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Partnership Equity for Services

The IRS Reconsiders its Position in Notice 2005-43

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EAST BAY TAX CLUB
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1. History

- a. **Sol Diamond v. Commissioner**, 56 T.C. 530 (1971), aff'd 492 F.2d 296 (7th Cir. 1974). Taxpayer sold compensatory partnership interest shortly after receiving it from the partnership – court holds that initial issuance of partnership interest gave rise to compensation income.
- b. **Campbell v. Commissioner**, T.C. Memo 1990-162, aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991). Tax Court, in a lengthy and controversial memo decision, holds that grant of “promotional” profits interest can generate income – reversed on appeal, but IRS settles before final resolution. Revenue Procedure 93-27 issued in the wake of the settlement.
- c. **Application to Partnerships and LLCs**. LLCs taxable as partnerships will be subject to these rules.

2. Current Rules – Revenue Procedure 93-27, 1993-2 C.B. 343

- a. **Liquidation Analysis**. Shortly after Campbell, IRS concludes that a service-provider partner can receive a mere profits interest in a partnership without recognizing income. If the partnership were to sell all of its assets for their FMV as of the time it issues the partnership interest, and were then to distribute the proceeds to its partners, a partnership interest is a mere profits interest if the recipient partner would receive no portion of the hypothetical distribution.
- b. **Exceptions**. General rule of Revenue Procedure 93-27 does not apply if (i) the profits interest relates to a “substantially certain and predictable stream of income from partnership assets,” (ii) the service partner disposes of the interest within two years of receiving it (query whether the service partner recognizes income in year of disposition or whether subsequent-year disposition retroactively alters tax characterization for the year the partnership interest was issued) or (iii) the issuing partnership is a publicly traded partnership.
- c. **“Naked” Profits Interests**.
 - i. **Capital Account Analysis**. Beware of unrealized appreciation – could give the service-provider partner an immediate interest in partnership capital under the liquidation analysis.
 - ii. **Book-Up To Allocate Unrealized Appreciation to Other Partners**. “Book-up” of capital accounts for existing partners, under Treasury Regulations Section 1.704-1(b)(2)(iv)(f)(5), could effectively allocate existing unrealized appreciation of partnership assets to those partners. This can safeguard the service-provider partner’s tax position, but it will prevent the service-provider partner from participating in current capital value of the partnership. (Prior to May 5, 2004, there was not explicit language authorizing a book-up on the admission of a service-provider partner – query if a self-help special allocation of unrealized appreciation to existing partners would achieve the same result.)
 - iii. **Vesting – No Section 83(b) Election – Revenue Procedure 2001-43, 2001-2 C.B. 191**. Revenue Procedure 2001-43 clarifies that an unvested profits interest (subject to substantial risk of forfeiture) is to be treated as granted and outstanding. No Section 83(b) election required. Service-provider partner is generally treated as a partner for tax purposes even if the partner is not fully vested.

d. **Capital Interest.**

i. **Service-Provider Partner's Recognition of Compensation Income.** Likely (but not directly stated) result under Revenue Procedure 93-27 is that the service-provider partner recognizes income equal to the value of his/her initial capital interest in the partnership. Rules of Section 83 should apply. Commentators disagree about the proper method of determining the value of the capital interest. See discussion in BNA Tax Management Portfolio 711-1st: Partnerships – Formation and Contribution of Property or Services, Section III.D.1.b.

(1) **Withholding and Employment Taxes.** If the service-provider partner had previously been a partner, he/she is probably not an employee – so issuance of capital interest is either a guaranteed payment (K-1 reporting) or a payment to a partner in a capacity other than that of partner (Form 1099). If the service-provider partner had been an employee who was not a partner, do wage and FICA/FUTA withholding apply? Or does simultaneous conversion to partner status shift this payment away from employee rules?

(2) **Vesting – Section 83(b) Election.** General rules of Section 83 will apply when capital interest is subject to a substantial risk of forfeiture. In the absence of a Section 83(b) election, there is troubling uncertainty under current law as whether the unvested recipient of the capital interest is to be treated as a genuine “partner” for tax purposes (see Treasury Regulations Section 1.721-1(b)(1)) or whether he/she is not the owner of the interest until the vesting conditions have lapsed (see Treasury Regulations Section 1.83-1(a)(1)).

ii. **Service Recipient Deduction.** Partnership is generally permitted a compensation deduction, with timing coordinated with the timing of the service-provider partner's income. Query whether the deduction can be specially allocated to the service-provider partner (or whether the service-provider partner can be specially allocated other deductions following admission as a partner to offset his/her compensation income).

3. **Corporate Equity for Services**

- a. **C Corporation – Section 83.** Rules are well established – Section 83 of the Code. No carve-out for mere profits interests.
- b. **S Corporation – Section 83, Despite Future “Flow-Through” of Income.** Same rules as those that apply to C corporations – despite flow-through of income and potential concerns about “double” taxation.

