Passthrough Partner

By J. Leigh Griffith

Transfer of Partnership Interest for Services Revisited—Part I

The primary forms of domestic business entities are those that are taxed as corporations for federal income tax purposes, those that are taxed as partnerships for federal income tax purposes and certain hybrid corporations such as REITs and S corporations. The traditional C corporation and corporate hybrids such as REITs and S corporations are considered entities separate from their owners or shareholders, although the income of the S corporation is generally “passed through” and REITs enjoy a dividends paid deduction mechanism. In contrast, an entity taxable as a partnership for federal income tax purposes is for some purposes treated as a separate entity and for others as an aggregate of interests that the partners have in the assets and activities of the partnership.

This mixture of aggregate and entity traits provides much of the historic tax and business strengths of the partnership form for business entities. As a result of the aggregate of interest concepts that permeate partnership taxation, partnerships have much greater flexibility in capital structure and the ability to tailor the tax and economics to the specific business needs and economic reality of the venture. One important example is a partnership’s ability to grant a partnership interest in future income and appreciation to a service provider without taxation with respect to the receipt of such interest. This partnership profits interest must be in exchange for services rendered and/or to be rendered to or for the benefit of the partnership by such service provider in a partner capacity or in anticipation of becoming a partner. In the corporate setting, with the exception of incentive stock options,1 the compensation of a service provider in any form of stock2 will ultimately result in the recipient

J. Leigh Griffith, J.D., LL.M., CPA, is a Partner at Waller Lansden Dortch & Davis, LLP, in Nashville, Tennessee.
recognizing gross income in connection with the receipt of the stock.

While compensatory partnership interests are literally granted on a daily basis, the tax consequences and rationale are among the most unsettled in the partnership area. There is a head-on collision of the concepts of Code Sec. 83, aggregate partnership tax principles, and practical reality. The issues have never been dealt with legislatively, are rather opaquely dealt with by the existing Treasury Regulations (“Regulations”), and have been thoroughly confused by inconsistent and less than stellar analysis by the courts. The taxation of compensatory partnership profits interests enjoyed a truce under Rev. Proc. 93-27 as supplemented by Rev. Proc. 2001-43, but this truce was somewhat destabilized in May 2005 with the issuance of Proposed Treasury Regulations (the “Proposed Regulations”) and their accompanying proposed Revenue Procedure of Notice 2005-43. The whole concept of partnership profits interests then became caught up in the politics of “carried interests” for hedge fund and venture fund managers.

This is a two-part column that attempts to summarize what constitutes a “profits interest,” the current status of “profits interest,” the requirements of the Proposed Regulations and proposed Revenue Procedure, and contrast the current status with that of the Proposed Regulations. Part I explores some of the tax history of compensatory partnership interests and the current state of the “law,” or perhaps “truce with the IRS.” Part II will examine the Proposed Regulations and proposed Revenue Procedure that attempt to join two alien concepts—Code Sec. 83 and the aggregate interest concept as embedded in Reg. §721-1(b)(1)—and contrast the requirements under those 2005 Proposed Regulations with the situation today. In the event that the Proposed Regulations were to be finalized in current form, virtually every personal service partnership would be required to review its governing documents, and many, if not most, would be required to revise their agreements.

**Pre-Diamond Law**

Prior to 1971 and the Tax Court’s decision in *Diamond,* it was believed that the grant of a compensatory interest in future profits by a partnership did not cause the service provider recipient to have taxable income. Reg. §1.721-1(b) strongly inferred that was the case, and there was footnote dictum in a 1965 Tax Court Memorandum decision that such regulation provided that the receipt of a partnership interest in future profits did not cause any tax liability.

However, there was (and is) no per se statutory basis for the appropriate treatment of “profits interests.” Reg. §1.61-2(d)(1) has long provided that gross income includes the fair market value of property received as compensation. Reg. §1.721-1(b)(1) presents a negative inference that a “profits interest” is not property for purposes of inclusion of income when the Regulation addressing the taxation of capital interests states:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 721. (Emphasis added.)

To the extent there is an inference that a partner giving up a right to be repaid his contributions meant that the receipt of an interest in partnership capital appreciation was excluded from taxation by Code Sec. 721 is perhaps negated because the Regulation also provides:

The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee’s future services.

It should be noted that this Regulation long pre-dates the enactment of Code Sec. 83. Even prior to the enactment of Code Sec. 83, a partner who received a capital interest in a partnership in consideration for services was taxed on the fair market value of the interest so transferred, without regard to the Code Sec. 721 Regulation’s reference to contributions. It should also be noted that the IRS issued Proposed Reg. §1.721-1(b)(1)(ii) in 1971 stating: “If the partnership interest is transferred after June 30, 1969 ... then the transfer of such interest in partnership capital shall be treated as a transfer of property to which section 83 and the regulations thereunder applies.” Although never finalized, this
The Sec. 83 applied.

In Diamond, both the Tax Court and the Seventh Circuit held the receipt of a profits interest was a taxable event. In this case, Mr. Diamond assisted in obtaining financing for a building under contract by Kargman. A land trust was created to hold title to the building if it was acquired under the contract. A month and a half later, the mortgage financing was obtained, and the building was acquired. Under the agreement, after Mr. Kargman recovered his capital, Mr. Diamond would be entitled to 60 percent of all profits and losses of the venture. Less than three weeks after the building was acquired, Mr. Diamond sold his interest to Kargman and claimed a short-term capital gain which was offset by Mr. Diamond’s capital losses. The IRS’s position was that Mr. Diamond had compensation income taxable under Code Sec. 61 and Reg. §1.721-1(b).12 Mr. Diamond argued Reg. §1.721-1(b) for the proposition he had no income on receipt of the interest. The IRS presented several arguments, including that there was no partnership, the land trust was an association taxable as a corporation (stock for services), and without much emphasis made the Code Sec. 61 argument with respect to a partnership profits interest.

The Tax Court in Diamond stumbled around a bit in its analysis and in addition to holding that the receipt of a profits interest represented compensatory income, also laid a trap for the unwary that exists today and will be discussed later herein. The court stated:

However, what is plain is that the Regulations do not call for the applicability of section 721 where a taxpayer has performed services for someone who has compensated him therefore by giving him an interest in a partnership that came into being at a later date. Regardless of whether there may have been some kind of equitable justification for giving the parenthetical clause some limited form of affirmative operative scope, as perhaps where there is a readjustment of partners’ shares to reflect services being performed by one of the partners, we cannot believe that the Regulations were ever intended to bring section 721 into play in a situation like the one before us.13

Mr. Diamond also argued that the interest had no value when received. The Tax Court dismissed this argument by noting that less than three weeks after receipt, Mr. Diamond sold it.

