presumably not be accurate (absent the finalization of the Proposed Regulations) if the partnership agreement required the current distribution of cash flow in amounts of net income allocated by the partnership or the forfeiting partner was entitled to her capital account balance on forfeiture. Such allocations and distributions would seem to meet the fundamental principles of economic effect as expressed in Reg. 1.704-1(b)(2)(ii)(*a*) and may meet the other requirements of economic effect if the other allocations of the partnership have economic effect. If the forfeiting partner has a right to her capital account on forfeiture, then it appears under the draft Revenue Procedure that the interest may not be subject to a substantial risk of forfeiture to begin with, making Section 83(b) inapplicable. Notice 2005-43 would test the value of interests in respect of which a safe harbor (liquidation value) election is in effect based on capital accounts adjusted for a deemed sale of all the assets of the partnership.
70

Prop. Reg. 1.704-1(b)(4)(xii)(*e*).
71

Prop. Reg. 1.706-3(b).
72

Prop. Reg. 1.704-1(b)(4)(xii)(*c*). For these purposes, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts. Prop. Reg. 1.704-1(b)(4)(xii)(*d*).
73

Prop. Reg. 1.706-3(b).
74

Prop. Reg. 1.704-1(b)(5), Example 29, does not indicate how the value is determined.
75

Of course, the loss on the forfeiture and the deductions or losses allocated in the forfeiture allocation may be subject to different limitations, depending on the classification and character of such losses.
76

See Reg. 1.83-2(a).
77

Treasury has indicated that it is particularly interested in whether Section 83 or another section of the Code provides authority for such a rule.
78

Reg. 1.83-6(c).
79

See the definition in Reg. 1.83-3(h).
80

S. Rep't No. 94-938, 94th Cong., 2d Sess. 100 (1976); Reg. 1.704-1(b)(2) prior to amendment by TD 8065, 12/24/85. See also Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976,* page 95, fn. 6.
81

Orrisch, 55 TC 395 (1970), *aff'd per cur.* 31 AFTR 2d 73-1069 (CA-9, 1973); Magaziner, TC Memo 1978-205, PH TCM ¶78205 .
82

Temp. Reg. 1.168(h)-1T, Q&A-22.
83

Reg. 1.514(c)-2(b)(1).
84

Also see generally Lipton, "Broad Scope of Section 470 Catches Many Non-Abusive Transactions," page 95, this issue.
85

See the discussion in the text accompanying note 35, *supra.*
86

The lower court opinion in Campbell, TC Memo 1990-162, PH TCM ¶90162 , held the profits interest to have a substantial value, but the ancillary issues of the impact on the partners' capital accounts and the deductibility of the interest's value by the partnership were not before the court. The Eighth Circuit's reversal (see 68 AFTR 2d 91-5425, 943 F2d 815, 91-2 USTC ¶50420 (CA-8, 1991)), holding the interest's value to be zero, rendered these matters moot.
87

See the "Questions, Issues, and Practical Applications" portion of this article, item 8, above.

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