COMPENSATING THE SERVICE PARTNER WITH PARTNERSHIP EQUITY:
CODE §83 and OTHER ISSUES

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The use of partnerships and limited liability companies ("LLCs") has become increasingly common in structuring all sorts of investments and business transactions, ranging from "new economy" venture-capital-financed start-ups and other private equity transactions to more traditional joint ventures. One common feature of many of these transactions is the extensive use of partnership or LLC equity to compensate executives and other service providers, giving them incentives aligned with the entity's equity investors.

Code §83, which governs the tax consequences of the transfer of property to a service provider, was enacted more than 30 years ago. While the operation of Code §83 is well understood where a corporation transfers its stock to an executive or other corporate employee, the operation of Code §83 where a partnership transfers a partnership interest to a service partner is in many important respects unclear, creating significant issues for partnerships, service partners and their tax advisors.[3]

Part A of the article briefly summarizes Code §83 and its interaction with Subchapter K. Part B focuses on the transfer of a partnership "capital" interest to a service partner. Part C focuses on the transfer of a partnership "profits" interest to a service partner. Part D focuses on the use of options on partnership interests to compensate a service partner as well as certain partner-to-partner transfers. Part E contains conclusions and recommendations.

A. Code §83 and Subchapter K

Under the general rule of Code §83, a service provider recognizes ordinary compensation income ("OI") equal to the fair market value ("FMV") of "property" received "in connection with the performance of services," less the amount (if any) paid for such property.[4] Property, for this purpose, includes all real and personal property other than (i) money, (ii) an option, or (iii) an "unfunded and unsecured promise to pay money or property in the future."[5]

In many circumstances, the service recipient will transfer property to the service provider subject to "vesting" restrictions, requiring the service provider to return the property back to the service recipient if the service provider does not provide the agreed services. If the vesting restrictions constitute a "substantial risk of forfeiture" ("SRF") and the property is not transferable by the service provider free of such restrictions, Code §83 defers the recognition and measurement of the service provider's OI until the property vests (i.e., the SRF lapses or the property becomes transferable free of such restrictions).[6] Thus, the service provider recognizes

OI on vesting and the amount of such OI is equal to the difference between the FMV of the property at vesting and the amount (if any) paid for the property.[7]

Property is subject to an SRF for purposes of Code §83 if the service provider's "rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[8] For example, restricted stock sold to a corporate employee is subject to an SRF where the employee must resell the stock to the employer corporation for the lesser of its cost or current FMV if the employee leaves the employ of the corporation before the end of a specified term. In most circumstances, if the service recipient has the right to repurchase the transferred property from the service provider for an amount that may be less than its FMV (at the time of the repurchase), unless the service provider performs services for a specified period, the property will be considered to be subject to an SRF for purposes of Code §83.[9]

Under Code §83 principles, a service provider who receives property subject to vesting restrictions is not considered to own the property until it vests. Thus, the service provider's holding period for such property does not begin until vesting and any current income received from the property before it vests is generally treated as compensation income rather than income (e.g., dividends) from the property.[10]

While deferral of the service provider's OI until vesting is a benefit, measurement of the service provider's OI at vesting can be a significant detriment if the property appreciates between initial receipt and vesting. Code §83 allows a service provider to determine his or her OI without regard to vesting restrictions if the service provider files an election with the IRS under Code §83(b) not later than 30 days after the receipt of the property. Where the service provider makes a timely Code §83(b) election, the service provider recognizes and measures any OI on receipt of the property and recognizes no additional income when the property vests. In addition, the service provider is regarded as the owner of the transferred property and his or her holding period for the property begins on receipt.[11]

Code §83(h) allows the service recipient to deduct an amount equal to the OI included in gross income by the service provider, generally at the time such income is so included, subject to capitalization rules and other general limitations.[12]

Before discussing the application of Code §83 to transfers of partnership interests, it is useful to define two different types of partnership interests that have long been distinguished in the tax law. A partnership interest transferred to a service partner in exchange for services may be either an interest in partnership capital or an interest in partnership profits or both. A "capital interest" is a partnership interest that would entitle the partner to a share of the value of the partnership's current assets, determined as if the partnership sold its assets for FMV and distributed the proceeds in a hypothetical liquidation of the partnership.[13] A "profits interest" is a partnership interest that is not a capital interest -- in effect, an interest in the partnership's future profits and appreciation of its assets.[14] These definitions are generally applied on receipt of a partnership interest. Over time, an interest that was a profits interest on receipt may become a capital interest, as the partnership's assets appreciate or it retains earnings.

Much has been written on the question of whether Code §83 applies to the transfer of a partnership interest to a service partner in exchange for services to the partnership. We will provide only a brief summary of the arguments. Readers who wish to explore this question in further detail should consult the extensive commentary on this topic.[15]

It is odd that, after 30 years, Code §83 and Subchapter K give little explicit guidance on the question. Code §83 and the regulations thereunder do not explicitly address it.[16] A proposed regulation under Code §721 issued almost 30 years ago, but never finalized, states that Code §83 applies to a transfer of an interest in partnership capital in exchange for services, but says nothing about a transfer of an interest in partnership profits.[17] The Code §704(b) regulations note that allocations respected under Code §704(b) may nonetheless have other tax consequences, citing Code §83 (along with Code §61 and Treas. Reg. §1.721-1(b)(1)), suggesting the regulatory draftsmen believed the receipt of rights to partnership allocations could, at least in some cases, be taxable under Code §83.[18]

Despite the lack of explicit guidance, Code §83, read literally, appears to apply to the transfer of a partnership interest to a service partner in exchange for services for the partnership. A partnership interest, whether in partnership capital or profits or both, is clearly property under state partnership and LLC law.[19] A transfer of property (here a partnership interest) to compensate the service provider (here the service partner) for performing such services is clearly "in connection with the performance of services."[20]

This result is reasonably well settled in the courts where the transferred partnership interest is a capital interest.[21] It is, however, less clear where the transferred partnership interest is merely a profits interest.

On the one hand, it is difficult to distinguish (in the absence of Rev. Proc. 93-27) between capital interests and profits interests under the actual statutory language of Code §83, except perhaps on valuation grounds.[22] Both types of partnership interests appear equally to be property for purposes of Code §83.[23] A profits interest seems to be no more a mere "unfunded and unsecured promise to pay money or property in the future" than a share of common stock.

On the other hand, Subchapter K contains indications that Code §83 may not apply to the receipt of a profits interest by a service partner.[24] As noted above, while Prop. Reg. §1.721-1(b)(1) states a service partner's receipt of a capital interest is taxable under Code §83, it says nothing about the receipt of a profits interest, implying receipt of a profits interest was not viewed as taxable by the regulatory draftsmen.[25] In addition, Code §707(a)(2), which in some circumstances treats the receipt of a partnership interest in exchange for services as a transaction between the partnership and one who is not a partner, would largely be unnecessary (at least for the service partner) if all transfers of partnership interests to service providers were subject to tax under Code §83.[26]

While several courts have held that Code §83 applies to the transfer of a profits interest,[27] the courts have also shown a clear reluctance to tax the service partner on receipt, avoiding immediate taxation by valuing the interest on a liquidation basis (so that its value, by definition, is zero) or by finding the transferred interest was incapable of valuation (at least in the absence of special factors indicating its FMV).[28] Moreover, the Eighth Circuit in *W.G. Campbell*, while holding the service partner had no income on valuation grounds, was clearly receptive to various arguments that Code §83 might not apply to the receipt of a profits interest.[29]

In many respects, the question of whether Code §83 applies to the transfer of a profits interest to a service partner has been rendered moot by Rev. Proc. 93-27 and Rev. Proc. 2001-43, which provide, as discussed below, that the receipt of a profits interest by a service partner is generally not taxable. However, Rev. Proc. 93-27 and Rev. Proc. 2001-43 do not state any underlying rationale for their conclusions and do not attempt to reconcile those conclusions with Code §83 and Subchapter K. The two revenue procedures are in the nature of administrative safe harbors, grounded in practical tax policy. Indeed, Rev. Proc. 2001-43 states that its benefits apply only if the partnership, the SP, and the other partners all treat the grant of an unvested profits interest to the SP in a manner consistent with Rev. Proc. 2001-43. This consistency requirement suggests that the IRS is concerned that Rev. Proc. 2001-43 may actually be inconsistent with Code §83, creating some risk the IRS could be subject to a whipsaw in which an SP reports no income on grant or vesting of a profits interest in reliance on Rev. Proc. 2001-43, while the partnership claims a compensation deduction on vesting on the ground that Code §83 applies and no Code §83(b) election was filed.

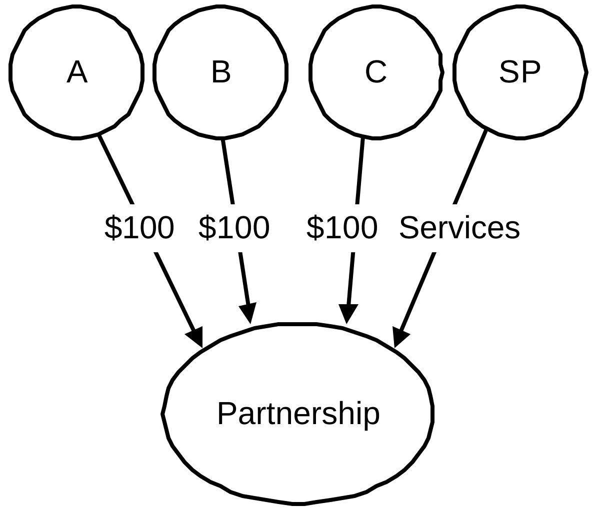
The IRS is currently "studying the extent to which section 83(a) applies to the issuance of certain partnership interests (i.e., a profits interest in a partnership) in exchange for services."[30] The IRS declined to include a cross reference to Code §83(f)'s holding period rules in recent regulations dealing with capital gain and holding period issues for partnerships and S corporations "in order to avoid any implication that section 83(a) applies to all partnership interests issued in exchange for services."[31]

For the remainder of the article, we will assume, except where noted otherwise, that Code §83 applies to the transfer of a partnership interest, whether a capital or profits interest, by a partnership to a service partner. Even those who would argue that Code §83 does not apply to a service partner's receipt of a partnership interest need to consider the risk that it does apply and the related tax consequences.

B. Transfers of a Capital Interest

While the transfer of a capital interest to a service partner ("SP") in compensation for services clearly results in the recognition of OI by the service partner under Code §83, there remain a number of important issues that are unclear. We would like to illustrate and analyze these and other issues through a series of simple, but concrete, examples.

<u>Example 1: Transfer of a Simple Capital Interest</u>. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. Under the partnership agreement, A, B, C and SP are entitled to identical allocations and distributions.



SP receives a capital interest in the partnership, because if the partnership were liquidated, SP would receive $75 cash (one-fourth of the $300 cash held by the partnership) and one-fourth of any other partnership assets. While it is clear that SP realizes OI on receipt of the capital interest, it is not entirely clear how much income SP recognizes.

One possibility is that SP simply recognizes $100 of OI, on the ground that the FMV of the partnership interest received by SP is $100 (because it is identical to the interest of A, B, and C and they each paid $100 for their interests) and SP paid nothing for it.[32] Code §83(a) suggests this approach, providing that a service provider recognizes income equal to the difference between the "fair market value of [the transferred] property" (here the partnership interest) and "the amount (if any) paid for such property."

A second possibility is that SP recognizes $75 of OI, on the ground that it is the value of the assets that would have been distributed to SP on liquidation of the partnership ($300 cash x 1/4).[33] Regulations under Code §721 support use of liquidation value to compute SP's OI, indicating that an SP recognizes OI equal to the FMV of the interest in capital received:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership ... whether made at the formation of the partnership or subsequent thereto. 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..., 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 61. The amount of such income is the *fair market value of the interest in capital* so transferred...

(emphasis added).[34] Assuming that the payment of compensation (through the transfer of a capital interest) to SP is not treated as creating a capitalized asset for the partnership, the total capital of the partnership is $300 and the liquidation value of SP's one-fourth interest in such capital is $75.

Use of liquidation value to measure SP's OI is consistent with the principles of Rev. Proc. 93-27, which provides that an SP is generally not taxed on receipt of a profits interest.[35] A, B, and C were each willing to pay $100 for a partnership interest in this example because they each received an interest in partnership capital worth $75 (after the capital shift to SP) and an interest in future partnership profits that must, on these facts, be worth $25. If we similarly bifurcate SP's partnership interest into a $75 capital interest and a $25 profits interest, it is appropriate to tax SP on receipt of the $75 capital interest but not the $25 profits interest.

Thus, we believe that the better answer is that SP's OI is based on the liquidation value of the transferred partnership interest rather than its FMV. This result is also strongly supported by the analysis of SP's capital account, as discussed below.[36] Of course, if the partnership's compensation expense results in the creation of a capitalized asset for the partnership, the liquidation value of SP's partnership interest would be greater than his share of partnership cash to the extent that SP was also entitled to a share of the capitalized asset. If the FMV of the capitalized asset is equal to the OI recognized by SP, on the facts of Example 1, SP would recognize $100 of OI.[37]

Two additional and related questions remain: what is SP's capital account determined in accordance with the Code §704(b) regulations and how should the partnership allocate the compensation deduction to which it is entitled under Code §83(h)?

The Code §704(b) regulations do not explicitly address how to determine SP's capital account in this context. Where there is no other guidance, Treas. Reg. §1.704-1(b)(2)(iv)(q) states that capital accounts should be determined so that capital accounts:

- are "consistent with the underlying economic arrangement of the partners," and
- contain the same total capital reflected on the partnership's book balance sheet.[38]

In Example 1, the first requirement indicates that SP's capital account, after formation of the partnership, must be identical to the capital accounts of A, B and C because SP's partnership interest is identical to the partnership interests of the other partners. The second requirement should be met if SP receives a capital account equal to the amount of OI recognized by SP, less the portion, if any, of the partnership's compensation deduction allocated to SP. The simplest way to insure that both requirements are met, in a manner consistent with the general capital account maintenance rules of Treas. Reg. §1.704-1(b)(2)(iv), is to adopt a cash purchase model in which SP is treated as receiving cash compensation from the partnership (equal in amount to SP's OI) that SP in turn uses to purchase a capital interest in the partnership.[39]

The partnership is entitled to a deduction under Code §83(h) equal to the OI recognized by SP. There are at least three ways in which the partnership could allocate the deduction among its partners:

- The partnership might seek to allocate the deduction solely to SP in an attempt to offset the OI recognized by SP.