After the Tax Court’s decision and prior to the Seventh Circuit’s decision to affirm the holding, commentators leveled several criticisms concerning the Tax Court’s holding, including (1) the valuation of a profits interest is exceedingly difficult and poses difficulties the Congress, the courts and the IRS have carefully avoided in other contexts;14 (2) if a service partner is taxable on receipt of a profits interest, such partner is likely taxed again on the same profits as they are realized by the partnership and includible in the service partner’s income subject only to a recovery in a capital transaction at the disposition of the interest;15 (3) the court could have determined that at the time the partnership was formed the land contract was worth more than the parties credited and therefore MR. Diamond received a capital interest;16 and (4) the court could have determined that Mr. Diamond was not acting in a capacity as a partner but as an independent contractor to Mr. Kargman and contributed neither capital nor services to the “partnership” and bore no substantial risk of loss.17

The Seventh Circuit, while affirming the Tax Court, noted the criticism that was leveled against the Tax Court’s decision18 and acknowledged the practical problems that would result from the taxation of the receipt of partnership profits interests.19 However, the court found no judicial interpretation,20 nothing in the statute, Regulations, legislative history or policy considerations on which to overrule the Tax Court’s determination that the receipt of a profits interest is a taxable event. The Seventh Circuit repeatedly noted that Mr. Diamond’s profits interest had a readily determinable value at the time of receipt and strongly implied that whether the receipt would be income or not under Code Sec. 61 may depend upon whether the profits interest had a determinable market value or not.21

The Seventh Circuit called on the IRS to issue appropriate regulations to achieve a degree of certainty, but in the absence of such regulations, the court deferred to the expertise of the Commissioner and the Judges of the Tax Court to sustain the decision that the receipt of a profit-share with determinable market value is income.22

In 1975 the IRS forwarded to Chief Counsel’s office a proposed Revenue Ruling that would treat the transfer of a profits interest for services as a taxable event. The Chief Counsel’s office responded with
GCM 36346 suggesting the publication of a ruling stating “… the Service will not follow Diamond to the extent it holds the receipt of an interest in future partnership profits as compensation for services results in taxable income.” Clearly there was a difference of opinion between the IRS and the Office of Chief Counsel. Although no ruling was ever published, it was commonly believed that the IRS would not take a litigation position contrary to GCM 36346. Indeed, in a non-docketed case involving a profits interest to attorneys providing legal services to a partnership over a number of years, the Tax Litigation Division provided a Non Docketed Service Advice Review concluding that a profits interest was not subject to Code Sec. 83.

This uncertain state of the law remained until Campbell in which the Commissioner conceded on brief before the Fifth Circuit that a profits interest was not subject to taxation and changed its argument (on which it won) from the receipt of a profits interest for services to or for the benefit of a partnership was taxable to the argument that the taxpayer did not provide services to the partnership. Notwithstanding the concession by the government, the Fifth Circuit chose to analyze the issue anyway and concluded “… Thus some justification exists for treating service partners who receive profits interests differently than those who receive capital interests.” The Fifth Circuit found more relevant to its analysis Code Sec. 707, holding that a partner generally receives a distributive share of income instead of compensation from his partnership and that only when treating the transaction as one between the partnership and a partner acting in a nonpartner capacity is the payment received by the partner not considered a distributive share. The Fifth Circuit then stated: “Arguably, section 707(a) would be unnecessary if compensatory transfers of profits interests were taxable upon receipt because, if so, every such transfer would be taxed without this section.” The Fifth Circuit concluded that in Diamond, Mr. Diamond received the profits interest for services provided other than in a partner capacity and that in Mr. Campbell’s situation, it was not so clear. Whether on the grounds that the factual basis was not sufficiently developed so as to be clearly erroneous as to whether Mr. Campbell provided services as a partner or for some other basis, the Fifth Circuit missed the opportunity to clarify the law, but rather simply determined that it agreed with Mr. Campbell’s argument that the profits interest he received had only a speculative, if any, value and on that basis reversed the Tax Court.

Against this morass, the IRS decided to call a truce and issued Rev. Proc. 93-17, which was later clarified by Rev. Proc. 2001-43. Collectively, Rev. Proc. 93-17 and Rev. Proc. 2001-43 are hereinafter referred to as the “Revenue Procedures.”

The Revenue Procedures and Current State of Affairs

In order to bring a bit of order to this chaotic situation involving the grant of profits interests to service providers who were not previously partners, virtually every day occurrence, the IRS issued Rev. Proc. 93-27. This revenue procedure defines a “profits interest” as “a partnership interest other than a capital interest.” A “capital interest” is defined as “an interest that would give the holder a share of the proceeds if the partnership’s [tangible and intangible] assets were sold for fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” This is commonly referred to as the liquidation method with the minimum threshold (the “Threshold”) that the pre-existing partners must receive in order to have a profits interest as the liquidation value. Obviously, when the determination of liquidation value is to be made is of critical importance. According to Rev. Proc. 93-27, it is generally made at the time of the receipt of the partnership interest. Rev. Proc. 2001-43 further clarifies the timing of the determination as to whether an interest is a “profits interest” or a “capital interest” is when the interest is received, even if the interest is substantially nonvested (within the meaning of Reg. §1.83-3(b)).

Practitioners and taxpayers should recognize the extraordinary importance of the “safe harbor” of the current Revenue Procedures. As discussed above, the state of the “law” is a mess, and there are basically reconcilable differences between Code Sec. 83 and its embedded entity approach and that of the aggregate theory of partnerships when it comes to compensatory profits interests for partners. Attempting to issue a profits interest and venturing outside the Revenue Procedures safe harbor is indeed sailing into rough tax seas.

At the present time, if the requirements of the Revenue Procedures applicable to a “profits interest” are met, despite the general rules of Code Secs. 61 and 83, the receipt of such a profits interest will
the IRS as a taxable event for the
partner or the partnership. 17 Rev. Proc. 2001-43 also
clearly overrides Code Sec. 83 in providing that the
holder of an unvested profits interest is to be treated
as a partner from the moment the unvested inter-

Rev. Proc. 93-27 imposes the following requirements:

- The interest must be a profits interest, not a capital
  interest.
- The service provider must provide services:
  - to or for the benefit of a partnership, and
  - in a partner capacity or in anticipation of
    being a partner.
- The profits interest does not relate to a substan-
  tially certain and predictable stream of income
  from partnership assets.
- The service provider recipient does not dispose
  of the profits interest within two years of receipt.
- The profits interest is not a limited partner inter-
  est in a “publicly traded partnership” within the
  meaning of Code Sec. 7704(b). 19

If the profits interest is substantially nonvested
at the time of grant, under Rev. Proc. 2001-43, the
service provider will be treated as receiving the
interest on the date of grant if:

- the partnership and the service provider treat the
  service provider as the owner of the partnership
  interest from the date of grant;
- the service provider takes into account the dis-
  tributive share of partnership income, gain, loss,
  deduction and credit associated with the interest
  in computing the service provider’s income tax
  liability for the entire period during which the
  service provider has the interest; and
- neither on the grant of the interest nor upon the
  substantial vesting of the partnership interest,
  neither the partnership nor any of the partners
  deducts any amount (as wages, compensation or
  otherwise) for the fair market value of the interest.

If the above requirements are met, an election un-
der Code Sec. 83(b) is not required, and the service
provider does not recognize income on the receipt
or vesting of the profits interest. 40 In essence, the Re-
venue Procedures implicitly acknowledge, at least in
the “safe harbor” circumstances, the aggregate prin-
ciples of partnership taxation trump Code Sec. 83.

As discussed later herein, there is no prohibition
in the Revenue Procedures against making a Code
Sec. 83(b) election, and there are circumstances
in which making such an election may be ben-
eficial. As also discussed later herein, there are
downsides to making such an election. Because
of potential complications to the partnership and
perhaps some level of uncertainty as to the ap-
propriateness of the Threshold, many partnerships
condition the issuance of the profits interest to a
service provider on the service provider making
a Code Sec. 83(b) election.

