Proposed Regulations Seek to Change Tax Treatment of Compensatory Grants of Partnership Interests

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Proposed regulations and a proposed revenue procedure recently issued by the Internal Revenue Service would, if finalized in their current form, apply Internal Revenue Code section 83 to the receipt of a partnership interest as compensation for services rendered to the partnership. While section 83 had previously been applied to situations in which corporate equity or partnership capital interests were received for services rendered, the tax treatment of the receipt of partnership profits interests was the subject of some uncertainty. The new rules would also provide a safe harbor under which a partnership and all its partners can ensure that the fair market value of a compensatory partnership interest is considered to be equal to its liquidation value.

Application of Section 83 to Partnerships

Under the new rules' application of section 83 to partnerships, a person receiving a partnership interest generally is subject to taxation at ordinary income tax rates on the fair market value of the interest at the time of receipt, and the partnership receives a corresponding deduction. The partnership itself does not recognize gain or loss in connection with the issuance of the partnership interest to the service provider. If the partnership interest is subject to a substantial risk of forfeiture at the time that it is issued, it is not subject to current taxation until it vests unless, within 30 days from the date of grant, the recipient elects to be currently taxed under section 83(b). An unvested interest for which no 83(b) election has been made will not be treated as owned by the recipient; the recipient will not be treated as a partner and will not be allocated any partnership tax items until vesting occurs or the election to be taxed currently is made. If an election is made and the partnership interest is subsequently forfeited, the aggregate amount of partnership items that have been allocated to the service provider are reversed. Finally, under the proposed regulations, compensatory options to acquire partnership interests, like compensatory stock options, are ignored for tax purposes until exercised or disposed of, at which point the recipient is required to include the full value of the interest, less any amounts paid in the case of exercise, as ordinary income and the issuing partnership is entitled to a corresponding deduction.

Valuation Safe Harbor

Although the new rules require that a compensatory partnership interest-whether a capital or profits interest-be included in income when received or vested, they provide a safe harbor under which a partnership and its partners can ensure that the fair market value of the interest is considered to be its liquidation value,

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which, in the case of a pure profits interest, will usually be zero. Liquidation value equals the amount of cash that the recipient of the interest would receive if, immediately after the transfer to the recipient, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for fair market value and then liquidated.

The proposed revenue procedure specifies the circumstances under which a partnership and its partners can make a safe harbor election. The safe harbor election is not available if the partnership interest issued to the service partner is (i) related to a substantially certain and predictable stream of income from partnership assets, such as high quality debt securities or a net lease, (ii) transferred in contemplation of a subsequent disposition or (iii) an interest in a publicly-traded entity. A partnership interest will be deemed to have been acquired in contemplation of a subsequent disposition if the disposition in fact occurs within two years of the date of issuance or if the interest is subject within the two-year period to a right to buy or sell, regardless of when exercisable (except for a right that arises solely by reason of the death or disability of the recipient). Unlike the rules under currently existing revenue procedures which permit the services for which the partnership interest is issued to be "to or for the benefit of" the partnership, the proposed safe harbor requires that the services be rendered "directly" to the partnership.

There are a number of procedural conditions that must be satisfied before an election to use the safe harbor will be valid. The election must be in written form and attached to the tax return of the partnership for the year that includes the election effective date, and the partnership must elect to have the safe harbor apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect. The partnership agreement must contain legally-binding provisions to the effect that the partnership itself and all partners, including transferees of existing partners, will comply with the requirements of the safe harbor election. The safe harbor election terminates automatically if the partnership fails to satisfy the conditions for its effectiveness or if the partnership or any partner takes a tax return position that is inconsistent with the requirements of the revenue procedure. Once an election to use the safe harbor is terminated, another election cannot be made until the fifth year after the year of termination.

Continuing Uncertainties

The proposed regulations do not address a number of questions that arise when compensatory partnership interests are issued. For example, how does one determine precisely when a compensatory partnership interest has been transferred? Although the answer to this question may be fairly clear when a partnership profits interest is granted to a newly-admitted partner, it is not as easily ascertainable when the profit share of an existing partner changes during the year either on a prospective or retroactive basis. This timing issue has particular importance in relation to nonvested interests because an election under section 83(b) must be made within 30 days of the transfer of the interest to which it relates.

Another question that is not directly addressed by the proposed regulations is how the fair market value of a partnership profits interest should be determined. An existing line of legal authorities has held that an interest in the future profits of a partnership is too speculative to be valued. The proposed regulations do not adopt this approach even though the regulations dealing with grants of stock options to employees contain a presumption that options do not have an ascertainable fair market value at the time of issuance. Even when the safe harbor is available, the proposed regulations' explicit inclusion of intangibles, such as goodwill and going concern value, as assets of the partnership that must be taken into account in determining liquidation value creates uncertainty, particularly in the case of service partnerships.

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Given the significant shift in approach to the taxation of the issuance of compensatory partnership interests embodied in the proposed regulations and revenue procedure, as well as the fact that the Internal Revenue Service has acknowledged that additional issues need to be addressed, it has to be assumed that the final guidance on the subject will differ from the current version. However, it seems unlikely that the Internal Revenue Service will reverse its decision to bring the grant of compensatory partnership profits interests under the umbrella of section 83. As a result, it is advisable for partnerships to reexamine the manner in which they compensate service providers in order to ensure that the tax consequences of their actions are still what the partnership and the partners expected. They must also be prepared to amend their partnership agreements and comply with a fairly detailed set of administrative rules if they wish to take advantage of the new safe harbor valuation election.

If you should have any questions regarding the foregoing, please contact

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