- The partnership might seek to allocate the deduction equally to all partners, including SP, on the ground that each has an identical partnership interest and hence an identical right to distributions and allocations.

- The partnership might seek to allocate the deduction to A, B, and C on the ground that they have borne the expense of any capital shift in favor of SP.

The proper choice appears clear when the impact of the allocation on the partners' capital accounts is taken into account.

If SP recognizes $75 of OI and no capitalized asset is created, the partnership's compensation deduction would also equal $75. If the deduction is allocated solely to SP, the partnership's capital accounts would be as shown in Table 1.

TABLE 1
DEDUCTION ALLOCATED TO SP

	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	75
Deduction	0	0	0	-75
Total	100	100	100	0

This allocation has some appeal, given SP did not actually contribute any cash or property to the partnership. However, this allocation leaves the partners' capital accounts unequal and hence is inconsistent with the economic deal among the partners and should be rejected.[40]

If the deduction is allocated to all partners equally, the partnership's capital accounts would be as shown in Table 2.

TABLE 2
DEDUCTION ALLOCATED TO ALL PARTNERS

	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	75
Deduction	-18.75	-18.75	-18.75	-18.75
Total	81.25	81.25	81.25	56.25

This allocation also produces unequal capital accounts and hence is inconsistent with the partners' economic deal.

If the deduction is allocated solely to A, B and C, the partnership's capital accounts would be as shown in Table 3.

TABLE 3 DEDUCTION ALLOCATED TO A, B AND C				
	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	75
Deduction	-25	-25	-25	0
Total	75	75	75	75

This allocation results in equal capital accounts, consistent with the partners' economic deal, and thus is the proper allocation of the deduction.

Analysis of partnership capital accounts and the allocation of the partnership's compensation deduction also supports using liquidation value to determine SP's OI. To illustrate this point, assume that in Example 1, SP recognizes $100 of OI based on the FMV of the transferred partnership interest. SP's deemed contribution under the cash purchase model is $100 and the partnership has a $100 deduction (assuming the compensation expense does not create a capitalized asset) to allocate among the partners. In this situation, allocating the partnership's $100 deduction solely to A, B, and C produces unequal capital accounts for the four partners and hence is inconsistent with the partners' economic deal (see Table 4).

TABLE 4 DEDUCTION ALLOCATED TO A, B AND C				
	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	100
Deduction	-33.33	-33.33	-33.33	0
Total	66.67	66.67	66.67	100

Capital accounts are also unequal if the deduction is allocated solely to SP (see Table 5).

TABLE 5 DEDUCTION ALLOCATED TO SP				
	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	100
Deduction	0	0	0	-100
Total	100	100	100	0

In this second case, capital accounts are equal only if the deduction is allocated equally to each of the partners, including SP (see Table 6).

TABLE 6 DEDUCTION ALLOCATED TO ALL PARTNERS				
	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	100
Deduction	-25	-25	-25	-25
Total	75	75	75	75

This capital account analysis shows that in net results, it should not matter to SP whether the OI recognized on grant of the partnership interest is $75 or $100, as long as no capitalized asset is created. If the $100 valuation is adopted, SP must be allocated $25 of the partnership's compensation deduction to equalize capital accounts, so that SP's net income is $75 in any event (either $75 of income or $100 of income less a $25 share of the partnership's deduction).

More generally, if the value placed on SP's partnership interest exceeds its liquidation value (i.e., the value of the assets SP would receive in an immediate liquidation of the partnership), SP must be allocated a share of the partnership's compensation deduction equal to the excess in order for capital accounts to be consistent with the economic deal among the partners. Thus, under either method, SP's net income (i.e., OI recognized on receipt of the transferred interest less SP's share of the partnership compensation deduction) should equal the liquidation value of the transferred interest.

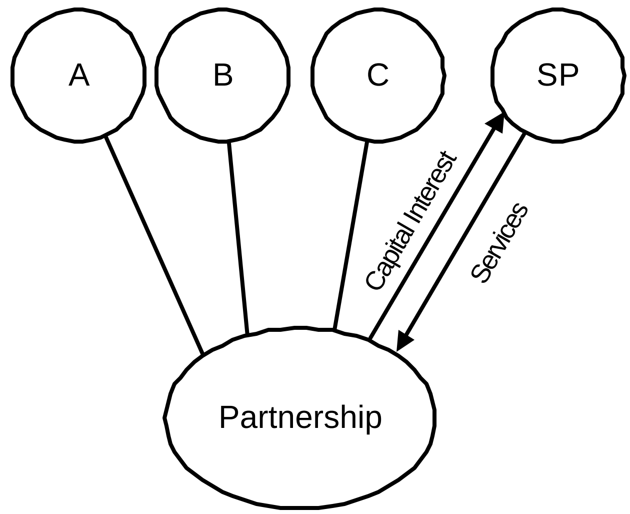
If a capitalized asset is created for the partnership (equal in value to SP's OI), there is, of course, no deduction to allocate, and each of the partners would have a capital account equal to $100, as illustrated in Table 7.

TABLE 7 CAPITALIZED ASSET CREATED				
	A	B	C	SP
Contributions	100	100	100	0
Deemed Contribution/OI	0	0	0	100
Deduction	0	0	0	0
Total	100	100	100	100

While we believe that the method outlined above is clearly the correct manner in which to construct capital accounts in accordance with Code §704(b), care must be taken that the actual allocations, distributions, and related capital accounts provided under the partnership agreement are consistent with this approach and with the partners' economic deal. In particular, because the Code §704(b) regulations do not explicitly provide for the results outlined above, carefully drafted terms in the partnership agreement implementing this approach are advisable and may prevent ambiguity and disagreement later.

Example 1 is simple in that the partnership has only cash assets when SP receives an interest. The analysis becomes more complex if SP receives a capital interest at a time when the partnership has appreciated assets.

<u>Example 2: Transfer of a Capital Interest where Partnership has Appreciated Assets</u>. A, B, and C form a partnership and each contributes $10 for a one-third interest. After the assets of the partnership appreciate to $300 (resulting in $270 of built-in gain in the partnership assets), the partnership transfers a one-fourth interest in allocations and distributions to SP in exchange for services.



SP has received a capital interest in the partnership, since SP would be entitled to receive $75 of assets (1/4 x $300 of partnership assets) from the partnership if it liquidated and hence should recognize $75 of OI (the liquidation value of SP's interest)[41] and the partnership should be entitled to a $75 deduction (assuming no capital asset is created), allocated to A, B and C as described above.[42]

Under Treas. Reg. §1.83-6(b), a person who transfers property to a service provider recognizes gain, unless Code §1032 applies, as if the property were sold for an amount equal to the sum of (i) the amount, if any, paid by the service provider and (ii) the OI, if any, recognized by the service provider. Code §1032 provides that a corporation does not recognize gain when it transfers its own stock in exchange for property and hence does not apply to a partnership transferring an interest in the partnership. Treas. Reg. §1.83-6(b) thus creates an important question.[43] Does the partnership recognize any gain when it transfers a capital interest to SP and, if so, how is the gain determined?

There are at least three theoretical possibilities:

- The partnership recognizes no gain;
- The partnership recognizes gain on a pro rata slice of its assets, as if it had transferred those assets to SP in exchange for services and SP then transferred those assets back to the partnership in exchange for a partnership interest; and
- The partnership recognizes gain equal to the FMV of the transferred partnership interest, as if it transferred an asset with a zero tax basis.

As a practical and policy matter, full gain recognition based on a zero basis model seems highly unlikely. The IRS has generally been reluctant to impose taxation under zero basis theories in other areas.[44] Thus, the real choice is between no gain recognition and gain recognition on a pro rata slice of partnership assets. Of these two choices, while the law is certainly not clear and there is risk a court might disagree, we believe the better answer is that the partnership recognizes no gain on the transfer of a capital interest to SP. We base this conclusion on the similarity in language between Code §721 and Code §1032, the appropriateness of a cash purchase model, the lack of policy reasons for gain recognition and the lack, after 30 years, of case law, rulings and regulations requiring gain recognition.

We start with Code §1032, which provides that a corporation does not recognize gain "on the receipt of money or other property in exchange for stock ... of such corporation." (Emphasis added.) Code §721 contains very similar language, stating that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." (Emphasis added.) Given the similarity in language, Code §721 and Code §1032 should be interpreted in a similar fashion when it comes to the recognition of gain or loss by the entity on transfers of equity interests to service providers.

In the corporate context, the IRS has shown a clear reluctance to tax corporations on the issuance of stock to service providers. Interpretive regulations under Code §1032 state that receipt of "property" for purposes of Code §1032 includes receipt of "services," so that a corporation does not recognize gain when it issues its own stock in compensation for services.[45] The IRS has also extended Code §1032 non-recognition beyond its literal reach to include the issuance of parent stock to subsidiary employees in exchange for services provided to the subsidiary, first by ruling and later by regulation.[46]

In contrast to the regulations under Code §1032, regulations under Code §721 do not state that the receipt of services by the partnership should be treated as the receipt of property. In fact, Treas. Reg. §1.721-1(b)(1) states that Code §721 does not apply in the case of a transfer of a capital interest in compensation for services:

> To the extent that any of the partners gives up any part of his right to be repaid his contributions ... in favor of another partner as compensation for services ..., 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 61. The amount of such income is the fair market value of the interest in capital so transferred...

While this language clearly states that SP recognizes income on receipt of a capital interest for services, we do not read it as requiring the partnership to recognize income.

Code §721 is different from Code §1032 in one key respect. It provides non-recognition both for the partnership and for its partners. In contrast, Code §1032 provides non-recognition treatment only for the corporation, not the recipient of stock. Non-recognition for recipients of stock is provided, if at all, only by other provisions of the Code, e.g., Code §351.

Thus, we believe the quoted regulatory language is intended to clarify that Code §721 does not prevent the recipient SP from recognizing OI on receipt of a capital interest for services. In this respect, the regulatory language quoted is analogous to Code §351(d)(1), which provides that stock issued for services is not treated as issued for property and hence cannot be received tax-free by the service provider under Code §351. There is nothing inconsistent about stating that services are property for purposes of Code §1032 (so that the corporation recognizes no gain) and are not property for purposes of Code §351 (so that it is clear the service provider recognizes OI). Consistent with Code §§1032 and 351(d)(1), we believe that services should be treated as property under Code §721 for purposes of determining whether the partnership recognizes gain and should not be treated as property under Code §721 for purposes of determining whether SP has OI.

We believe that the regulatory language supports, or is at least consistent with, this view. After stating that Code §721 does not apply to the transfer of a capital interest to SP for services, the regulations go on to provide detailed rules about the amount and timing of SP's income. The regulations also state that the value of the capital interest to SP is treated as a guaranteed payment under Code §707(c) if the services are rendered to the partnership. The regulations say nothing at all about whether the partnership recognizes income and, if so, how much. This strongly indicates the regulatory draftsmen believed the partnership would not recognize income in such case. Moreover, this argument is equally strong under the 1971 proposed regulations that will, if finalized, add a reference to Code §83 to the Code §721 regulations.

The fact that Treas. Reg. §1.83-6(b) refers to Code §1032 as the only exception to the gain recognition rule is not fatal to this argument. As noted above, the Code §83 regulations do not refer to partners, partnerships and the transfer of partnership interests and it is clear the regulatory draftsmen did not consider the application of Code §83 in the partnership context.[47] Thus, it is natural that there would be no reference to an exception for gain recognition in the case of a transfer of a partnership interest to SP. Moreover, as discussed above, our reading of Code §721 and the regulations thereunder is consistent with the statutory and regulatory scheme under Code §1032. Thus, the fact that the Treas. Reg. §1.83-6(b) recognizes an exception for Code §1032 supports a similar exception for Code §721.

The cash purchase model we suggested in connection with the capital account analysis for Example 1 also supports no gain recognition by partnership. Under a cash purchase model, the partnership would be viewed as transferring the partnership interest to SP in exchange for cash (which cash SP would have previously received as a compensatory bonus), an exchange that clearly is within the nonrecognition rules of Code §721.[48] The adoption of an explicit cash purchase model is well within the appropriate scope of interpretation of Code §§721 and 83. The IRS recently adopted a cash purchase model in connection with the zero basis regulations under Code §1032 as a conceptual mechanism to avoid gain recognition.[49] These regulations (which deal with both compensatory and non-compensatory situations) were not adopted pursuant to any specific grant of statutory authority and hence are interpretative rather than legislative regulations. Moreover, the IRS had already reached similar results prior to the issuance of the regulations through published and private rulings.[50] Thus, we believe that taxpayers, as well as the courts and the IRS, are entitled to apply a cash purchase model, as a matter of interpretation, to avoid gain recognition under Code §§83 and 721, even in the absence of specific regulations.

Where possible, it is generally advisable for a partnership to pay an actual cash bonus to an SP who can then use the cash bonus to purchase an interest in the partnership, so that the actual form of the transaction is within the scope of non-recognition under Code §721.[51] Of course, there is risk that a court intent on finding gain recognition would collapse the cash bonus and cash purchase, treating the transaction as a simple compensatory issuance of a capital interest.[52]

As a policy matter, there is nothing inherent in the flow-through nature of a partnership that requires gain recognition where a partnership transfers a capital interest to an SP. No corporate-level gain is recognized when an S corporation with appreciated assets transfers stock to an employee.[53] There is little reason for the IRS to favor the use of S corporations over partnerships by mandating gain recognition for a partnership where none would be required for an S corporation.