Although the requirements of these Revenue Pro-
cedures appear straightforward, with the benefit of
understanding the history of profits interests and
reading the requirements in such a light, it is not
uncommon to see potential foot faults where tax-
payers and their advisors may well be outside this
limited “safe harbor.” Since a storm may well be
raging in this area of the tax law, remaining in the
harbor is advised. An analysis or commentary with
respect to each of the requirements of the Revenue
Procedures follows:

First, the interest received must be a “profits
interest” versus a “capital interest.” The Revenue
Procedures adopt a liquidation value test to de-
determine if the interest is a “profits interest” or a
“capital interest.” 41 In order to be a profits interest,
the following question should be answered. If all of
the tangible and intangible assets of the partnership
were sold and the partnership paid its debts and
obligations and liquidated immediately following
the award of the interest, would the service provider
receive anything in the liquidation? If the answer is
“yes,” then the interest is a capital interest and the
Revenue Procedures do not apply. If the answer is
“no,” then the interest is a profits interest and the
Revenue Procedures apply. The minimum Thresh-
old in favor of the pre-existing partners in order to
have a profits interest is the liquidation value of the
partnership. This simple analysis is much easier in
time than in reality. Since there is no actual sale
and liquidation, how does one determine what is
the appropriate minimum Threshold? Second, often
the existing partners of the partnership desire for the
service provider to “have some skin in the game”
and require the service provider to contribute some
cash or other property. The concept of profits interest as articulated in the Revenue Procedures can literally be read as all or nothing. If the service provider contributes cash or other property in conjunction with the receipt of an interest, the service provider may be receiving a capital interest even if the capital that is returned on the deemed sale and liquidation is only the funds the service provider contributed.

Although this column is focused on profits interests, contrasting the failure to have a profits interest is appropriate to underline the fact that the tax treatment to the parties is entirely different. An accidental issuance of a capital interest for services can have unpleasant side effects.

If a capital interest is involved and the service provider’s cash does not equal or exceed the fair market value of the interest, the service provider will have taxable income equal to the difference between the fair market value and the amount paid for the interest. However, if, as is often the case, the cash or other property contributed equals the then fair market value of the capital interest, but the interest is not substantially vested (as that term is defined in Code Sec. 83), the timing rules of Code Sec. 83 nevertheless will apply. In such case, in the absence of a Code Sec. 83(b) election, the timing of the recognition of income will be when the property becomes substantially vested (transferable or no longer subject to a substantial risk of forfeiture). That may be several years down the road from the acquisition of the interest, and the values may be significantly different. The service provider would then have compensatory income equal to the difference between the then fair market value at date of vesting and the amount paid for the interest. The partnership would receive a deduction (or have a capitalized expenditure) for the like amount. As discussed later herein, the timing of the deduction (or capitalization) is a bit uncertain if the partnership and the service provider have different tax year due to a conflict between Code Secs. 706 and 83(h), which are both potentially applicable.

For the period between issuance and vesting, there are material differences as well to both the service provider and the partnership if an anticipated profits interest is actually a capital interest and no Code Sec. 83(b) election is made. Under the Revenue Procedures, the recipient of a profits interest is treated as a partner from the date of receipt. In the absence of a Code Sec. 83(b) election, a person with an unvested capital interest is not treated as owning the property and, unless is otherwise a partner, will therefore not be a partner. If the service provider is not otherwise a partner, such person may well be an employee. Any distributions such service provider receives will be recharacterized as compensation. The classification of a service provider as an employee or self-employed (a partner) has withholding and benefits ramifications including various ramifications under the Patient Protection and Affordable Care Act and the American Taxpayer Relief Act of 2012, which are beyond the scope of this column.

In absence of a Code Sec. 83(b) election, the vesting of the capital interest, even if acquired at fair market value originally, may generate substantial compensation when vested because of a change in the value of the partnership over the period from grant to vesting. This will not only have the income recognition consequence to the service provider and a deduction (or capitalization event) to the partnership, but it may trigger a deemed sale of an undivided interest in each asset of the partnership in exchange for the service provider’s services and a constructive contribution of such undivided assets to the partnership by the service provider.

With respect to the partnership or the partners, if a capital interest is provided to a service provider, the transaction could be viewed as the distribution of an undivided interest commensurate with the capital interest in the partnership in each of the partnership’s assets to the service provider and a contribution by the service provider back to the partnership. This would cause the partnership to recognize gain or loss on the issuance if a Code Sec. 83(b) election is made or upon the vesting if a Code Sec. 83(b) election is not made. While current law is unclear, the Proposed Regulations would not impose a taxable transaction on the partnership but have a mechanism for a book up and the application of Code Sec. 704(c).

Although clear guidance is lacking in this area, in the event a service provider is to contribute to the capital of the partnership as well as receive a profits interest, it may be prudent to differentiate between the interests. This may be true even if a Code Sec. 83(b) election is made. Under the Revenue Procedures, the recipient of a profits interest is treated as a partner from the date of receipt. In the absence of a Code Sec. 83(b) election, a person with an unvested capital interest is not treated as owning the property and, unless is otherwise a partner, will therefore not be a partner. If the service provider is not otherwise a partner, such person may well be an employee. Any distributions such service provider receives will be recharacterized as compensation. The classification of a service provider as an employee or self-employed (a partner) has withholding and benefits ramifications including various ramifications under the Patient Protection and Affordable Care Act and the American Taxpayer Relief Act of 2012, which are beyond the scope of this column.

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profits,48 the specific authority for that proposition in the context of the Revenue Procedures appears limited. There is some indirect support. For example, the Eleventh Circuit in discussing Code Sec. 721 has stated: “Similarly, when a taxpayer contributes both property and services to a partnership in exchange for a partnership interest, the taxpayer is entitled to exclude from gross income only that portion of the interest which was exchange for property.”49 If the partnership and service provider treat the interest as a single interest, will the IRS bifurcate it?

There also is a private letter ruling that lends some support.50 From the author’s standpoint, it is better to avoid the question in the context of the profits interest component that would otherwise qualify under the Revenue Procedures than to find out the answer. The separate issuance of a capital interest can easily be documented to reflect that property with a fair market value equal to the fair market value of such capital interest was contributed for such capital interest.51 If a substantial risk of forfeiture applies to such capital interest, strong consideration should be given to making a Code Sec. 83(b) election with respect to the capital interest.52 Separate documentation evidencing the separate issuance of a profits interest can be executed clearly indicating that, as a result of such interest, the service provider with respect to such interest would not be entitled to receive anything if all of the partnership’s assets were sold and the partnership liquidated immediately after the issuance of the profits interest and compliance with the requirements of the Revenue Procedures. If the capital contribution is mixed with the profits interest, the result may well be that the service provider is deemed to have only acquired a capital interest, and Code Sec. 83 with all of its terms and valuation methods will apply. The result may well be the service provider will be obligated to recognize compensation income with respect to the profits interest component under the rules of Code Sec. 83 and will be outside the protection of the Revenue Procedures.

Consideration should be given to the appropriate documentation that the value the existing partners must receive is equal to or greater than the Threshold at the time any profits interests are issued. While appraisals or other third-party verification of value would be nice, it is not common for such effort and expense to be undertaken in most circumstances and is generally not necessary. Fortunately, if the Threshold is developed in good faith and the parties are unrelated, it is likely the Threshold determination will be presumed to be fair market value. In the context of capital account maintenance, the Regulations provide:

... the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in an arm’s-length negotiations, and (2) the partners have sufficiently adverse interests ...53

Similarly, in the context of payments for a partner’s interest in a partnership, the Regulations in part provide:

Generally, the valuation placed by the partners upon a partner’s interest in partnership property in an arm’s-length agreement will be regarded as correct.54

Essentially, when the parties have adverse interests and are at arm’s length, the Threshold as determined and agreed by the parties should have a presumption of correctness. The general partner, board or manager should have some good-faith rationale for the determination of such Threshold, and it is appropriate to document such basis and rationale. However, the tax advisors for the Company and for the service providers should apply a reasonableness test to Threshold to see if it seems to make economic sense. The adage of “pigs get fat and hogs get slaughtered” applies to this situation.