4. **Notice 2005-43, 2005-24 I.R.B. 1221 (6/13/2005)**

- a. **Concurrent Issuance of Proposed Revenue Procedure and Proposed Treasury Regulations.** Notice 2005-43 announces a shift in IRS thinking about the tax treatment of compensatory partnership equity. The Notice sets out a proposed Revenue Procedure and substantially coincides with the issuance of proposed Treasury Regulations under

Section 83 and Subchapter K. Notice 2005-43 and the new Proposed Regulations are attached to this outline as Exhibits A and B.

b. Move Towards Coordination with Corporate Equity Rules. The general thrust of the Notice is to eliminate the special treatment accorded to the compensatory grant of partnership profits interests under Revenue Procedure 93-27. The new rules would apply to all partnership interests regardless of whether the interests are capital interests or profits interests. But the new rules also provide a new safe harbor that would retain many aspects of the Revenue Procedure 93-27 liquidation analysis, so long as the issuing partnership and its partners comply with specified procedures.

- i. **Valuation Issues.** Normal valuation issues, commonly confronted on the issuance of compensatory stock, will arise.
- ii. **“Double” Taxation – Income on Grant and Subsequent Allocations of Partnership Income.** The service-provider partner would receive an increase in his/her partnership interest basis and his/her capital account equal to the amount included in income as a result of receiving the partnership interest. These increases should, over the term of the partner’s ownership of the partnership interest, provide a tax benefit that would offset the inclusion in income as of the date the partnership interest is issued.

c. Unvested Equity Without a Section 83(b) Election. The new rules would provide that a person who holds an unvested partnership interest and does not file a timely Section 83(b) election on receipt of the interest will not be treated as a partner for tax purposes until the vesting conditions lapse.

d. Forfeiture Allocations. If a service-provider partner does make a Section 83(b) election and later forfeits some or all of his/her partnership interest due to his/her failure to satisfy vesting conditions, the new rules require that the partnership make “forfeiture allocations” to the service-provider partner for the year of the forfeiture. The allocations are intended to offset prior partnership allocations to that partner.

e. Reporting – Employees. The new rules would generally clarify that a partnership interest issued to an employee would be reported as income on Form W-2, “Wage and Tax Statement,” for the year in which the partnership interest must be included in the employee’s income.

f. Liquidation Analysis -- Safe Harbor Election.

- i. **Echoes of Revenue Procedure 93-27.** The new rules retain a safe harbor procedure under which the partnership and its partners may apply a liquidation analysis, similar to the rules described in Revenue Procedure 93-27, to determine the value of a partnership interest issued to a service-provider partner. If the safe harbor applies, and the partnership interest is a “naked” profits interest, the service-provider partner would not recognize income on receipt of the interest.
- ii. **Election Binding on All Partners.**
 - (1) **Timing – At or Prior to Equity Grant.** The safe harbor election must be made by the partners and the partnership on or before the date the partnership issues a partnership interest under the safe harbor.
 - (2) **Safe Harbor Election Attached to Partnership Return.** For the first taxable year that a partnership is subject to the safe harbor election, a safe harbor election must be attached to the partnership tax return.





- (3) **Either in the Partnership Agreement or in Unanimous Binding Partner Consent.** The safe harbor election must be either (i) in the partnership agreement itself so that it is binding on all partners or (ii) in binding written documentation executed by each of the partners in the partnership.
- (4) **The Magic Language.** Sample language for the safe harbor election is attached to this outline as Exhibit C.
- (5) **Avoid Partner Whipsaw Reporting Positions.** The detailed safe harbor requirements seem to reflect an obsessive concern by the IRS that it not be whipsawed by inconsistent reporting positions. That is, the new rules go to great lengths to block the service-provider partner from reporting a zero valuation while the partnership or other partners claim a deduction based on a higher valuation for the compensatory partnership interest.

g. **Procedural Aspects.**

- i. **Proposed Regulations.** The Notice should be read in conjunction with the concurrent Proposed Regulations. The Proposed Regulations include a preamble that does a good job of describing the current state of the law on this topic.
- ii. **Prospective Only.** The new rules are intended to apply only when final Treasury Regulations are published. The new rules are not currently in effect. Until the new rules become effective, taxpayers may continue to rely on Revenue Procedure 93-27

EXHIBIT A

Notice 2005-43, 2005-24 I.R.B. 1221 (6/13/2005)

EXHIBIT B

Notice of Proposed Regulations – REG-105346-03 (5/24/2005)



EXHIBIT C

Sample Safe Harbor Language – Insert to Partnership Agreement

- h. **Safe Harbor Election for Partnership Interests Issued to Service Providers.** The Partnership hereby elects, on behalf of itself and its Partners, pursuant to IRS Notice 2005-43, 2005-24 I.R.B. 1221 (June 13, 2005), to have the Safe Harbor described in Notice 2005-43 (or any successor to such Notice) apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the Safe Harbor election remains in effect. This election will be effective commencing as of the January 1, 2006 issuance of an interest in the Partnership to XYZ. This Section 6.h is intended to be legally binding on the Partnership and all of the Partners. The Partnership is authorized and directed to file any documents required to perfect this election, and the Partnership and each of its Partners agree to comply with all requirements of the Safe Harbor with respect to Partnership interests issued in connection with the performance of services while the election remains effective. Any successor in interest to any Partner in the Partnership shall assume the transferring Partner's obligations pursuant to this election.