The form of the transaction and Subchapter K's general treatment of transfers of partnership interests also favors the no gain recognition approach. Gain recognition is predicated on a hypothetical transfer of a slice of partnership assets to SP, a transaction that clearly did not occur. While a transfer of a slice of partnership assets to SP coupled with a recontribution is economically similar in effect to the direct transfer of a partnership interest to SP, the tax law often allows partners and partnerships to choose from among forms that have identical economics, but different tax results.[54] Moreover, if a hypothetical transaction is needed (e.g., to provide a conceptual framework for giving SP a capital account), the cash purchase model is at least as persuasive as a transfer of a slice of assets.[55] The non-recognition approach is also consistent with Subchapter K's general treatment of the transfer of a partnership interest as a transfer of an interest in an entity rather than as a transfer of a share of the partnership's assets.[56]

Finally, although there are many cases discussing the treatment of SP on receipt of a capital interest in a partnership in exchange for services,[57] we have been unable to discover a case or ruling actually requiring a partnership to recognize gain on the transfer of a capital interest to an SP. In addition, as noted above, the Code §721 regulations, while describing in detail SP's recognition of OI on receipt of a capital interest, say nothing about the partnership recognizing gain. This absence strongly suggests that the IRS has chosen, over the years, not to assert that the transfer of a partnership capital interest to SP in exchange for services requires a partnership to recognize gain.

Partner-level gain recognition has been required in one case, *McDougal v. Commissioner*,[58] where an individual and an SP formed a two-person partnership and the individual transferred an interest in appreciated property (a racehorse) to SP in connection with formation of the partnership. Prior to formation of the partnership, SP had performed services for the individual and had been promised, in addition to a cash fee, a half-interest in the property in the future after the individual had recovered his costs of acquiring the property. The court analyzed the transaction as if the individual had first transferred a one-half undivided interest in the appreciated property to SP and the individual and SP thereafter contributed their interests in the property to the newly formed partnership. The individual (not the partnership) recognized gain on the transfer as if the undivided interest had been sold for its FMV and SP recognized OI equal to the value of SP's interest in the appreciated property.

McDougal is distinguishable from Example 2 on the issue of gain recognition in two critical respects.[59] First, in form, the individual transferred an interest in the appreciated property to SP prior to (or perhaps in connection with) the formation of the partnership.[60] Gain was recognized on this partner-to-partner transfer of assets because Code §721 does not apply.[61] Indeed, it would appear that no partnership existed until SP received a share of the appreciated property. Second, the interest in the appreciated property was transferred to SP in exchange for services rendered to the individual (not the partnership) and the individual (not the partnership) had an obligation to transfer an interest in the property to SP. In such case, treating the transaction as one involving a transfer of assets from the individual to SP may be appropriate.

McDougal, however, highlights the increased risk of gain recognition where SP receives a capital interest on formation of a partnership and other partners contribute appreciated assets. While we would allow non-recognition where SP's services are provided to or for the benefit of the partnership, if the parties first contribute the assets to a partnership and then transfer a partnership interest to SP, there is risk a court could disagree.[62] It is certainly easier to recast such a transaction as a transfer of assets to SP than it is to recast the transfer of a partnership interest in an ongoing partnership as a transfer of assets.

On balance, based on the arguments set forth above, we believe that the partnership should not recognize gain in Example 2. We believe this conclusion is consistent with the position routinely taken today by many partnerships that issue capital interests to SPs. Of course, there is certainly some risk, we hope small, that the IRS and/or a court could disagree. We hope the IRS will, as part of its study of partnership options and convertibles announced in Notice 2000-29, issue clear guidance stating that gain recognition is not required.[63]

Under the cash purchase model, SP's capital account in Example 2 should equal the OI recognized on receipt of the capital interest, or $75. However, in contrast to Example 1, merely giving SP a $75 capital account will not cause A, B, C, and SP to have equal capital accounts, as illustrated in Table 8.[64]

TABLE 8
NO CAPITAL ACCOUNT WRITE-UP

	A	B	C	SP
Contributions	10	10	10	0
Deemed Contribution/OI	0	0	0	75
Deduction	-25	-25	-25	0
Total	-15	-15	-15	75

However, because SP is deemed to contribute $75 cash to the partnership in exchange for an interest under the cash purchase model, the partnership is entitled to write up capital accounts under Treas. Reg. §1.704-1(b)(2)(iv)(f).[65] If the partnership writes up capital accounts to reflect the $270 of built-in gain in its assets at the time of the transfer of a capital interest to SP and allocates such built-in gain to the capital accounts of A, B and C, the partners' capital accounts will be equal (which is necessary to reflect the economic deal between the partners). (See Table 9).

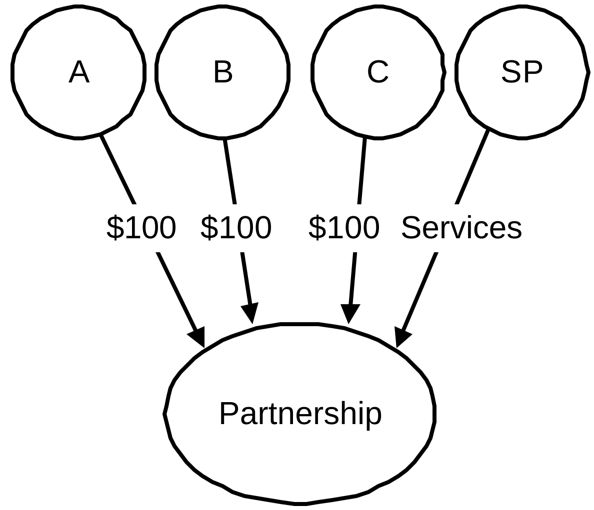
TABLE 9 CAPITAL ACCOUNT WRITE-UP				
	A	B	C	SP
Contributions	10	10	10	0
Deemed Contribution/OI	0	0	0	75
C/A Write Up	90	90	90	0
Deduction	-25	-25	-25	0
Total	75	75	75	75

Because SP has been taxed on the full liquidation value of the capital interest received for services, it would be unfair and duplicative to tax SP on any of the built-in gain in the partnership's assets to the extent that those assets are later sold or disposed of by the partnership. Writing up capital accounts generally solves this problem for SP, since it allows the partnership to apply Code §704(c) principles to allocate built-in gain in its assets to A, B, and C and not to SP (so-called "reverse Code §704(c) allocations").[66]

The Code §704(b) regulations do not, however, require a partnership to write-up capital accounts on admission of a new partner.[67] Depending on how a partnership agreement's capital account, allocation and distribution provisions are drafted, a failure to write up capital accounts on the transfer to SP may have important tax and economic consequences. It could expose SP to risk of taxation on the built-in gain in the partnership's assets by preventing the partnership from using reverse Code §704(c) allocations (although properly drafted special allocations could presumably avoid this problem). It could also increase the amount of the taxable capital shift to SP. For example, assume that the partnership agreement in Example 2 gave SP a $75 capital account on receipt of his capital interest and the partnership did not write up capital accounts. If SP is viewed as entitled to his $75 capital account plus 1/4th of the appreciation in the partnership's assets, the liquidation value of his interest could be $142.50 ($75 + (1/4 x $270 built-in gain)) instead of $75.

In Examples 1 and 2, the partnership interest received by SP was fully vested. The analysis becomes more complex if, as is often the case, SP's partnership interest is subject to vesting restrictions designed to insure that SP performs the agreed services.

Example 3: Transfer of a Capital Interest Subject to Vesting. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. Under the partnership agreement, A, B, C and SP are entitled to identical allocations and distributions. If SP fails to perform services for two years, SP forfeits the partnership interest back to the partnership. The partnership's assets appreciate to $600 at the end of year two.



Measured at formation, SP has received a capital interest, since SP would receive $75 (1/4 x $300 cash) if the partnership liquidated immediately after SP received the partnership interest. However, because SP forfeits the partnership interest back to the partnership if SP does not perform services for two years, SP's interest is subject to vesting restrictions that constitute an SRF within the meaning of Code §83. Thus, the tax consequences to SP and the partnership turn on the timing rules of Code §83.

If SP does not make a Code §83(b) election, SP's OI is measured when the partnership interest vests at the end of year two.[68] Because the partnership's assets have appreciated to $600, the liquidation value of SP's capital interest is $150 on vesting (1/4 x $600) and SP recognizes $150 of OI. The partnership is entitled to a $150 deduction, equal to SP's OI.

Although there was no built-in gain in the partnership's assets when SP received the partnership interest, there is built-in gain in the partnership's assets when the interest vests. Because the Code §83 timing rules measure SP's OI and the partnership's deduction at vesting (where no Code §83(b) election was filed), the vesting restrictions make Example 3 more like Example 2 than Example 1. SP's capital account, the amount of any capital account write-up and the built-in gain for purposes of reverse Code §704(c) allocations should, in this case, all be determined at the time of vesting, not initial grant. Moreover, as discussed above in connection with Example 2, there is a small risk that the partnership may recognize gain at vesting on a slice of its assets attributable to the capital interest transferred to SP.[69]

Under Code §83 principles, SP would apparently not be treated as a partner in the partnership until vesting.[70] A number of important consequences follow. All of the partnership's taxable income and loss prior to SP's vesting would be allocated to A, B and C for income tax purposes and none would be allocated to SP. Any distribution of cash or other property to SP prior to vesting would not be a partnership distribution subject to Code §§731-737; rather it would be treated as a payment of compensation to SP generally causing SP to recognize OI and entitling the partnership to an equal deduction.[71] Allocations of income to SP for partnership book capital account purposes would generally not result in income to SP (provided that distributions related to such allocations remained subject to vesting). However, such allocations would generally increase the taxable capital shift to SP on vesting (and the related deduction to the partnership).

The consequences to SP and the partnership change markedly if SP makes a timely election under Code §83(b).[72] The vesting restrictions are ignored for purposes of determining SP's OI and the partnership's deduction.[73] Thus, on partnership formation, SP recognizes $75 of OI and the partnership is entitled to a $75 deduction. In essence, the Code §83(b) election causes Example 3 to be treated as Example 1.[74] Moreover, if SP makes a timely Code §83(b) election, SP will be treated as a partner from the original transfer of the partnership interest, eliminating the complexities caused by Code §83(f) and related rules. Thus, many partnerships require that an SP make a Code §83(b) election with respect to a partnership interest subject to vesting.

C. <u>Transfers of a Profits Interest</u>

Partnership profits interests come in many varieties.[75] A profits interest may represent a simple constant percentage share of all partnership profits. Alternatively, it may represent a formula share of partnership profits, with the holder's share increasing or decreasing with the level of partnership profits. In some cases, a profits interest receives a share of partnership profits only after the partners providing capital receive a preferred yield on their invested capital.

Although a profits interest, by definition, has no liquidation value, it may be, nonetheless, a valuable property right, since it allows the holder to receive a share of partnership profits without investing (or, in many cases, even risking) any capital. As described in Part A above, prior to the issuance of Rev. Proc. 93-27, the tax treatment of an SP who received a profits interest in exchange for services rendered to a partnership was subject to significant uncertainty and controversy.

The issuance of Rev. Proc. 93-27[76] brought much needed certainty to this confused area. Under its safe harbor, the receipt of a profits interest by an SP is not "a taxable event for [SP] or the partnership" if five conditions are met:

1. SP must receive the profits interest in exchange for "the provision of services to or for the benefit of [the] partnership."

2. The services must be provided by SP "in a partner capacity or in anticipation of being a partner;"

3. SP may not dispose of the profits interest within two years of its receipt;

4. The profits interest must not relate to "a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high quality net lease;" and

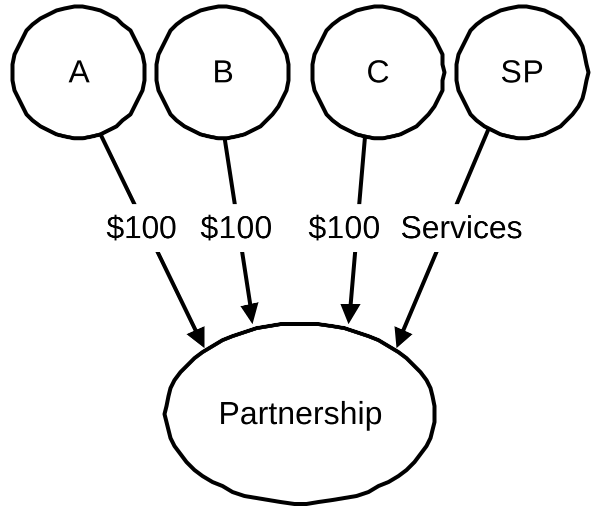
5. The partnership must not be a publicly traded partnership.

The result in Rev. Proc. 93-27 is strongly suggested by capital account analysis. SP's capital account should be zero immediately after receipt of a profits interest, reflecting the fact that SP has made no contribution of property and has no other right to current partnership capital (i.e., the liquidation value of SP's interest is zero). If SP were required to recognize OI on receipt of the profits interest, as if the partnership paid SP a bonus equal to its FMV, SP would apparently receive a capital account equal to the OI recognized (under the cash purchase model discussed in Part B above).[77] The partnership would be entitled to a deduction equal to SP's OI, but would be required to allocate the deduction to SP in order to reduce SP's capital account to zero. Thus, SP's income and deduction would wash. If SP recognized OI, but received no capital account, allocation of the partnership's deduction to SP or the other partners would distort partnership capital accounts so that they would not reflect the economic deal among the partners.

The treatment of SP's receipt of a profits interest under Rev. Proc. 93-27 is significantly better than the treatment of an employee's receipt of corporate stock. While the economics of a profits interest can be approximated in the corporate context by giving investors preferred stock for most of their invested capital and selling investors and the employee "cheap" common stock, the employee will recognize OI under Code §83 equal to the excess of common stock's FMV (not liquidation value) over the amount paid for such stock. In addition, if the common stock layer is too thin, there may be risk that value could be reallocated from the preferred stock to the common stock, creating additional OI for the employee. In contrast, in the partnership context, the fact that partners who provide capital are merely entitled to a return of their capital (but no yield) before SP shares in profits generally does not create an OI risk for SP. Because the partners providing capital are entitled to a return of their capital before SP is entitled to anything, SP's interest is still a profits interest with a zero liquidation value.