Although not common, it is not rare for the Threshold for a portion of a profits interest to be a moving target that increases at some rate over time or has a minimum internal rate of return for investors with respect to some portion of the profits interest participation. So long as the minimum Threshold is equal to or greater than the determined liquidation value of the partnership at the date of issuance, this requirement will be met. The minimum is a floor, not a ceiling.

Second, the service provider must be providing services to or for the benefit of the partnership. The requirement that services be provided55 to or for the benefit of the partnership (i.e., the entity issuing the partnership interest) appears fairly straightforward but is sometimes potentially disregarded or in the case of the formation of a partnership can lead to a surprising
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and unfavorable result to the taxpayer. Although providing services in anticipation of becoming a partner would appear to apply to a person providing services in the formative stages of a partnership, the IRS has taken the position it does not, at least if the service provider is only the second partner.56

This requirement imposes at least two levels of inquiry. First, is the service provider providing services to or for the benefit of the partnership and receiving the profits interest for such services, or are the services provided to or for the benefit of a different person? If the service provider is providing services to or for the benefit of something or someone other than “the partnership” which is ostensibly awarding the profits interest, then the award of the profits interest is outside the scope of the Revenue Procedures. The service recipient is simply paying the service provider with property—an interest in a partnership or perhaps an interest in property that is then contributed to the partnership. Often this potential situation can be seen arising with investment funds or syndicators where key employees receive an interest in the operating partnerships regardless of whether the specific service provider is providing services to the particular partnership or only to one or more “sister” partnerships. One method to minimize this risk is for the formation of a service partnership to provide specified ongoing services in a partner capacity to all of the investment fund operating partnerships or syndicated operating partnerships and for the key employees to be partners of this partnership. In that manner, regardless of which key employees are providing services, the service partnership would be providing services for the operating partnerships and in turn receiving a profits interest associated with such services. The key employees would be providing services for the benefit of the service partnership whether their services benefit one or all of the operating partnerships since the performance of the services is a benefit to the service partnership. Often new key employees are given a profits interest in the service partnership and thereby indirectly participate in the profits interests of the operating partnerships.57

From a business perspective totally independent of tax, this structure accommodates the comings and goings of key personnel with no or minimal disruption to the operating partnerships.

The meaning of “for the benefit” of the partnership is not entirely clear in all circumstances. When are activities for another entity “for the benefit” of the partnership in absence of a legal obligation of the partnership to provide services to the entity? For example, the service provider is an employee of a corporation and provides services to the corporation in which the partnership issuing the profits interest owns stock. Are the services to the corporation for the benefit of the partnership? Does this answer change based on the percentage of the stock the partnership owns? Perhaps there is a different answer when the partnership owns 80 percent or more of the stock than when the partnership owns 20 percent or less of the stock of the corporation. Is the percentage of the partnership’s assets represented by the corporate stock relevant? If the stock represents 100 percent of the assets of the partnership, is that a different situation than if the stock represents one percent of the assets of the partnership (even if the dollar value of the stock is the same)?

A second and more nuisanced inquiry as a result of this first requirement is whether there is a partnership to whom or for which services are being provided? The commentators criticizing the Tax Court’s decision in Diamond noted that the court could have grounded its decision on the basis that there was no partnership for which services were provided. Mr. Diamond’s services were rendered prior to the acquisition of the property. Only Mr. Kargman and Mr. Diamond were the alleged partners, and the transitory nature of Mr. Diamond’s interest may indicate that there was never a partnership.58 The IRS appears to have the view that a partnership cannot be formed by the granting of a profits interest, rather services are performed for the other “partner” that then transfers a property right to the service provider, and the partnership is formed. This view may be based on the Tax Court case of McDougal.59 In McDougal, Mr. McDougal owned a race horse, and Mr. McClanahan, a horse trainer, agreed to form a partnership with Mr. McDougal contributing the horse and Mr. McClanahan contributing certain services. Upon McDougal recovering his cost, the horse was actually contributed to a partnership with Mr. McClanahan receiving a profits interest and entitled to half the profits—all of the losses were to be allocated to Mr. McDougal. The court found that a half interest in the horse was transferred to Mr. McClanahan, and that Mr. McDougal and Mr. McClanahan each made a property contribution of undivided interests in the horse to the partnership. It appears that the government’s position is that if a partnership does not otherwise exist, the services are rendered
to a party other than the partnership and therefore do not meet the requirements of the Revenue Procedures. Indeed the preamble to the 2005 Proposed Treasury Regulations citing McDougal states: “... [t]he rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity ... that becomes a partnership under §301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest.”

Third, the services must be provided in the capacity of a partner or in anticipation of becoming a partner. With respect to service partnerships in which the recipient of the profits interest is providing services on an ongoing basis to or for the benefit of the partnership and furthering the partnership’s business, this requirement generally should easily be satisfied. Some commentators consider the nature of the services important, particularly where capital is a material income producing factor—are these services traditionally carried on by a partner or by an independent contractor or employee? The IRS may look to see if the services are those traditionally provided by an employee or independent contractor, even if the service provider is providing substantial services for the partnership after the grant. In this context, the IRS was at one point particularly concerned about profits interests and movie tax shelters. If the service provider provides services in anticipation of becoming a partner and thereafter does not continue to provide material services, the question is more difficult. Examples that some commentators have used of services that would traditionally be performed by independent contractors or employees include the legal work of organizing the partnership, mortgage brokering, or movie directing. The Eighth Circuit in Campbell differentiated Diamond on the grounds Mr. Diamond did not intend to function as a partner, and commentators have noted that his work was that of a mortgage broker and completed prior to the acquisition of the real estate.

The “in the capacity of a partner” may interact with the requirement of “providing services for the benefit of the partnership” as discussed above. Would a key employee of a corporation in which the partnership owned a small interest be rendering services in the capacity as a partner of the partnership? In contrast, if a partnership controls the corporation, it is perhaps easier to see services being provided in the capacity of a partner and for the benefit of the partnership.

Does the requirement that a service provider be treated as a partner following the grant of a profits interest infer that “in anticipation of becoming a partner” is limited to services provided prior to the grant?

Fourth, Rev. Proc. 93-27 has three specific exclusions to the receipt of a profits interest not being a taxable transaction. These are in part focused on whether the profits interest has an ascertainable value but also appear to draw in other aspects of the case law. Clearly, the IRS has not totally acquiesced in the concept that a profits interest is not property for purposes of Code Sec. 83. In the Revenue Procedures, the IRS has focused on the difficulty to determine value, and the courts’ decision in Campbell and other cases that the profits interest therein had only speculative value and were without fair market value. Rev. Proc. 93-27 excludes from the “safe harbor” three situations in which perhaps the Internal Revenue Service believes the fair market value is determinable upon issuance.

1. Exclusion 1—profits interests related to substantially certain and predictable stream of income from partnership assets. This presumably involves situations in which such a stream of income is easily capable of being valued. The examples used in Rev. Proc. 93-27 are profits interests relating to streams of income from high-quality debt securities or a high-quality net lease. Capital is a material income producing factor in these sorts of partnerships which may or may not make it less likely that the services would be those in the capacity of a partner. The concept that to tax a profits interest in essence taxes the service provider on the value of the services he provides in the future for which he receives a distributive share of taxable income and gain is less present in a partnership whose stream of income is from capital investment producing a largely passive predictable stream of income. What constitutes a substantially certain stream of income from partnership assets, however, is not defined other than by the two examples.