Rev. Proc. 93-27 makes compensating SP with a partnership profits interest very attractive. As discussed below, it creates a number of opportunities as well as a few tax issues. For purposes of the examples, we will assume that SP is treated as a partner of the partnership for federal income tax purposes.[78] We will also assume that requirements 3, 4, and 5 of Rev. Proc. 93-27 are met (i.e., SP does not dispose of the partnership interest within 2 years of receipt, the profits interest does not relate to a substantially certain and predictable stream of income, and the partnership is not a publicly traded partnership). Finally, we assume that SP has, or may obtain (through the performance of services), a fully vested interest in future profits and appreciation not thereafter dependent on the performance of additional services.[79]

<u>Example 4: Transfer of a Simple Profits Interest</u>. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. Under the partnership agreement, A, B and C are entitled to return of their capital; thereafter profits (and related distributions) are split equally between A, B, C and SP (1/4th each).



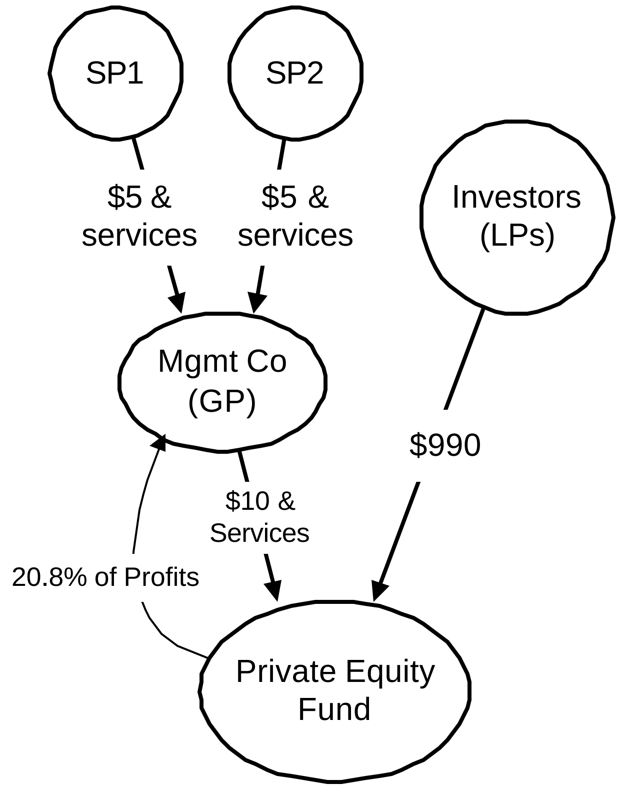
SP receives a profits interest because if the partnership liquidated immediately after formation, the partnership's $300 would be distributed to A, B, and C to return their invested capital and SP would receive nothing. Thus, Rev. Proc. 93-27 applies and SP recognizes no OI on receipt of the interest. Instead, SP will be taxed on his or her share of partnership income under Code §702 and the character of that income will be determined by the character of the partnership's income. Thus, if the partnership recognizes capital gain, SP's allocable share of the gain will also be capital gain, even though the allocation is made for SP's services.[80]

Because SP recognizes no OI on receipt of the profits interest, the partnership is not entitled to any deduction under Code §83(h). However, the amount of income included by A, B, and C in the future will be reduced by allocations of partnership income to SP. In addition, the partnership does not recognize any gain with respect to the issuance of the profits interest to SP.[81]

As we noted in Part A above, a profits interest received by SP may become a capital interest over time, as the partnership's assets appreciate or the partnership retains its earnings. Assume after formation of the partnership in Example 4, it breaks even on day-to-day operations for three years, while its assets appreciate in value to $600, at which point the partners decide to liquidate the partnership, distributing to each partner a share of the partnership assets in kind. A, B, and C would be entitled to receive $175 in assets each ($100 capital contribution + 1/4 x $300 appreciation in the partnership assets) and SP would be entitled to receive $75 in assets (1/4 x $300 appreciation in the partnership assets).[82] Because SP receives the distribution of assets as a partner, it should generally be tax-free under Code §731 and the same should generally be true for A, B and C.[83] On these facts, SP would take a zero basis in his or her share of the distributed assets.[84]

In many cases, SP will also make a capital investment in the partnership in addition to receiving a profits interest.[85] For example, the managers of a private equity fund generally make a capital investment in the fund and receive both a carried interest in fund profits and a return on their invested capital.

<u>Example 5: Profits Interest with Purchased Capital Interest and Tiered Partnerships</u>. SP1 and SP2 form a partnership, MgmtCo, to serve as the general partner of a private equity fund partnership. SP1 and SP2 contribute $5 each to MgmtCo, which MgmtCo in turn invests in the fund. Limited partner investors contribute $990 to the fund. MgmtCo is entitled to 20% of the fund's profits as a carried interest and a share of the fund's profits (after carried interest) in proportion to contributed capital. Thus, MgmtCo receives 20.8% of the fund's profits (20% carried interest plus 1% x (100% - 20%) of profits). All partners in the fund (including MgmtCo) are entitled to a return of their invested capital before MgmtCo is entitled to carried interest profits. SP1 and SP2 share all allocations and distributions from MgmtCo equally.

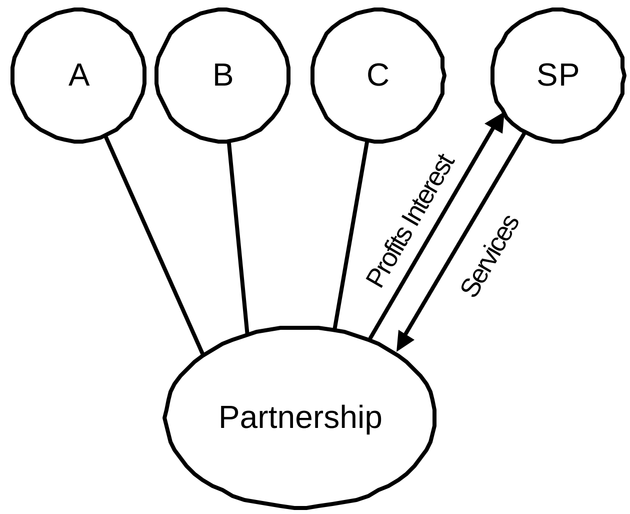


If the private equity fund and MgmtCo were liquidated immediately after formation, SP1 and SP2 would merely receive back their contributed capital ($5 each). Under a literal reading of Rev. Proc. 93-27, SP1 and SP2 have capital interests because they are entitled to a share of partnership capital on liquidation.[86] However, their interest in partnership capital is exactly equal to the amount they contributed. It would clearly make no sense to deny SP1 and SP2 the benefits of Rev. Proc. 93-27 with respect to their carried interest merely because they have also purchased a capital interest with a liquidation value exactly equal to the value of their contributions. Thus, we would bifurcate SP1's and SP2's partnership interest into a purchased capital interest (resulting in no OI since they paid an amount equal to the liquidation value of the capital interest) and a profits interest (here the carried interest) received tax-free under Rev. Proc. 93-27. Even if SP1 and SP2 were technically denied the benefits of Rev. Proc. 93-27 as a result of their purchased capital interest, the capital account analysis discussed above in connection with Example 1 indicates that their OI should be measured by the excess of the liquidation value of their interest (here $5 each) over the amount they paid for the interest (here also $5), so again they should recognize no OI.

Example 5 contains a subtler issue produced by the tiered-partnership structure.[87] The assets of MgmtCo include both its $10 capital interest in the fund and its carried interest in fund profits. MgmtCo's carried interest in fund profits is an asset that likely has significant value and, if this carried interest value is taken into account in determining the liquidation value of the MgmtCo interests received by SP1 and SP2, SP1 and SP2 would potentially recognize significant OI. While SP1 and SP2 could clearly avoid this risk by becoming direct general partners of the fund, we see no reason, policy or otherwise, to force them to do so in order to avoid the recognition of OI on formation of a fund. Thus, we would look through a tiered-partnership structure in applying Rev. Proc. 93-27 or, equivalently, we would value MgmtCo's interest in the fund on a liquidation basis in determining the liquidation value of SP1's and SP2's interests in MgmtCo.

Examples 4 and 5 involve the issuance of profits interests to SPs on formation of a partnership. Profits interests are also issued to SPs by existing partnerships. The existence of appreciated assets complicates the analysis.

<u>Example 6: Profits Interest where Partnership has Appreciated Assets</u>. A, B, and C form a partnership and each contributes $10 for a one-third interest. After the assets of the partnership appreciate to $300 (resulting in $270 of built-in gain in the partnership assets), the partnership transfers to SP, in exchange for services, a one-fourth interest in future profits (and related distributions) after A, B and C receive the $300 of existing value.



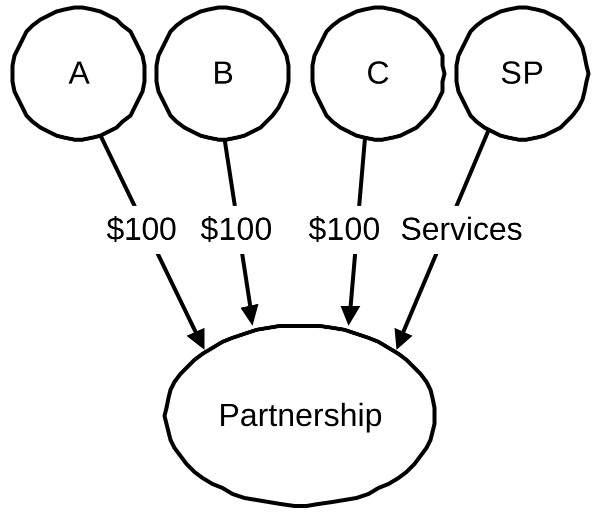
SP receives a profits interest because, if the partnership were liquidated immediately after SP received the interest, A, B, and C would receive the $300 of partnership assets (including the $270 of built-in gain) and SP would receive nothing. Thus, SP recognizes no OI and the partnership has no deduction.

The partnership is not entitled to write-up capital accounts and apply reverse Code §704(c) allocations to allocate built-in gain to A, B, and C when it is later recognized, because SP makes no actual or deemed contribution to the partnership.[88] However, as long as SP's interest is a true profits interest, SP has no economic interest in existing capital and built-in gain. Any built-in gain, as it is later recognized, ought to be allocated to A, B and C under normal Code §704(b) principles. Insuring that this is the case generally requires careful drafting of the partnership's allocation and distribution provisions.

To achieve this result, the partnership agreement should allocate the built-in gain in the partnership's assets to A, B, and C. Alternatively, if the partnership agreement uses "distribution-driven" or "forced" allocations,[89] the agreement could provide that the first $300 of distributions attributable to disposition proceeds[90] from the partnership's assets will be made to A, B, and C and that all other distributions will be made equally to all four partners. If neither approach (or equivalent) is used, SP may be entitled to a share of built-in gain under the agreement and SP's interest may not be a profits interest at receipt (with the consequences discussed in Part B, Example 2 above).

A partnership will often impose vesting restrictions on SP's ability to retain the profits interest in order to insure that SP performs the agreed services. Such vesting restrictions raise the issue of whether the timing rules of Code §83 apply.

Example 7: Transfer of a Profits Interest Subject to Vesting Restrictions. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. Under the partnership agreement, A, B and C are entitled to return of their capital; thereafter profits (and related distributions) are split equally between A, B, C and SP (1/4th each). SP forfeits the interest if SP fails to perform services for the partnership for two years. The partnership's assets appreciate in value to $600 at the end of year two.



Although in our experience, vesting restrictions are the norm, Rev. Proc. 93-27 did not address the effect of vesting on SP's and the partnership's tax consequences. Rev. Proc. 93-27 states that the determination of whether a partnership interest is a capital interest or a profits interest is "generally made at the time of receipt of the partnership interest." It is unclear whether the use of the word "generally" was intended to allow the Code §83 timing rules to govern when to measure whether SP's interest is a profits interest (by acknowledging such determination could be made at a time other than receipt) or, perhaps more likely, was intended to leave the question ambiguously unanswered.[91]

If the Code §83 timing rules govern and if SP does not make a Code §83(b) election, SP's interest will be tested on vesting at the end of year two. At that point, SP's interest will be a capital interest since SP would receive $75 on liquidation of the partnership (1/4 x $300 of appreciation in the partnership's assets). SP thus would recognize $75 of OI and the partnership would be entitled to a $75 deduction, allocated to A, B, and C.[92] In addition, as discussed in Example 3, SP would apparently not be treated as a partner until the interest vests.[93]

In contrast, if SP makes a timely Code §83(b) election with respect to the receipt of the partnership interest[94] (or if the Code §83 timing rules do not apply), SP's interest will be tested on receipt when it is clearly a profits interest. SP will recognize no OI on receipt under Rev. Proc. 93-27, the partnership will have no deduction and SP will be recognized as a partner for tax purposes from the initial transfer.

The IRS issued Rev. Proc. 2001-43 to clarify the application of Rev. Proc. 93-27 to grants of unvested profits interests.[95] Under Rev. Proc. 2001-43, the IRS will treat SP as receiving an unvested profits interest on its grant date and "will not treat the grant of the interest or the event that causes the interest to become substantially vested ... as a taxable event for [SP] or the partnership" provided that each of the following conditions are met:

1. Both the partnership and SP treat SP as the owner of the profits interest from its grant date and SP "takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that [profits] interest in computing [SP's] income tax liability" for all periods during which SP holds the interest.[96]

2. "[N]either the partnership nor any of the partners deducts any amount (as wages, compensation or otherwise) for the fair market value of the [profits] interest" at grant or on vesting.

3. All conditions set forth in Rev. Proc. 93-27 are satisfied.

Rev. Proc. 2001-43 states that an SP "to which this revenue procedure applies need not file an election under section 83(b) of the Code."

While we welcome Rev. Proc. 2001-43 as good practical tax policy, unfortunately it leaves a number of questions and risks for taxpayers in practice. First, like Rev. Proc. 93-27, Rev. Proc. 2001-43 is an administrative safe harbor and does not state any rationale for its conclusions. While it is tempting to conclude that the IRS believes Code §83 does not apply to the grant of a profits interest to an SP, the most that can be said is that the IRS has determined the timing rules of Code §83 should not, as a matter of tax policy, apply to the grant of an unvested profits interest to an SP who comes within the terms of Rev. Proc. 93-27 and Rev. Proc. 2001-43. Indeed, Rev. Proc. 2001-43 contains some suggestion that the IRS is worried Code §83 may, under a literal reading, apply to the grant of a profits interest. Rev. Proc. 2001-43 provides that its benefits apply only if the partnership, the SP, and the other partners all treat the grant of an unvested profits interest to the SP in a manner consistent with Rev. Proc. 2001-43 (i.e., conditions one and two above are satisfied). Absent this consistency requirement, the IRS is apparently concerned it could be subject to a whipsaw in which an SP reports no income on grant or vesting of a profits interest in reliance on Rev. Proc. 2001-43, while the partnership claims a compensation deduction on vesting on the ground that Code §83 applies and no Code §83(b) election was filed.

Second, Rev. Proc. 2001-43's consistency requirement creates the risk that an SP who relies on the revenue procedure and does not file an election under Code §83(b) on receipt of an unvested profits interest could lose the benefits of the revenue procedure's safe harbor (with potentially disastrous tax consequences if the partnership's assets appreciate significantly between grant and vesting) merely because the partnership or one of its partners (perhaps a former partner who left the partnership on poor terms but retained a partnership interest) claims a compensation deduction on grant or vesting. An SP can obtain some protection from inconsistency if the partnership and its partners agree contractually (in the partnership agreement or a side agreement) to treat the grant and vesting of the profits interest in a manner consistent with Rev. Proc. 2001-43. However, the costs of obtaining such an agreement, monitoring it, enforcing it, and claiming damages if it is breached appear to significantly exceed the costs of filing an election under Code §83(b) that should avoid the issue altogether.

Third, Rev. Proc. 2001-43 applies only if all of the requirements of Rev. Proc. 93-27 are satisfied, which means that all of the ambiguities created by Rev. Proc. 93-27 must be addressed prior to the reliance on the seemingly simple rules of Rev. Proc. 2001-43. For example, the safe harbor of Rev. Proc. 2001-43 could be lost (on the grounds that the conditions of Rev. Proc. 93-27 are not met) where:

- SP's services are not provided "to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner,"

- SP leaves within 2 years of the grant of the profits interest and is required to sell the profits interest back to the partnership,

- SP purchases a capital interest at the same time SP receives a profits interest (if the IRS refuses to bifurcate the interest into separate capital and profits interests), or

- The IRS argues SP received a capital interest (rather than a profits interest) in an existing partnership, because the IRS disagrees on audit with the partnership's valuation of its assets and argues that SP received an interest in existing capital appreciation.

While these ambiguities also exist under Rev. Proc. 93-27, the consequences of being wrong under Rev. Proc. 2001-43 may be more severe (and more easily avoided). An SP who does not file a Code §83(b) election in mistaken reliance on Rev. Proc. 2001-43 could be required to recognize huge amounts of OI if the partnership's assets appreciate between grant and vesting. In contrast, an SP who files a Code §83(b) election and later finds that Rev. Proc. 93-27 does not apply may still argue, as discussed above, that the profits interest should be valued on a liquidation basis or that the profits interest is incapable of valuation. In addition, even if the partnership interest is found to be a capital interest, the SP should, based on the Code §83(b) election, be entitled to value the partnership interest at grant when its value may be significantly lower than at vesting.

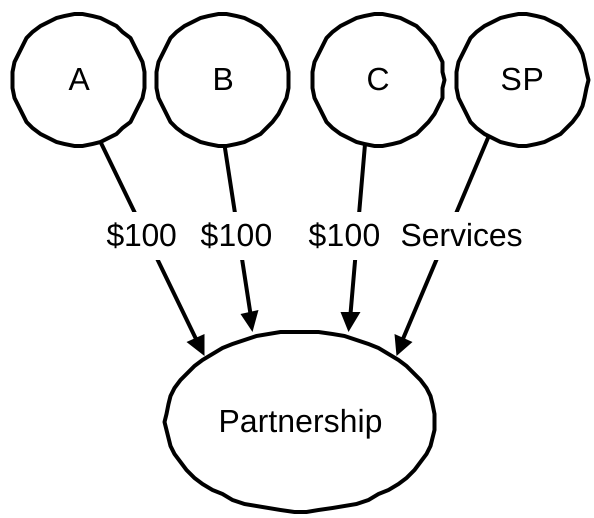
Taxpayers should be entitled to rely on Rev. Procs. 93-27 and 2001-43, at least when they are squarely within the terms of the revenue procedures.[97] In addition, as a practical matter, having openly invited taxpayers not to file Code §83(b) elections with respect to profits interests, we hope the IRS would be slow to deny the benefits of Rev. Proc. 2001-43's safe harbor to an SP on the basis of the ambiguities set forth above.[98] Thus, on the facts of Example 7, Rev. Proc. 2001-43 should generally apply (assuming the Rev. Proc. 2001-43 consistency requirements are met) and SP should recognize no OI on the grant or vesting of the profits interest, whether or not SP files a Code §83(b) election with the IRS. In addition, SP should be regarded as a partner of the partnership from the grant date and, while the partnership will not be entitled to any deduction, the amount of partnership income allocated to A, B, and C will be reduced by allocations of income to SP in respect of its profits interest.

However, because of the ambiguities outlined above, we generally continue to recommend that an SP file a Code §83(b) election with respect to the receipt of an unvested profits interest. The risk of falling outside Rev. Proc. 2001-43's safe harbor (with its potentially high tax cost) can be eliminated entirely by filing a simple Code §83(b) election with little cost (i.e., SP should report no income as a result of the election based on Rev. Proc. 93-27).

If the IRS would like to reduce the number of Code §83(b) elections it receives with respect to unvested profits interests, it should consider modifying Rev. Proc. 2001-43 to provide greater certainty to taxpayers. For example, the IRS could provide that the consistency requirement of Rev. Proc. 2001-43 is deemed met if the SP and the partnership agree contractually (either in the partnership agreement or in a side agreement) to treat the grant and vesting of the profits interest in accordance with Rev. Proc. 2001-43. In addition, the IRS could provide that where an SP fails to file a Code §83(b) election in reliance on Rev. Proc. 2001-43 and is later found to be outside the terms of the safe harbor (e.g., because one of the conditions set forth in Rev. Proc. 93-27 is not met), the IRS will deem a Code §83(b) election to have been made.

In many cases, a partnership would like to grant SP an interest in existing capital, but does not want SP to recognize OI. It is generally possible to grant a profits interest to SP that disproportionately allocates profits to SP, until SP catches up to the desired level of capital. Depending on the parties' expectations as to the future level of partnership profits, such catch-up allocations may approximate the economics desired by the parties without creating OI for SP on receipt of the partnership interest.

Example 8: Profits Interest with Catch-Up Allocations. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. Under the partnership agreement, A, B and C are entitled to return of their capital; the first $100 of profits are allocated to SP; thereafter, profits (and related distributions) are split equally between A, B, C and SP (1/4th each).



SP has received a profits interest within the meaning of Rev. Proc. 93-27. If the partnership were liquidated, A, B, and C would receive the $300 of partnership cash as a return of their capital and SP would receive nothing. Thus, SP should recognize no OI on receipt of the interest. However, if the partnership has at least $100 in profits, SP's capital account will catch up to A, B, and C's capital accounts and thereafter the partners' capital accounts will remain equal (see Table 10).

TABLE 10 CATCH-UP ALLOCATIONS				
	A	B	C	SP
Contributions	100	100	100	0
1st $100 of Profits	0	0	0	100
2nd $100 of Profits	25	25	25	25
Total	125	125	125	125

By taking the economic risk that the partnership may not have enough profits to allow a catch-up, SP has avoided the upfront recognition of OI that would occur if SP received a capital interest identical to those of A, B and C. If the partnership's profits are sufficient (i.e., at least $100), SP will ultimately be entitled to the same aggregate distributions as A, B and C.

In certain cases, there may be some risk that temporary catch-up allocations and related distributions to SP could be viewed as Code §707(a) payments from the partnership to a person who is not a partner.[99] This risk should generally be small if the catch-up allocations are subject to significant entrepreneurial risks, SP is expected to be a partner for a significant period of time with a significant continuing interest in partnership profits, and SP does not perform similar services for other persons in a non-partner capacity.[100] If Code §707(a) were to apply, SP would generally be treated as receiving OI fee income rather than catch-up partnership allocations and distributions. For a cash method SP, there may be little harm in such characterization, unless the catch-up allocations would otherwise have been made from partnership capital gain.[101]

A number of choices must be made in designing a profits interest for SP with catch-up allocations. These choices are important because they determine (i) the level of certainty that SP will catch up (or, equivalently, the economic risk that SP will not catch up) and (ii) the character and timing of taxable income resulting from catch-up allocations.

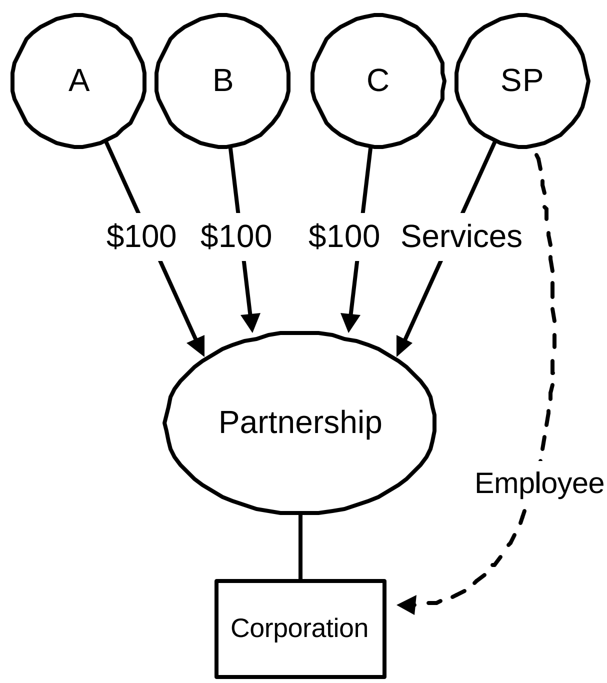
First, the parties must determine the source of catch-up allocations. If the partnership has built-in gain in its assets when it issues the partnership interest with catch-up allocations to SP (a situation not present on the facts of Example 8), SP's interest will be a profits interest only if the catch-up allocations cannot be made from built-in gain. Catch-up allocations could be made from any and all partnership income and gains (other than built-in gain), if SP wants the greatest certainty that he or she will catch up. However, this approach may also increase the likelihood that SP recognizes OI as a result of catch-up allocations (e.g., if ordinary partnership operating income is allocated to SP as part of the catch-up allocations) and may also result in such allocations being made earlier rather than later. Alternatively, catch-up allocations could be made to SP only out of gain from the sale of partnership assets (and not from ordinary partnership operating income). Under this alternative, SP would increase the chance that catch-up allocations would be made out of partnership capital gain income and possibly defer recognition of catch-up allocations as compared to the first alternative. The cost to SP of these benefits is increased risk that there will be insufficient partnership income available to make catch-up allocations. Of course, the partnership and SP could mix these two approaches or agree to make catch-up allocations out of any other designated pool(s) of partnership income.

The partners should also consider whether the catch-up allocations will be made out of future "gross profits" or "net profits" of the partnership. Either choice is consistent with SP's interest being a profits interest under Rev. Proc. 93-27. Use of gross profit allocations may increase the likelihood that SP catches up, since the partnership may have gross profits on one or more assets (excluding built-in gain) even if the partnership has an aggregate net loss.[102] However, use of gross profit allocations may, in some cases, create an increased risk that such allocations and related distributions are seen as a Code §707(a) transaction between the partnership and one who is not a partner. We note the legislative history of Code §707(a)(2)(A) acknowledges that allocations of gross income may appropriately be treated as a partnership distributive share if they "represent an entrepreneurial return" or if they involve "significant entrepreneurial risk."[103]

Finally, the partners need to determine whether SP will be entitled to 100% of the partnership income out of which catch-up allocations and distributions are to be made or some lesser percentage (e.g., 95% or 90%). Again, a higher percentage will generally give SP greater certainty of catching up. However, in situations where there are reasons to fear recharacterization under Code §707(a), giving SP a smaller percentage may decrease the Code §707(a) risk.

In Examples 4 through 8, SP is a partner in the partnership and performs services for the partnership. The application of Rev. Proc. 93-27 and Rev. Proc. 2001-43 is more complex if SP also has other roles, for example, as an employee of a related corporation.

<u>Example 9: Profits Interest Where SP is also an Employee</u>. A, B, C and SP, a service partner, form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership and its subsidiaries. Under the partnership agreement, A, B and C are entitled to return of their capital; thereafter profits (and related distributions) are split equally between A, B, C and SP (1/4th each). The partnership uses a portion of its capital to purchase 80% of the stock of a corporation. SP becomes president and CEO of the corporation.

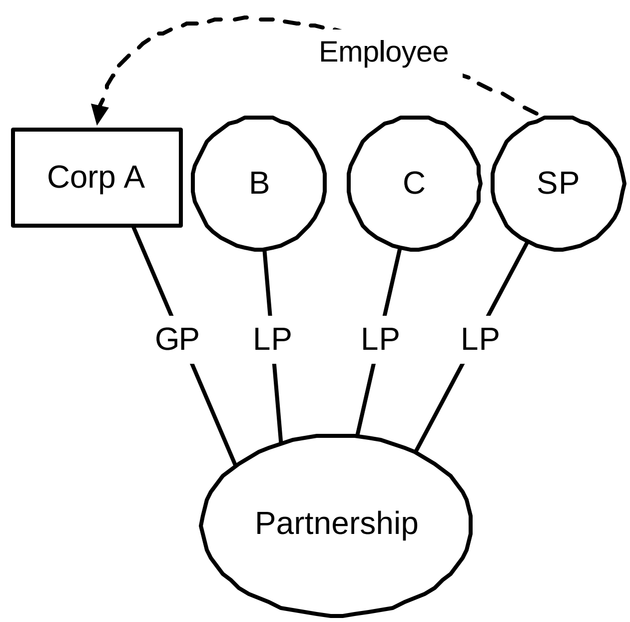


SP receives a profits interest in the partnership because SP would receive no assets if the partnership were liquidated immediately after SP's receipt of the partnership interest. However, as noted above, Rev. Proc. 93-27 applies to eliminate SP's OI risk only if SP receives the profits interest "for the provision of services to or for the benefit of [the] partnership in a partner capacity or in anticipation of being a partner."