2. Exclusion 2—if within two years of receipt, the partner disposes of the profits interest. The two-year time period, at least in part, may be an administrative extension of the approximately three weeks holding period of Mr. Diamond from the date of the acquisition of the property on February 18, 1962, and his sale of his interest on March 8, 1962. The extremely short period of time Mr. Diamond held the interest made it easy for the courts to determine the sales price was the value on the date of receipt. Obviously, the longer the period between issuance
and the disposition date of the interest, the less reliable is the assumption the disposition price is approximate to the value at issuance. Whether two years is a bit long for a presumption of day one value may be open to discussion; nevertheless, the two-year bright line will provide a clear valuation (or valuation starting point) within or prior to the audit period if the disposition is by sale or exchange. However, if the disposition is by gift (or bequest), the valuation issue does not change, although a valuation is required for other purposes. The revenue procedure does not say that the value received on a disposition is the value of the interest on receipt and therefore taxable day one as compensation. What it says is the receipt of the profits interest is outside the safe harbor of the Revenue Procedures and by implication can be valued. In addition, a rapid disposition of a profits interest other than by death would tend to indicate the service provider did not intend to be a partner in the partnership subject to entrepreneurial risk and reward and was not providing services as or in anticipation of becoming a partner. The exact meaning of “disposition of the profits interest” is not entirely clear. Literally, a sale of a substantial portion of the assets of the partnership and the subsequent distribution of such proceeds during the two-year period may not run afoul of this exclusion, if the service partner retains his or her interest, and the partnership continues for valid business reasons. Distributions (other than in dissolution of the partnership) are generally not considered to be dispositions of partnership interests. Obviously, the retention of a small amount of assets in the partnership or the lack of business purpose for the continuation of the partnership can color the picture. Although a disposition within two years is clearly outside the terms of the Revenue Procedures’ safe harbor, the author anticipates that the facts and circumstances surrounding a sale of the partnership’s assets and the liquidation of the partnership or a sale of all or substantially all of the partnership interests of all of the partners would be relevant to a court. Perhaps equally important are the facts and circumstances indicating that the assets of the partnership appreciated if the purported Threshold was dramatically less than the ultimate disposition values. The validity of the profits interest, as a profits interest versus a capital interest, may be suspect if there is a large discrepancy, and any presumption of the validity of the Threshold may be overcome. Therefore, the two-year period may be a form of “look back” for testing the validity of the Threshold as well. Nevertheless, if an unexpected opportunity arose for such a transaction and any appreciation or “jump” in value appears to have occurred after the issuance of the profits interest, the author believes it is likely that the courts would find the issuance of the profits interest nontaxable if the other parameters of Rev. Proc. 93-27 and 2001-43 are met, even if the IRS chose to challenge the transaction.

3. Exclusion 3—the receipt of a limited partnership interest in a “publicly traded partnership.” This is presumably on the basis that the interest in a publicly traded partnership more easily has a readily ascertainable fair market value and in all likelihood is similar enough to other investment interests that are sold to the public to make valuation reasonably possible. Publicly traded partnerships will generally involve capital as a material income-producing factor which again minimizes some of the theoretical arguments as to why the receipts of a profits interest for a service provider should be exempt. This exclusion may also reflect an IRS dislike of publicly traded partnerships. In Notice 2005-43’s proposed revenue procedure, even general partner interests in publicly traded partnerships are excluded.

Fifth, with respect to profits interests subject to substantial risk of forfeiture, the partnership and the service provider must both treat the service provider as the owner of the partnership interest from its date of grant. Perhaps this requirement is linked to the testing for profits versus capital interest on day one. Potentially it colors the “anticipation of becoming a partner” with some inference that such services can be provided prior to the grant of the profits interest but not after such grant. This inference would indicate that services after the grant are in the capacity as a partner. The author believes such an inference is unwarranted from a business perspective. Time vesting requirements are definitionally incentivizing each key person to provide services in anticipation of becoming a partner.

A bi-product of treating the service provider as the owner of the partnership interest from the date of grant appears to be the service provider ceases being an employee and becomes self-employed. This may be a potential real world problem in more situations than generally realized. Profits interests, particularly in closely held operating businesses, are often given to key personnel who have traditionally been employees all of their lives. These people often desire to have withholdings and perceive great
value to some of the “tax-free” benefits that an employer may provide an employee and on which a self-employed person must recognize income (although often subject to an offsetting deduction). It is not uncommon to see purported profits interests be given to individuals who continue to be issued W-2s, and who are otherwise treated as employees. This practice would seem not only to take the award of the profits interest out of the “safe harbor” but is also inconsistent with the concept of providing services as a partner—although prior to vesting this may not be inconsistent with providing services in anticipation of becoming a partner. From a technical tax perspective, it is difficult to see how a taxpayer can claim he or she received an interest for purposes of determining whether it is a profits interest or a capital interest today, starting a holding period, and then claim that with respect to such interest, he or she should not be treated as a partner until vesting or some other future time or event. If a person receives a profits interest which is tested on the date of grant and on which the appreciation is not recognized on vesting, it is reasonable from a tax policy perspective that such person should be treated as a partner from receipt. Nevertheless, in the real world of closely held businesses attempting to attract and retain qualified key personnel and using profits interests as an important tool for the process, often it does not make sense to the businesspersons as to why such personnel cannot be employees and have a profits interest, and certainly why such personnel cannot be an employee prior to vesting.

The author has seen operating business situations where the partners desire for key personnel to have the incentive of the upside, but for various reasons do not want to treat them as partners until the vesting events occur. There is not an uncommon mindset in many closely held businesses organized as partnerships for federal income tax purpose that the service provider is earning his or her interest complying with the vesting requirements and until earned, such person is not really a partner and should not be treated as one. These people are in fact providing services in anticipation of becoming a partner (one of the requirements above) and holding “becoming a partner” in front of them is part of the perceived carrot. This requirement to treat service providers with profits interests as partners from the date the profits interest is issued may not meet the businessperson’s expectations. However, failure to comply means the requirements under the safe harbor are not met. This may be a more frequent event than generally realized. The existing partners should be educated that, until or unless the rules are changed, this requirement is simply part of the “safe harbor price” for determining whether an interest is a profits or capital interest on the date of grant and for not recognizing income at the time of the future vesting.

Sixth, although the requirement that the service provider take into account his or her distributive share of partnership income, gain, loss, deduction and credit associated with the interest is listed as a separate requirement in Rev. Proc. 2001-43, it is an embedded corollary to treating the service provider as the owner of the partnership interest from the date of grant. This requirement poses some of the same real world concerns that the fifth requirement poses, but is sometimes easier to deal with than the fifth requirement as the rights associated with the profits interest may be able to be shaped to better fit the business circumstances. This requirement does not require that the partner holding the profits interest receive a particular share of income, gain, loss or distribution, only that he or she receive the share associated with his or her interest. Special allocations and distributions that, per the terms of the partnership interests have priority to or come before the allocations and distributions of the profits interest, should be acceptable so long as such allocations have substantial economic effect. Under the Revenue Procedures, a revaluation of the assets and adjustments to capital accounts are not required upon the issuance of a profits interest but would be permitted.68

There are an infinite variety of terms establishing the distributive share of income, gain, loss and deduction attributable to a partnership interest as well as distributions. This flexibility applies to profits interests as well. The Revenue Procedures do not appear to dictate any terms (other than the interest be a profits interest which requires a minimum amount of sub-ordination to the pre-existing partners) but require that whatever the terms are, they be honored from the date of grant.

Examples of common term patterns for partnership interests include the following:

1. The service provider receiving the profits interest is entitled to x percent of the future profits and loss (subject to the substantial economic effect rules) and x percent of the capital appreciation (with the capital baseline being the Threshold) that occurs after
the issuance. The service provider would be entitled to x percent of cash distributions supported by the future earnings but would not be entitled to distributions of future capital transaction proceeds until the pre-existing partners received proceeds from such transactions equal to the Threshold. Gain on capital transactions would be allocated to the pre-existing partners at least until gain equal to the gain that would have been recognized had all the assets been sold and debts paid on the day the profits interest was issued to the service provider. Under this form of profits interest, if the partnership’s operations are profitable, the service provider with the profits interest will start building a positive capital account balance if the distributions are less than the operating profits.

2. The service provider receiving the profits interest is entitled to the same x percent of future profits and losses and capital appreciation as provided in example 1 above, but with the exception of tax distributions associated with the future operating profits, the service provider holding the profits interest will not be entitled to cash distributions until the pre-existing partners receive an amount equal to the Threshold. The pre-existing partners receive all cash distributions (other than tax distributions) until the Threshold is crossed. Although beyond the scope of this column, since the distributions of cash and property to the pre-existing partners is unlikely to exactly match the taxable profits and gains, it may be more appropriate for annual target allocations of income, gain and loss to be the mechanic for maintaining capital accounts than the traditional percentage formulas. Tax distributions are also generally required as it is possible there will be a period when the profits interest is receiving allocations of income and gain and yet not receiving distributions. While not receiving immediate allocations and distributions, the partnership allocations and distributions are building toward the crossing of the Threshold to full participation.

It should be noted that the requirements of Rev. Proc. 2001-43 do not require that the nonvested service provider receive the cash distributions that otherwise may be associated with the profits interests.

3. In lieu of revaluing the partnership assets and adjusting the capital accounts pursuant to the Treasury Regulation, the service provider receiving the profits interest is not entitled to any allocations of future profits, gains or losses until the pre-existing partners receive allocations of income and gain equal to the difference between the Threshold and the pre-profits interest capital account balances of the pre-existing partners. The service provider will receive allocation of income after the pre-existing partners receive allocations of gain and profits equal to the difference between the Threshold and the pre-profits interest capital account balances. The service provider by virtue of the profits interest is not entitled to distributions in excess of tax distributions until the pre-existing partners receive distributions equal to the Threshold. This is true whether the profits interest is vested or unvested. In this scenario, even if the partnership is profitable, the service provider with the profits interest will not start building a positive capital account until closer to the time the Threshold is crossed. Although beyond the scope of this column, the specific facts pertaining to the partnership and the nature of the profits interest are factors in determining whether a revaluation of the partnership assets and adjusting the capital accounts should be undertaken. As a technical matter, there are advantages and disadvantages to revaluing assets and restating capital accounts with the issuance of profits interests with respect to the different forms of
partnership profits interests that may be issued. Under
the Revenue Procedures, the decision to revalue or
not to revalue can be decided by the partnership at
the time. In addition special allocation of income
and gain satisfying the substantial economic effect
tests of the Regulations can be superimposed on the
basic allocation patterns.74

Seventh, neither the partnership nor any of the
partners may deduct any amount (as wages, com-
ensation or otherwise) for the fair market value of
the profits interest. This is an obvious requirement
for a nonrecognition transaction. If the recipient
does not have income as a result of the receipt of
the profits interest, no other party should have a
deduction as a result of the grant of the profits inter-
est. Indeed, under the analysis of Campbell, a valid
profits interest would have a speculative fair market
value of zero, and therefore there is no income or
deduction in any event.

Under the Revenue Procedures, no Code Sec.
83(b) election is required. While no Code Sec.
83(b) election is required, there is nothing in the
Revenue Procedures that would preclude a Code
Sec. 83(b) election. Although it appears to be gen-
erally assumed that the liquidation valuation method
can be used in conjunction with the Code Sec.
83(b) election for a profits interest that complies
with the safe harbor of the Revenue Procedures,
the author is unaware of any current direct author-
ity for that proposition.75 As discussed previously
there is a theoretical question as to whether the
grant of a profits interest is the transfer of property
for Code Sec. 61 and 83 purposes. Arguably, the
parenthetical in Reg. §721-1(b) means that at least
for purposes of Code Sec. 61, the grant of a profits
interest is not the transfer of property, although
the Courts of Appeals in Diamond and Campbell
implicitly considered a profits interest property.
Just to add confusion, however, some courts have
refused to recognize the service provider as a partner
and analogized the profits interest as similar to an
unfunded promise to pay in the future.76 In GCM
36346 (1977), the Chief Counsel’s Office found it
difficult to generally quarrel with the Tax Court’s
finding in Diamond that a compensatory interest is
property under Reg. §1.61-2(d)(1). However, while
admitting that the analogy is not perfect, the GCM
made the analogy that when the interest is defined
to preclude any interest in partnership assets, such
an interest became analogous to an unfunded, unse-
cured promise to pay deferred compensation which
is not taxable upon receipt and is not considered to
be property. The IRS position at this time, however,
appears to have changed and to be that the grant of
a profits interest is the transfer of property. As dis-
cussed in Part II of this article, the Proposed Treasury
Regulations77 concerning compensatory partnership
interest clearly takes the position that the transfer of
a profits interest is the transfer of property for Code
Sec. 83 purposes.78

At the present time, the decision to make or not
make a Code Sec. 83(b) election for a profits interest
is not always perfectly clear. If the taxpayer and his
or her advisors is absolutely certain that the profits
interest is in fact a profits interest and the IRS would
be unsuccessful in challenging whether there would
be no distribution with respect to such interest if all
of the tangible and intangible assets of the partner-
ship were sold and the partnership were liquidated
the next day, then a Code Sec. 83(b) election would
be of no or very limited benefit.79 However, if there
is a risk that the IRS may be successful with the argu-
ment there was a capital interest issued (as discussed
under “First, the interest received must be a “profi ts
interest” versus a “capital interest,”” theoretically,
$1.00 will taint the whole interest), a Code Sec.
83(b) election should be considered. The advantage
of making the Code Sec. 83(b) election is it protects
against future arguments by the IRS that the original
issuance involved a capital interest (as opposed to a
profits interest) and that compensation is computed
on the fair market value of the interest when the risk
of forfeiture lapses at the value at such date. Any tax
and other dislocations that will result from the service
provider not being deemed to be a partner prior to
vesting will also be avoided. The downside of a Code
Sec. 83(b) election is the potential application of the
literal language of Reg. §1.83-2 that may prevent a
loss or deduction to the service provider with respect
to accumulated profits attributable to the compensa-
tory interest if such interest is later forfeited.80 This
language provides:

If property for which a section 83(b) election is in
effect is forfeited while substantially nonvested,
such forfeiture shall be treated as a sale or ex-
change upon which there is realized a loss equal
to the excess (if any) of -- (1) The amount paid (if
any) for such property, over, (2) The amount real-
ized (if any) upon such forfeiture. If such property
is a capital asset in the hands of the taxpayer, such
loss shall be a capital loss.81
The application of the Code Sec. 83 Regulations would appear to have the following consequences. It would convert a subsequent forfeiture which is normally not considered to be a sale or exchange into a sale or exchange. Second, in a literal reading, the specific calculation of loss under the Regulation is only the amount paid (if any) over the amount realized (if any). The profits that have been allocated to the service provider partner with the nonvested profits interest and on which such partner has been required to report his or her distributive share of profits and gain may be ignored under these Regulations. At least one prominent commentator believes this may be the unfortunate result. Another does not seem to disagree that the Regulation may dictate the result, but criticizes the result:

These results are clearly inappropriate and almost certainly unintended: the Section 83 Regulations do not address partnerships or partnership interests, so it is not surprising that they fail to make clear that a service provider who forfeits a partnership interest may claim a loss to the extent such loss is attributable to prior inclusions of properly allocated partnership income.