On the facts of Example 9, we believe that Rev. Proc. 93-27 should apply, so that SP recognizes no OI.[104] SP performs at least some services directly for the partnership. In addition, services SP performs for the corporation should be regarded as "for the benefit of [the] partnership" since the corporation is a subsidiary of the partnership. While a portion of SP's services are performed in an employee capacity, rather than in a partner capacity, Rev. Proc. 93-27 does not require that all services actually be performed as a partner, since it also covers services performed "in anticipation of being a partner." Moreover, we see no policy reason to deny the benefits of Rev. Proc. 93-27 to SP in this case.

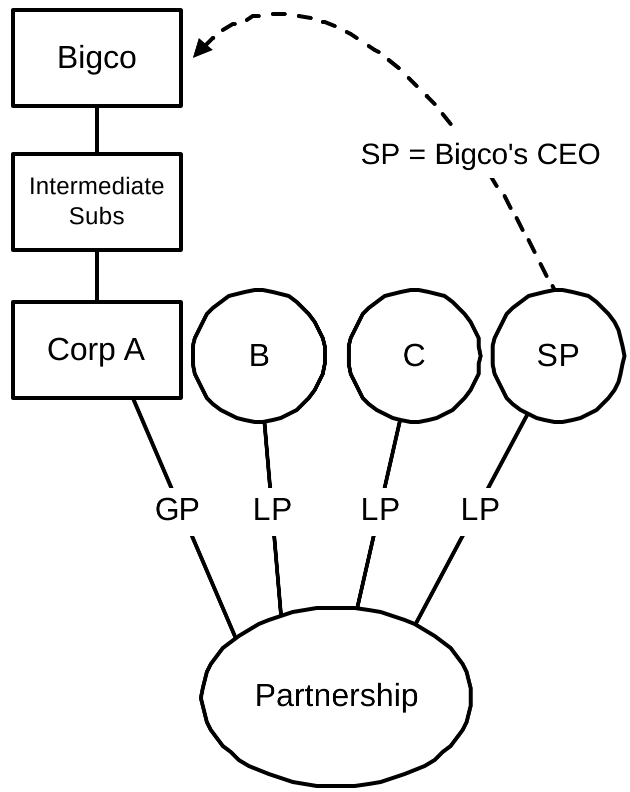
If the partnership owns no assets other than the stock of the corporation and if there is no non-tax business purpose for the existence of the partnership, there may be a risk the IRS would attempt to apply the partnership anti-abuse regulations to disregard the partnership.[105] In such a case, SP might be viewed as receiving stock in the corporation, subject to tax under Code §83.[106] In most cases, this risk will be small. There are generally non-tax reasons for creating the partnership.[107] Indeed, the difficulty of creating a stock interest for SP with the exact economic attributes of a pure profits interest may itself be a business reason for creating the partnership.[108] Moreover, the anti-abuse regulations generally apply only where there is a principal purpose to reduce the aggregate taxes of the partners. In this context, such overall tax reduction may often not occur. Any OI that would have been recognized by SP without the partnership would have produced an equal deduction under Code §83(h) for the corporation (subject, of course to capitalization rules and other general limits).

In general, where SP performs employee services related to the partnership's business, we believe that such services are for the benefit of the partnership and that SP should, therefore, be entitled to the benefits of Rev. Proc. 93-27. For example, SP may perform employee services for the corporate general partner of a limited partnership:



Such a structure might be adopted for significant non-tax reasons, for example, to minimize SP's exposure to partnership liabilities. Provided that the services performed by SP are related to the partnership's business, Rev. Proc. 93-27 should apply to SP's receipt of a profits interest in the partnership.

On the other hand, where SP performs no services for the partnership and SP's employee services are unrelated to the partnership's business, Rev. Proc. 93-27 should not apply. Thus, where SP is the CEO of the ultimate parent of the partnership's corporate general partner and performs no services related to the partnership's business, Rev. Proc. 93-27 should not apply to a the grant of a profits interest to SP. In such case, Code §83 principles are likely to apply.



D. Options on Partnership Interests and Partner-to-Partner Transfers

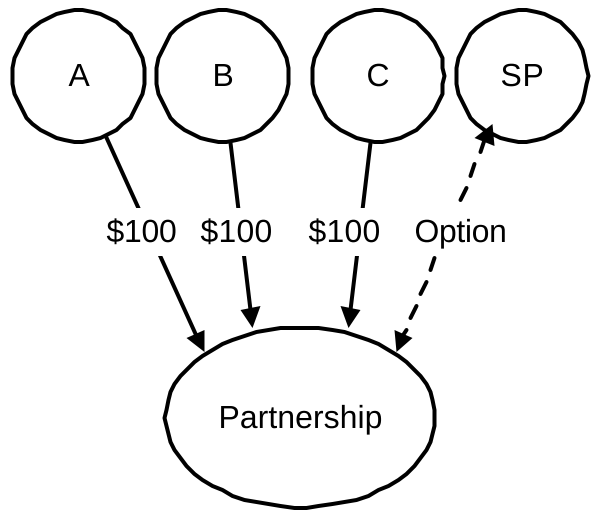
For a variety of business reasons, a partnership may want to reward a service provider with an option to acquire an interest in the partnership. The opportunity to share in the appreciation of the partnership's business and assets without risking capital may be attractive to the service provider and the option creates an incentive for the service provider that is largely aligned with the interests of the partnership's other owners.[109] Moreover, in recent years, options have been very popular in general and much in the news, creating a demand for options even in situations where there are more tax-efficient alternatives.

In theory, an option can be granted on either a capital interest or a profits interest. We will concentrate on options on a capital interests for two reasons. First, even if the underlying partnership interest is a profits interest at grant, it is likely to be a capital interest by the time of exercise when tax consequences generally arise.[110] Second, because a partnership can grant a profits interest to SP without creating OI on receipt for SP, it seems likely that the partnership would simply grant the profits interest to SP and not make it the subject of an option.

Drafting an option on a partnership interest is a complex task and is normally much more difficult than drafting an option on a share of common stock in the corporate context. It requires an understanding of the parties' economic deal, the partnership's allocation, distribution and capital account mechanics and the interaction of those mechanics with the purchase of a partnership interest on exercise of the option (including, e.g., the initial capital account to be given to SP on exercise of the option and the impact of writing up (or not writing up) capital accounts on option exercise).

There is little direct authority on the tax treatment of compensatory options in the partnership context. However, exercise of an option is simply the purchase of a partnership interest for an amount equal to the exercise price and generally should be analyzed accordingly.

<u>Example 10: Option on a Partnership Interest</u>. A, B and C form a partnership. A, B and C contribute $100 each to the partnership's capital. SP agrees to perform services for the partnership. The partnership grants SP an option to acquire a 25% interest in the partnership which interest will entitle SP to 25% of all partnership distributions after exercise of the option. The partnership's assets appreciate in value to $600 at the end of year two and SP exercises the option.



SP should recognize no income or gain on receipt of the option, provided the option has no readily ascertainable FMV.[111] When SP exercises the option, SP purchases for $100 a capital interest in the partnership with a liquidation value equal to $175 (1/4 x ($100 exercise price + $600 in other partnership assets)). SP thus recognizes $75 of OI and the partnership is entitled to a $75 deduction.

The partnership has appreciated assets at the time the option is exercised. Thus, there is some risk, we hope small, that the partnership recognizes gain on the option exercise. However, the risk of gain should be smaller in the context of an option exercise than it is in the context of a pure grant of a capital interest (as described in Example 2) for two reasons. First, by paying the exercise price of the option, SP has purchased a portion of the partnership interest received for cash. The partnership should recognize no gain on the purchase of an interest for cash. Thus, if gain recognition is required in Example 10, the partnership should recognize only $37.50 of gain. Second, SP exchanges the option for the balance of the partnership interest received. While the option is not property for purposes of Code §83 (and hence the exchange of the option for a partnership interest would not reduce SP's OI), the option might be property for purposes of Code §721, eliminating gain recognition for the partnership.

Under the cash purchase model, SP should receive a Code §704(b) capital account equal to $175, the sum of SP's $100 contribution to the partnership plus $75 OI recognized. The partnership should generally write-up capital accounts[112] as of exercise of the option and apply reverse Code §704(c) allocations to avoid taxing built-in gain to SP. See Example 2 above.

An option on a partnership interest is economically similar to a profits interests in many respects. In Example 10, if the partnership had given SP a one-fourth interest in partnership profits (after A, B, and C received their $300 capital back) rather than an option, SP's partnership interest would have had a liquidation value of $75 at the end of year two (assuming partnership operations broke even), an amount equal to the spread in SP's option at the end of year two.

Both an option and a profits interest generally share in partnership appreciation (unless, perhaps, in the case of an option, the partnership sells assets and distributes the proceeds before exercise of the option). However, if SP holds an option, pre-exercise appreciation will be taxed as OI. In contrast, if SP owns an equivalent profits interest, SP may recognize capital gain to the extent that (i) the partnership sells a capital asset, (ii) SP sells the partnership interest, or (iii) the partnership distributes assets in kind to SP and SP later sells them. SP's holding period for a profits interest begins on receipt of the interest, while SP's holding period for a partnership interest received on exercise of an option begins only at exercise.

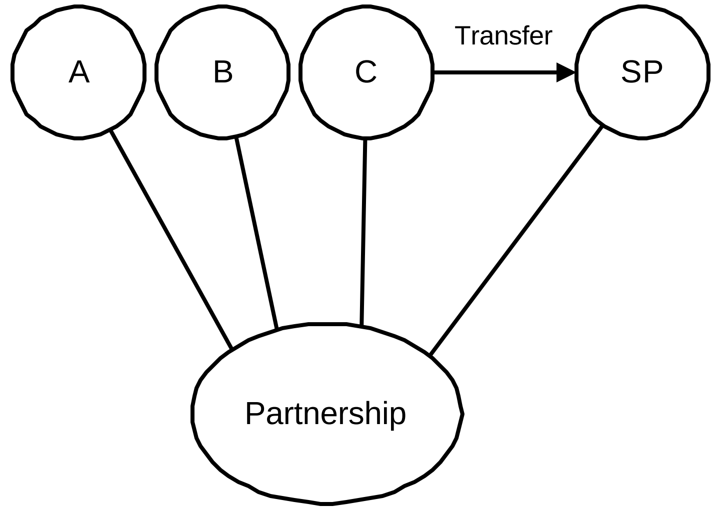
A profits interests can be allocated a share of the partnership's current earnings (although it need not be).[113] In contrast, an option generally does not share in current earnings if the current earnings are distributed before the option is exercised (unless the terms of the option provide for adjustments where there are pre-exercise distributions).

From the partnership's perspective, use of an option will result in a deduction on exercise, but also creates at least some risk of gain recognition by the partnership. While a profits interest does not result in an actual deduction for the partnership, allocations of income to SP reduce the income allocated to other partners and generally have the effect of a deduction (although timing and character differences may exist when compared with a deduction on option exercise).

On balance, a profits interest will often be more tax efficient for SP than an option, at least in cases where substantial capital appreciation is expected or at least hoped for. Given the fact that allocations of income to SP reduce income allocated to other partners, a profits interest seems relatively efficient at the partnership level as well. Thus, partnerships seeking to compensate and give SP an incentive should consider the use of a profits interest as an alternative to an option.

Examples 1 through 10 have all dealt with partnership interests issued by the partnership (including on exercise of an option) to SP. Consequences may change if a partner instead makes the transfer to SP.

Example 11: Partner-to-Partner Transfer of Capital Interest. A, B and C form a partnership contributing $10 each to the partnership's capital in exchange for a one-third interest. The partnership assets appreciate in value to $300. SP agrees to perform services for the partnership. C transfers one-half of C's partnership interest to SP.



SP receives a capital interest in the partnership, because if the partnership liquidated immediately following the transfer, SP would receive $50 (1/6 x $300 of partnership assets). SP should therefore recognize $50 of OI, the liquidation value of the transferred interest.

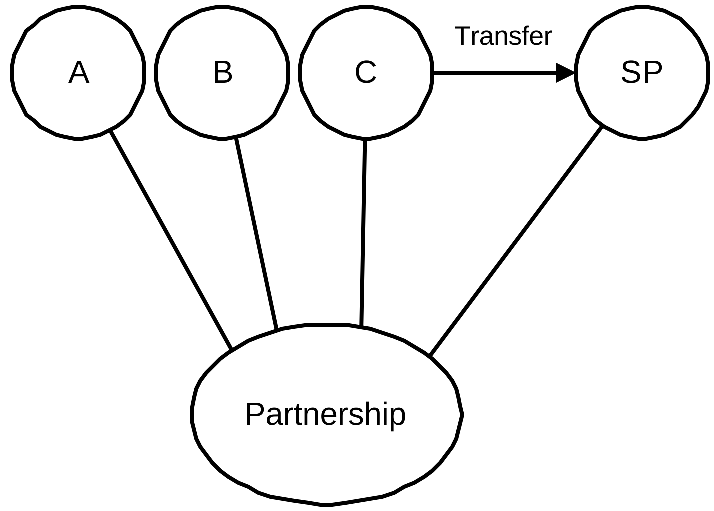
The consequences to C of the transfer of the capital interest will depend on whether C or the partnership is viewed as the transferor of such interest. If C is viewed as the transferor, C will recognize $45 of gain (the liquidation value of one-half of C's partnership interest less $5 tax basis) because C is not entitled to the protection of Code §721 or other non-recognition rules.[114] A $50 deduction would be available under Code §83(h) (subject, as usual to capitalization and other general limits). Because SP will be providing services to the partnership, the deduction most likely should be claimed by the partnership.[115] However, at the partnership level, the deduction ought to be allocated to C, given C has borne the economic cost of paying the compensation.

If C is regarded as the transferor and if the partnership makes an election under Code §754, SP will receive a stepped-up basis in SP's share of partnership assets under Code §743.

While treating C as the transferor appears the most likely result, given that such characterization is consistent with the form chosen by the parties, it is at least possible the IRS could recharacterize the transaction. The IRS may recharacterize it as a contribution by C to the partnership of one-half of his or her interest, followed by a transfer of an equal interest by the partnership to SP. Regulations under Code §83 similarly recharacterize a corporate shareholder's transfer of stock to a corporate employee.[116] In such case, C would presumably recognize no gain under Code §721. The consequences to SP and the partnership would be as outlined in Example 2. The partnership should recognize no gain as discussed, although there is some risk the IRS would disagree. The partnership's $50 deduction would be allocated to C (in contrast to Example 2, in Example 11, even under this recharacterization, C has borne the cost of the compensation). No step-up would be available to SP under Code §§754 and 743, given SP receives the partnership interest from the partnership.

It is also possible that a partner could transfer a portion of his or her interest in future profits to SP.

<u>Example 12: Partner-to-Partner Transfer of Profits Interest</u>. A, B and C form a partnership contributing $10 each to the partnership's capital in exchange for a one-third interest. The partnership assets appreciate in value to $300. SP agrees to perform services for the partnership. C transfers to SP one-half of C's interest in partnership distributions in excess of $100 (i.e., in excess of C's current share of partnership capital).



SP receives a profits interest under Rev. Proc. 93-27, because if the partnership liquidated immediately after the transfer to SP, SP would receive nothing. SP should therefore recognize no OI. Rev. Proc. 93-27 does not restrict its safe-harbor to transfers by a partnership and thus should apply.[117] Because SP recognizes no OI, there is no deduction available under Code §83(h) and neither C nor the partnership should recognize any gain.[118] As a result, it should not matter in this context whether C or the partnership is deemed to be the transferor of the interest received by SP.

E. <u>Conclusions</u>

We hope the analysis set forth in this article provides a useful and consistent framework for analyzing the tax consequences of issuing partnership equity to service partners. As noted above, the IRS is currently studying these and related issues.[119] Based on our analysis, we recommend that the IRS take the following actions (by ruling or regulation) to clarify the law in this area:

- The IRS should clarify that SP's OI attributable to the receipt of a partnership interest in exchange for services to the partnership is based on the excess, if any, of (i) the liquidation value of the partnership interest over (ii) the amount, if any, paid by SP. This harmonizes the treatment of capital interest and profits interests and is consistent with Rev. Proc. 93-27.

- The IRS should clarify that SP receives a capital account under the Code §704(b) regulations on receipt of a capital interest equal to the OI recognized (or equivalently, equal to the liquidation value of the interest received). Furthermore, the IRS should adopt a cash purchase model in order to provide a conceptual framework for giving SP a proper capital account in a manner that is consistent with current capital account maintenance rules. Adoption of a cash purchase model also makes it clear that the partnership can write up capital accounts on the transfer of a capital interest to SP and apply reverse Code §704(c) allocations, in each case allowing it to better match tax consequences to the partners' economic deal.

- The IRS should clarify that the partnership does not recognize gain when it issues a capital interest to SP in exchange for services (including through exercise of an option to purchase a partnership interest).

- The IRS should clarify whether, as a substantive legal matter, Code §83 timing rules apply to determine if a partnership interest received by SP is a capital or a profits interest where the interest is subject to vesting restrictions on receipt. In addition, the IRS should give greater certainty to taxpayers who do not file a Code §83(b) election with respect to an unvested profits interest in reliance on Rev. Proc. 2001-43 that any compensation income will be measured at the grant date of the interest and not on its vesting date.

- The IRS should clarify that Rev. Proc. 93-27 applies even in situations where SP performs services as an employee (e.g., to a partnership subsidiary or to the partnership's general partner), provided that those services benefit the partnership and are related to its business.

While we believe that a court should reach these results under current law, IRS guidance would provide helpful certainty in planning for the grant of equity interests in partnerships to service partners and remove unnecessary complexity.

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[1] William R. Welke is a partner and Olga A. Loy is an associate in the Chicago office of Kirkland & Ellis. The authors gratefully acknowledge the receipt of helpful comments and suggestions from George Javaras and Don Rocap of Kirkland & Ellis. In addition, the authors have benefitted from many discussions of the topics addressed in this article over the years with Pat Gallagher, George Javaras, Jack Levin, Don Rocap, Jeff Sheffield, and Keith Villmow also of Kirkland & Ellis.

[2] This paper was originally presented at the University of Chicago Federal Tax Conference in November, 2000 and published in 79 Taxes 94 (2001).

[3] For simplicity, we will use the term "partnership" to refer to any entity treated as a partnership for federal income tax purposes, including an LLC that has not "checked-the-box" to be taxed as a corporation. Similarly, we will use the term "partner" to refer to any person treated as a partner of a partnership for federal income tax purposes, including a member of an LLC.

[4] Code §83(a). *See also* Code §61(a)(1) and Treas. Reg. §§1.61-2(a)(1), (d)(1) and (d)(6). A full discussion of Code §83 is beyond the scope of this article. For an extensive discussion, see Ginsburg & Levin, *Mergers, Acquisitions and Buyouts*, ¶¶1314.1.1-1314.1.6 (December 2001).

[5] Treas. Reg. §1.83-3(a)(2) and (e); Treas. Reg. §1.83-7. Options may constitute property for purposes of Code §83 if they have a "readily ascertainable fair market value" within the meaning of Treas. Reg. §1.83-7. In our

experience, most options encountered in the compensatory context do not have a "readily ascertainable fair market value." Thus, unless otherwise stated, all options discussed below do not have a "readily ascertainable fair market value."

[6] Unless otherwise stated, we use "subject to vesting" to mean property that is subject to an SRF and cannot be transferred free of such restrictions. We use "vested" to refer to property that is not (or is no longer) subject to an SRF or which can be transferred to a third party free of any SRF.

[7] Code §83(a); Treas. Reg. §1.83-1(a)(1).

[8] Code §83(c)(1); Treas. Reg. §1.83-3(c)(1).

[9] Treas. Reg. §1.83-3(c)(1). An SRF does not exist merely because the service recipient retains the right to buy the transferred property back from the service provider for an amount equal to its FMV at the time of the repurchase because, in such case, there is no forfeiture.

[10] Treas. Reg. §1.83-1(a)(1); Code §83(f); Rev. Proc. 80-11, 1980-1 C.B. 616.

[11] Treas. Reg. §1.83-4(a); Rev. Rul. 83-22, 1983-1 C.B. 17; Rev. Proc. 83-38, 1983-1 C.B. 773.

[12] Code §83(h); Treas. Reg. §1.83-6(a)(1) and (4). Under Treas. Reg. §1.83-6(a)(2), a service provider is deemed to have included OI in gross income if such income is reported to the service provider on a timely filed Form W-2 or Form 1099, even if the service provider does not actually include such income on his or her income tax return. *See* Treas. Reg. §1.83-6(a)(1) and (3) for special rules regarding the timing of such deduction if the service recipient and service provider have different taxable years.

[13] *See, e.g.*, Rev. Proc. 93-27, 1993-2 C.B. 343; *See also Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171, 1176 (1990), *aff'd*, 969 F.2d 669, 674 (8th Cir. 1991); *Campbell v. Commissioner*, 943 F.2d 815, 822 (8th Cir. 1991), *aff'g in part and rev'g in part*, 59 T.C.M. 236 (1990); *Johnston v. Commissioner*, 69 T.C.M. 2283, 2286 fn. 5 (1995).

[14] *Id.*

[15] *See* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, (3d ed. 1997) [hereinafter "McKee"] at ¶ 5.01-5.10; Cowan, *Receipt of a Partnership Interest for Services*, 32 NYU Inst. on Fed. Tax'n 1501(1974); Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 Tax L. Rev. 247 (1991); Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 Tax Law Rev. 287 (Fall 1991); Hortenstine & Ford, *Receipt of a Partnership Interest for Services: A Controversy That Will Not Die*, 65 Taxes 880 (Dec. 1987); Gehrke, *Section 83 Applied to Partnership Transactions: The Road to Certainty in Planning and Controlling the Tax Consequences of Exchanges of Partnership Interests for Services*, 13 Fla. St. U. L. Rev. 325 (1985); Banoff, *Conversions of Services Into Property Interests: Choice of Form of Business*, 61 Taxes 844 (Dec. 1983).

[16] The Code §83 regulations do not use the term "partner" and use the term "partnership" only in a cross reference added in 5/2000 to Treas. Reg. §1.1032-3, the zero basis rules for corporations. *See* Treas. Reg. §1.83-6(d)(1). While Code §83 refers to "the person who performed such services," a reference broad enough to include a service partner, the regulations under Code §83 generally describe the rules of Code §83 in terms of "employees" and "independent contractors." *See* Treas. Reg. §§1.83-1(a)(1); 1.83-3(f); 1.83-7(a)(1).

[17] Prop. Reg. §1.721-1(b)(1)(i), 36 Fed. Reg. 10787 (6/3/71). The current version of Treas. Reg. §1.721-1(b)(1), adopted before the enactment of Code §83, merely states that receipt of an interest in partnership capital (as opposed to an interest in partnership profits) in exchange for services constitutes income to the service partner under Code §61.

[18] Treas. Reg. §1.704-1(b)(1)(iv).

[19] *See, e.g.*, Delaware Revised Uniform Partnership Act (2000), §15-502 (partnership interest is personal property); Delaware Revised Uniform Limited Partnership Act (1983), §17-701 (partnership interest is personal property); Delaware Limited Liability Company Act (1992), §18-701 (LLC interest is personal property); Revised Uniform Partnership Act (1994), §502 (partnership interest is personal property); Revised Uniform Limited Partnership Act (1976), §701 (partnership interest is personal property); Uniform Limited Liability Company Act (1995), §501(b) (LLC interest is personal property).

[20] The phrase "in connection with the performance of services" has been read even more broadly to capture transfers of property that are not themselves direct compensation for services. *See, e.g.*, *Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd*, 734 F.2d 478 (9th Cir. 1984) (restricted stock received "in connection with the performance of services" even though employee paid FMV for such stock).

[21] *See Mark IV Pictures, Inc. v. Commissioner* , 60 T.C.M. 1171, 1176 (1990), *aff'd*, 969 F.2d 669, 674 (8th Cir. 1992); *Larson v. Commissioner*, 55 T.C.M. 1637 (1988); *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd*, 103 F.2d 485 (10th Cir. 1983). For cases holding the receipt of a capital interest taxable under Code §61, *see United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965); *Edgar v. Commissioner*, 56 TC 717 (1971); *Johnston v. Commissioner*, 69 T.C.M. 2283 (1995) (holding that receipt of capital interest in a partnership is subject to timing rules of Treas. Reg. §1.721-1(b)(1)). *See also* Treas. Reg. §1.721-1(b)(1) and Prop. Treas. Reg. §1.721-1(b)(1)(i).

[22] Even those who argue that Code §83 does not apply to the receipt of a profits interest often believe that Code §83's timing rules govern the determination of whether a partnership interest is a profits interest or a capital interest where vesting restrictions are involved. *See* McKee, ¶5.01, ¶5.02[1].

[23] Of course, the receipt of many common profits interests would not be subject to tax under Code §83, even if it applies. For example, in many law and accounting partnerships, profit shares are reset periodically so that a partner has no beneficial interest in future years' profits. Treas. Reg. §1.83-3(a). Moreover, in many cases, a professional partner who ceases to perform services merely receives a return of his or her capital contributions and no future share of profits, an arrangement constituting a permanent "nonlapse restriction" on the property that should be taken into account in valuing the partnership interest under Code §83, resulting in a value equal to the partner's contributed capital and no OI on receipt. *See* Treas. Reg. §1.83-5.

[24] Receipt of a profits interest by a service provider in exchange for services provided to a person other than the partnership and which do not benefit the partnership should generally be fully subject to Code §83.

[25] Current Treas. Reg. §1.721-1(b)(1), adopted prior to the enactment of Code §83, similarly implies that the receipt of a profits interest by a service partner is not taxable under Code §61.

[26] *See Campbell v. Commissioner*, 943 F.2d 815 at 822 (8th Cir. 1991) (Code §707(a)(2) would "be unnecessary if compensatory transfers of profits interest were taxable upon receipt, because if so, every such transfer would be taxed without this section"). The legislative history of Code §707(a)(2) states that "if a partner received an interest in a partnership in exchange for services, he *may* recognize income upon that receipt" (emphasis added), citing Code §§61 and 83 and the *Diamond* case. *See* S. Rep. No. 169, Vol. 1, 98th Cong., 2nd Sess., 226, fn. 4 (1984).

[27] *See St. John v. United States*, 84-1 USTC ¶9158 (C.D. Ill. 1983) (the receipt of profits interest was a taxable event, but interest valued at zero); *Kenroy Inc. v. Commissioner*, 47 T.C.M. 1749 (1984) (same); *Campbell v. Commissioner*, 59 T.C.M. 236 (1990), *rev'd*, 943 F.2d 815 (8th Cir. 1991) (receipt of a profits interest taxable and

subject to timing rules of Code §83); *See also Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974) (receipt of a profits interest was taxable under Code §61).

[28] *See Campbell v. Commissioner*, 943 F.2d at 815 (8th Cir. 1991); *St. John v. United States*, 84-1 USTC at ¶9158 (C.D. Ill. 1983); *See also Diamond v. Commissioner*, 492 F.2d at 286 (7th Cir. 1974) (stating in a pre-Code §83 case, "surely in many if not the typical situations it will have only speculative value, if any").

[29] 943 F.2d at 822 (citing non-recognition theory and Code §707 considerations).

[30] T.D. 8902, 2000-41 I.R.B. 323; *See also* IRS Notice 2000-29, 2000-23 I.R.B. 1241 (requesting "public comment on the federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership").