Perhaps an argument may be that the accumulated profits attributable to such interest represent the deemed receipt of property by the service provider and the deemed contribution of property back to the partnership and represents a form of payment for the interest. Unfortunately, at this time, there is no clear answer as to how the accumulated profits associated with a profits interest is treated in the event a Code Sec. 83(b) election is made and the interest is forfeited. Interestingly, the same appears to be the case of S corporation stock as well. There is a significant risk that the accumulated profits on which taxes was presumably paid will not even generate a capital loss on forfeiture.

In contrast, if (1) no Code Sec. 83(b) election is made with respect to the receipt of a profits interest, and (2) no consideration is received on the forfeiture, then in the event of a subsequent forfeiture of the profits interest for which the service provider partner has recognized his or her distributable share of partnership operating profits from the date of grant to the date of forfeiture, the forfeiting partner may be able to claim an ordinary loss equal to such net accumulation under general tax benefit principles as the forfeiture may not be viewed as a sale or exchange, particularly if there is no deemed distribution as a result of debt. In addition, Reg. §1.83-1(b)(2) provides for ordinary loss treatment upon forfeiture if no Code Sec. 83(b) election is made. Referring to Code Sec. 83 Regulations under these circumstances, however, is a bit awkward since the beginning point for a profits interest under the Revenue Procedures is not applying Code Sec. 83. One major commentator, has observed that it is rumored the IRS is hostile to the analysis that an ordinary loss for such accumulation is possible.

If a capital interest is mistakenly or intentionally issued by a partnership for services rendered, does the partnership recognize gain or loss on the issuance? Reg. §1.721-1(b) provides that Code Sec. 721 does not protect the service provider from the receipt of taxable income, and Code Sec. 83 will cause the service provider to recognize taxable income equal to the fair market value of the interest received.

If a capital interest is issued, neither the Revenue Procedures nor the Regulations address the impact of the issuance of a capital interest on the partnership or the existing partners as opposed to the recipient service provider. There is no doubt, however, that a capital interest in a partnership is property. Under general principles of federal tax law, when appreciated property is used to pay an obligation, gain is recognized by the transferor. In this case, is there a capital shift away from the existing partners to the new partner? Depending as to whether the entity or aggregate paradigm is applicable, is there a transfer of property by each partner to the new partner or from the partnership to the new partner on which gain or loss will be recognized? In GCM 36346, the Chief Counsel’s Office expressed the belief that if a capital interest is involved, the partnership may be entitled to a deduction for the value of the capital interest transferred and that if such value exceeds the basis of the interest, the transferor will be required to recognize gain. The GCM also expresses the view that when the service provider receives an interest in unrealized appreciation or unrealized receivables, the potential for double taxation can be avoided if the partnership makes a Code Sec. 754 election to make the optional basis adjustments under Code Sec. 743(b).

The timing of the recognition of the service provider’s income on receipt of a fiscal year partnership
interest on which the service provider makes a Code Sec. 83(b) election has a technical Catch 22 as there is a conflict between Code Secs. 83 and 706 as to the timing of recognition and deduction (or capitalization). The Regulations under Code Secs. 706 and 83 take different positions as to when income and deductions arise. Regulations under Code Sec. 721 treat the issuance of a capital interest of a partnership in exchange for services as a guaranteed payment.\textsuperscript{90} Guaranteed payments are included in a partner’s income in the partner’s tax year with which or within which the partnership’s tax year ends in which the partnership deducted the payment.\textsuperscript{91} Code Sec. 83, however, provides for a service recipient (in this case the partnership) to claim a deduction (if one is permitted) for the tax year in which or with which ends the tax year of the service provider in which the amount is included in the service provider’s income. If the partnership and the service provider have the same tax years, then there is no technical problem. If the partnership and the service provider have different tax years, there is a technical problem. The 2005 Proposed Regulations discussed in Part II of this column resolve the conflict by having the rules applicable to Code Sec. 83 override the rules applicable to a guaranteed payment.\textsuperscript{91}

Although discussed elsewhere in this column, the issuance of a partnership interest will cause nonrecourse debt to be reallocated among the partners with the new partner receiving a share of such nonrecourse debt equal to his or her profits percentage.\textsuperscript{92} Since a decrease in a partner’s share of debt is a deemed distribution, it is possible for an existing partner to have a taxable event by virtue of the issuance of the new partnership interest (profits or capital).

**Effect of Forfeiture**

Forfeitures of all or a portion of profits interests are common events. With respect to the service provider that received a profits interest and made a timely Code Sec. 83(b) election and later forfeits his or her interest, the Code Sec. 83 Regulations provide that the service provider does not recognize a deduction but rather has a deemed sale or exchange of his or her interest with a loss\textsuperscript{93} equal to the difference, if any, between the amount paid, if any, for the profits interest and the amount, if any, received on the forfeiture.\textsuperscript{94} As previously discussed in this column, this would literally mean that the accumulated profits attributable to such profits interest and on which such service provider was obligated to report as taxable income would not generate a loss or deduction to the forfeiting service provider.

Assuming a Code Sec. 83(b) election has not been made, as discussed previously in this article, there is an argument that the forfeiting service provider can obtain an ordinary deduction equal to the amount of accumulated profits (less distributions and losses) allocated to such service provider if no portion of partnership debt is allocated to the profits interest at the time of the forfeiture.\textsuperscript{95} If the partnership has nonrecourse debt with a portion allocated to the service partner, the service partner is treated as if there was a sale or exchange in consideration of the share of debt. Under this analysis, however, the service partner is likely entitled to account for any accumulated profits previously allocated to such service provider with respect to the profits interest in determining the amount of gain or loss.

The effect of a forfeiture of a profits interest on the partnership and the other partners is not addressed under the existing case law, Regulations, or the Revenue Procedures regardless of whether a Code Sec. 83(b) election was made or not made. This is problematic if the forfeiting partner has been allocated net profits and has a positive capital account balance at the date of forfeiture. These forfeitures are common occurrences and Rev. Proc. 2001-43 requires the recipient of a profits interest be allocated income, gain and loss associated with the profits interest from date of grant. Unless the profits interest participation in income and gain is subordinate to the actual return of the Threshold amount and the operating agreement has allocations of income and gain to the pre-existing partners during such pre-forfeiture period that comport with substantial economic effect (or reflect the underlying interest such person had in the partnership), the service provider with a profits interest will have a positive capital account balance at the time of forfeiture if the partnership is profitable, and the distributions of cash and property with respect to such profits interest are less than the net operating income allocated to such profits interest.

If the service provider made a Code Sec. 83(b) election, is it appropriate for gain recognition at that time for the partnership or the partners, particularly if the service recipient does not obtain a loss with
respect to the accumulated profits element per Code Sec. 83? Would a symmetry in tax law provide a basis for the position that under Code Sec. 83 since the service provider does not recognize a loss based on any accumulation, the remaining partners do not recognize income or gain as a result of the forfeiture? Some commentators do not believe this is the case.

If the aggregate theory applies, and there was a deemed transaction with the partners when the profits interest was issued and such partners recognized gain or loss, does the forfeiture trigger an adjustment under the tax benefit rule? Is it possible that a reversal of prior year gain or loss is the result? If the tax benefit rule applies with respect to reversing any initial gain or loss recognized by the pre-existing partners when the profits interest was issued, does the tax benefit rule then possibly dictate that any accumulated profits in excess of distributions be reversed out as well. In a 2005 article in Taxes, Susan Kalinka wrote:

Under the tax benefit rule, in any case in which a taxpayer has enjoyed a tax benefit, such as an exclusion from income or a deduction, in an earlier year, and in a later year, something happens that is inconsistent with the premise upon which the earlier tax benefit was based, the taxpayer must recapture as income the amount of the prior tax benefit. [Citing Hillsboro Nat’l Bank, SCt 83-1 USTC ¶ 9220, 460 US 370.] Because a service provider who makes a Code Sec. 83(b) election on the receipt of a restricted partnership interest is treated as a partner before the interest vests, the forfeiture of the partnership interest is inconsistent with the prior treatment of the service provider as a partner for federal income tax purposes. …Because the service provider is treated as a partner as a result of the Code Sec. 83(b) election, a portion of partnership income may be allocated to the service provider. Partnership income that is allocated to the service provider is not included in the income of the other partners. If the service provider forfeits the partnership interest, the tax benefit rule should require the other partners to include in income their shares of the partnership income that earlier was included in the income of the service provider.96

There does not appear to be any express authority as to the tax consequences to the partnership and other partners on the forfeiture of a profits interest. Many practitioners believe there is no requirement that there be a reversal of the allocations of partnership tax items that were made to the service provider prior to forfeiture or a recognition of gain at the time of forfeiture.

As will be discussed further in Part II of this column, the Proposed Regulations specifically provide a mandatory mechanism for reversals of the tax items that were allocated to the service provider if the safe harbor is elected.97 The Proposed Regulations do not require that all of the tax items be reversed if, in the year of forfeiture, the items that can be allocated are insufficient to achieve a full reversal although the IRS has asked for comments on this aspect.98 Is there a bit of an inference that without the Proposed Regulations, an adjustment is not required?

Collaterally, how capital accounts of the remaining partners are adjusted is correspondingly unclear. If the position is taken that the forfeiture of a profits interest with accumulated profits is a nothing for the partnership and the other partners, a consistent action would be to simply eliminate the capital account balance of the forfeiting profits interest. If the position is taken that the aggregate accumulated profits element represents income or gain to the remaining partnership or remaining partners, it would seem their capital accounts should be increased by a like amount.

At best, the correct federal income tax treatment of both the service provider and the partnership and/or the remaining partners upon a forfeiture of a profits interest is unclear at this time. Part II will examine the Proposed Regulations attempt at a solution, the requirements of such Proposed Regulations and some of the problems associated with the Proposed Regulations, particularly with respect to traditional service partnerships.

**Endnotes**

1 Code Sec. 422.
2 While there are restricted stock rules and special rules applicable to options that may defer the timing of the realization or recognition event, with the exception of Incentive Stock Options, when the stock is actually received and not subject to substantial risk of forfeiture or is freely transferable, the service recipient will have compensation income equal to the then fair market value of the stock. See Code Sec. 83(a) and (b).
3 1993-2 CB 343.
4 2001-2 CB 191.
5 REG-105346-03, 70 FR 29675 (May 24, 2005).
6 Partnership Guidance On Hold Pending Legislative Action, Treasury Officials Say.
the return be contingent upon the partnership’s future success. Determined such an interest was a profits interest and Code Sec. 83 did not apply. It analogized the interest to an unfunded promise to pay and acknowledged that upon disposition, capital gain was possible.


At this point the Commissioner concedes that the tax court erred in holding that the receipt of a profits interest in exchange for services to the partnership should be considered ordinary income to the service provider.” Campbell, id., 943 F2d, at 818.

Campbell, supra note 25, 943 F2d, at 822.

Id. (citing Pratt, CA-5, 77-1 USTC ¶9347, 550 F2d 1023, 1026).

Id. (citing McKee, supra note 14, at ¶ 5.02[1] [b], at 5-13 to -14).

Id.

Id., at 823.

The author refers to the “current state of affairs” versus the “current state of the law” because in the author’s opinion there is no actual current state of the law other than conflicting and incomplete analysis.

Rev. Proc. 93-27, Section 2.02.

Rev. Proc. 93-27, Section 2.01. Although the Revenue Procedure does not expressly state that in the liquidation of the partnership the debts and obligations of the partnership must be paid to determine if there are proceeds received by the holder of an interest in the partnership, that is implicit in the concept of liquidation as the state law rights of creditors take preference over the rights of equity holders.

The Revenue Procedure does not flesh out any exceptions as to when “generally” would not apply.

Rev. Proc. 93-27, Section 2.01.

See Rev. Proc. 93-27, Section 4.01.


Rev. Proc. 93-27. While the use of the liquidation method to determine whether an interest is a capital interest or a profits interest is clearly appropriate, care should be taken not to confuse such a test with the determination of a capital interest’s fair market value.

McKee, supra note 14, at ¶ 5.03[1] (“Even though a profits interest described in these revenue procedures is nonvested, (1) the usual rule that nonvested property is valued and taxed when it vests is turned on its head, even in the absence of a §83(b) election, and (2) the recipient of the nonvested property is treated as the owner of the property from the date it is received, again regardless of whether a §83(b) election is made.”)

P.L. 111-248.

P.L. 112-240.

Reg. §1.83-6(b).


There seems to be a common perception that if a Code Sec. 83(b) election is made with respect to a profits interest qualifying under the Revenue Procedures, the value of the profits interest will continue to be the zero value attributed by the Revenue Procedures. It is unknown whether that is in fact correct, although it appears reasonable in most contexts.

See for example, Douglas A. Kahn, The Proper Treatment of the Transfer of a Compensatory Partnership Interest, 62 Tax Lawyer 1, 24 (Fall 2008).

D.N. Stafford, CA-11, 84-1 USTC ¶9316, 727 F2d 1043, 1055. This language is also quoted by the Eighth Circuit in Mark IV Pictures, Inc., CA-8, 92-2 USTC ¶50,365, 969 F2d 669, 672.

LTR 200329001 recited the following fact: “Participating executives will make a capital contribution of $a per unit in the Plan and will receive an initial capital account of $a per unit. In connection with the issuance of Plan units, Y [the partnership] will revalue its assets and adjust its existing partners’ capital accounts.” Representations were made concerning the exceptions of Rev. Proc. 93-27. The conclusion of the IRS in the PLR is: “…we conclude that the issuance and vesting of Plan units issued by Y as compensation for services performed by participating executives to or for the benefit of Y are nontaxable events under Rev. Proc. 93-27, as clarified by Rev. Proc. 2001-43.” The LTR did not provide an analysis or affirmatively bifurcate the interest.

In the context of starting a new partnership, the capital contribution and issuance of a capital interest should occur prior to the issuance of the profits interest, particularly if there are not two other capital partners at the time the service provider is to be issued units. This will at least permit the argument that the service provider is receiving an interest in an existing partnership and not providing services for the other soon to be partner and receiving something which is then contributed to the partnership. See F.C. McDougal, 62 TC 720, Dec. 32,746 (1974), acq., 1975-2 CB 2.

Reg. §§1.83-2(a) and -4(a).


Reg. §1.736-1(b)(1).

Presumably the performance of services for this purpose includes the Code Sec. 83 concept of refraining from the performance of services. See Reg. §1.83-2(f).

See for example, McDougal, supra note 51. This was also a ground for taxation as compensation argued by the government in Diamond.
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