[31] T.D. 8902, 2000-41 I.R.B. 323.

[32] *See, e.g.*, *Johnston v. Commissioner,* 69 T.C.M. 2283 (1995); *Larson v. Commissioner*, 55 T.C.M. 1637 (1988). Although difficult on the facts of Example 1, it might be possible in other cases to argue for a minority discount in valuing SP's partnership interest under this approach. *See, e.g.*, *Edgar v. Commissioner*, 56 T.C. 717 (1971) (allowing a 25% minority interest discount).

[33] *See, e.g.*, *Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171 (1990), *aff'd,* 969 F.2d 669 (8th Cir. 1992). A minority or other discount generally seems inappropriate where SP's income is based on liquidation value.

[34] Treas. Reg. §1.721-1(b)(1). *See also* Prop. Reg. §1.721-1(b)(1)(i) (stating that after the effective date of Code §83, "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" (emphasis added)).

[35] *See* Part C below for a detailed discussion of Rev. Proc. 93-27 and Rev. Proc. 2001-43.

[36] If SP recognizes $100 of income on receipt of the partnership interest, SP would also be allocated $25 of the partnership's compensation deduction. So in any event, SP's net income from receipt of the partnership interest ought to be $75.

[37] SP's OI would be equal to the value of the one-fourth of the partnership's assets he would receive on liquidation, including both a share of the partnership's cash and the newly created asset. Thus, if the FMV of the newly created asset is equal to SP's OI, SP's OI would be determined by solving the following equation: OI = 1/4 x (OI + $300). SP's OI would equal $100 and the partnership would have $400 in assets ($300 cash and $100 representing the new capitalized asset).

[38] The regulation also states that, in these circumstances, capital accounts should be based on federal tax accounting principles to the extent possible.

[39] Compare Treas. Reg. §1.1032-3 (adopting a cash purchase model for purposes of zero-basis regulations generally applicable to corporations).

[40] If the capital interest is intended to compensate SP for services rendered before SP became a partner, Code Sec. 706(d)(1) may limit the partnership's ability to allocate its Code Sec. 83(h) deduction to SP.

[41] Treas. Reg. §1.721-1(b)(1), quoted above, inartfully suggests that the capital shift, and hence SP's OI, might be based on the extent to which another partner "gives up any of his right to be repaid his contributions." It is clear, however, that under Code §83, the amount of capital shift must be measured based on the FMV of the shifted

interest in capital and not merely the amount of partners' original capital contributions. Compare Rev. Proc. 93-27, §2.01 (defining a capital interest by reference to the FMV of the partnership's assets).

[42] It is possible, in some cases, that A, B, and C may not be able to use the deduction currently if their share of earnings from the partnership and basis are insufficient. Code §704(d).

[43] Treas. Reg. §1.83-6(b) is currently under study. *See* Regulatory Preamble to T.D. 8883, 2000-23 I.R.B., 115 (adopting zero basis regulations under Code §1032).

[44] *See, e.g.*, Rev. Rul. 80-76, 1980-1 C.B. 15; TAM 199901003 (9/22/98); Treas. Reg. §1.1032-3; Treas. Reg. §1.1502-13(f)(6).

[45] Treas. Reg. §1.1032-1(a).

[46] Rev. Rul. 80-76, 1980-1C.B. 15; Treas. Reg. §1.1032-3(e), Examples 4 through 10. Prior to the issuance of Treas. Reg. §1.1032-3, the IRS had also extended non-recognition treatment to a subsidiary's use of parent stock to acquire assets in a non-compensatory context. *See* TAM 199901003 (9/22/98). For a similar rule under the consolidated return regulations, rendered obsolete by Treas. Reg. §1.1032-3, *see* Treas. Reg. §1.1502-13(f)(6).

[47] Treas. Reg. §1.83-6(d)(1) mentions partnerships in a cross reference, added in 5/2000, to the new zero basis regulations under Code §1032, dealing with issuance of parent company stock to acquire assets or services for subsidiary corporations and partnerships.

[48] Although Code §721(a) refers to only to contributions of "property," it is clear that its non-recognition rule for the partnership must extend to contributions of money as well. *See, e.g.*, Treas. Reg. §1.721-1(c) (referring to issuance of partnership interests for cash in a "qualified underwriting transaction").

The interaction of the *Alves* case and Treas. Reg. §1.83-6(b) also makes it clear that Code §721 must be an exception to gain recognition under Treas. Reg. §1.83-6(b). Assume that SP purchases an interest in the partnership for cash or other property with a value equal to the value of the partnership interest received and that, although SP pays for the partnership interest, SP would not have been offered the right to purchase the interest had SP not agreed to perform services for the partnership. *Alves* holds that Code §83 generally applies to a transfer of property in such case, even though SP pays full FMV. *See Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd*, 734 F.2d 478 (9th Cir. 1984) (restricted stock received "in connection with the performance of services" under Code §83(a) even though employee paid FMV for such stock). If there is no exception under Treas. Reg. §1.83-6(b) for transfers within Code §721, the regulation would appear literally to require gain recognition by the partnership based on the cash or other property paid by SP, a truly absurd result.

[49] *See* Treas. Reg. §1.1032-3(b).

[50] *See* Rev. Rul. 80-76, 1980-1C.B. 15; and TAM 199901003 (9/22/98).

[51] A partnership concerned about the risk of gain recognition could also issue a profits interest to SP. Because SP recognizes no income on receipt of a profits interest under Rev. Proc. 93-27, the partnership would not recognize any income under Treas. Reg. §1.83-6(b). Moreover, the profits interest could have a "catch-up" feature designed to allocate future profits disproportionately to SP in order to make up for the fact that SP does not initially receive a capital interest. *See* Part C, Example 8, below.

[52] *But see* Rev. Rul. 84-111, 1984-2 C.B. 88 (accepting form chosen by taxpayer to incorporate partnership, even though alternatives are economically identical).

[53] Code §1032; Treas. Reg. §1.1032-1(a).

[54] *See, e.g.*, Rev. Rul. 84-111, 1984-2 C.B. 88 (accepting form chosen to incorporate partnership, even though alternatives are economically identical); Treas. Reg. §1.708-1(c)(3) (providing that a merger of partnerships is generally to be taxed in accordance with an "assets over" model pursuant to which the terminating partnership is deemed to have transferred its assets to the continuing partnership in exchange for an interest in the continuing partnership and then liquidated; however, if the parties structure the transaction using the "assets up" form – i.e., if the terminating partnership distributes its assets to its own partners who then contribute them to the continuing partnership – the form chosen will be respected notwithstanding the transitory ownership of assets by the terminating partnership's partners).

[55] Some authors believe that a transfer of an undivided interest in partnership assets is required in order to determine appropriate capital accounts. *See* McKee, ¶5.03[1][b]; Gergen, *"Why a Partnership Should Recognize Gain on an Exchange of a Partnership Interest for Services,"* 47 Tax Notes 1487 (1990). We believe that the cash purchase model adequately addresses these concerns without requiring a hypothetical transfer of a slice of assets.

[56] For example, the seller of a partnership interest generally determines gain and holding period with reference to the partnership interest's basis and holding period, except to the extent that Code §751's hot assets rules apply. Code §741. But cf. Rev. Rul. 91-32, 1991-1 C.B. 107 (where a foreign person sells a partnership interest, look through partnership in order to determine share of gain that is effectively connected with a U.S. trade or business and gain subject to Code §897). The purchaser of a partnership interest is generally treated as purchasing an interest in an entity for purposes of determining basis and holding period. Code §742; Treas. Reg. §1.1223-3. The purchase has no effect on the basis of the purchasing partner's share of the partnership's assets unless a Code §754 election is in place.

[57] *See, e.g., Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171 (1990), *aff'd*, 969 F.2d 669, 674 (8th Cir. 1992); *Larson v. Commissioner*, 55 T.C.M. 1637 (1988); *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd*, 103 F.2d 485 (10th Cir. 1983); *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965); *Edgar v. Commissioner*, 56 T.C. 717 (1971); *Johnston v. Commissioner*, 69 T.C.M. 2283 (1995).

[58] 62 T.C. 720 (1974).

[59] *McDougal* is interesting in a number of respects. First, the IRS argued *against* recognition of gain by the individual on the transfer to SP. Second, neither the individual nor SP argued that the partnership began on initial acquisition of the property by the individual, a time when SP's interest could have been characterized as a profits interest.

[60] This seems clear from the court's description of the facts. *See McDougal v. Commissioner*, 62 T.C. 720, 721 (1974). However, the court later referred to the transaction as if the individual transferred an interest in partnership profits and capital to SP.

[61] Even if the transaction were viewed as a partner-to-partner transfer of a partnership interest rather than a partner-to-partner transfer of the appreciated property, Code §721 would not apply to allow the individual to avoid gain recognition. Query whether a recharacterization rule similar to Treas. Reg. §1.83-6(d) could apply, at least where the services are performed for the partnership. *See* Part D, Example 11 below.

[62] The identity of the service recipient (i.e., one of the partners as opposed to the new partnership) is likely to be very important in such analysis. Where a new partner is admitted to a disregarded entity, the admission is treated as a sale of assets from the old owner to the new partner where the new partner's consideration is paid to the old owner. In contrast, if the new partner's consideration is paid to the new partnership, no transfer from old owner to new partner results. *See* Rev. Rul. 99-5, 1999-1 C.B. 434.

[63] Discussion of non-compensatory options and convertibles is beyond the scope of this article. However, we believe that the non-recognition result and the cash purchase model we advocate in the compensatory setting is

consistent with nonrecognition in the case of the exercise and conversion of noncompensatory options and convertibles.

64 Capital accounts would be unequal even if the partnership were to recognize gain as if it had transferred a pro rata slice of its assets to SP. The capital accounts are unequal because the partnership assets have built-in gain at the time of SP's admission. While partial gain recognition would reduce the amount of the built-in gain, it would not eliminate it (unless all of the partnership's capital were shifted to SP), and a capital account write up would still be necessary in order to equalize capital accounts. Thus, capital account analysis does not give any guidance on the question of whether the partnership should recognize gain on the transfer to SP.

65 Note, both the cash purchase model and the partial transfer of assets model provide a conceptual basis for writing up capital accounts.

66 Treas. Reg. §1.704-1(b)(4)(i). Code §704(c) principles would also deal with effective recognition of the built-in gain on depreciable and amortizable property over time through reduced depreciation/amortization deductions. A, B, C and SP will still need to choose a method under Code §704(c) to reflect built-in gain (i.e., the traditional method with ceiling rule, the curative allocation method or the remedial allocation method). *See* Treas. Reg. §1.704-3. The partners may wish to agree contractually on the appropriate method when the partnership grants a capital interest to SP in order to eliminate later disagreements.

67 Treas. Reg. §1.704-1(b)(2)(iv)(*f*) states that a "partnership agreement *may* ... increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property ... on the partnership's books." (Emphasis added.)

68 Code §83(a); Treas. Reg. §1.83-1(a)(1).

69 On these facts, the gain, if recognized by the partnership would be $75 (i.e., 1/4 x $300 built-in-gain at vesting).

70 *See* Part A above. *See also* Treas. Reg. §1.83-1(a)(1); Code §83(f); Rev. Proc. 80-11, 1980-1 C.B. 616. *See also* Treas. Reg. §1.1361-1(b)(3) (S corporation stock subject to vesting restrictions not treated as outstanding if the service provider does not make a Code §83(b) election). IRS may be rethinking this issue, at least in part. It recently declined to include a reference to Code §83(f) in recently promulgated Treas. Reg. §1.1223-3 dealing with holding periods for partnership interests. IRS noted that it was "studying the extent to which section 83(a) applies to the issuance of certain partnership interests (i.e., a profits interest in a partnership) in exchange for services. Section 83(f) is relevant to the extent that section 83(a) applies with respect to a partnership interest. However, in order to avoid any implication that section 83(a) applies to all partnership interests issued in exchange for services, a cross reference to section 83(f) has not been included in the final regulations." T.D. 8902, 2000-41 I.R.B. 323.

71 Unless SP owned another vested partnership interest, such compensation would not be a guaranteed payment under Code §707(c) since SP would not be a partner at all. To the extent that the partnership distributed appreciated property to SP prior to vesting, it would generally recognize gain as Code §731(b) would not apply.

72 A Code §83(b) election must be filed within 30 days of the transfer the property. Code §83(b)(2).

73 Code §83(b)(1); Treas. Reg. §1.83-2(a).

74 If SP fails to vest and forfeits the partnership interest, SP may not be entitled to any deduction with respect to the forfeiture and previous inclusions of income attributable to the Code §83(b) election. *See* Code §83(b)(1). While Treas. Reg. §1.83-2(a) relaxes the statutory rule to some extent, it still limits the deduction on forfeiture to the amount, if any, paid by SP for the interest over the amount, if any, received by SP on forfeiture of the interest.

75 A profits interest is often referred to as a "carried interest."

[76] 1993-2 C.B. 343.

[77] *See* Example 1 above.

[78] On the issue of whether a person is a partner, *see, e.g., Commissioner v. Culbertson*, 337 U.S. 733 (1949); *See also* McKee, ¶5.03[2].

[79] Where this is not true, it is possible that receipt of a partnership profits interest would not create OI for an SP under normal Code §83 principles, even if Rev. Proc. 93-27 were unavailable. *See* the discussion in footnote 23 above.

[80] *See* LTR 9219002 (1/27/92); *Wheeler v. Commissioner*, 37 T.C.M. 883 (1978).

[81] Rev. Proc. 93-27 states that the IRS "will not treat the receipt of [a profits] interest as a taxable event for the partner *or the partnership*." (Emphasis added.) Because SP recognizes no OI and pays nothing for the profits interest, this result would probably be reached under Treas. Reg. §1.83-6(b) in any event.

[82] This assumes that the partnership agreement provides that assets distributed in kind will first be marked-to-market for capital account purposes, with any resulting book gain or loss allocated to the partners' capital accounts. To the extent that SP received more than $75 in assets, there would be a taxable capital shift on liquidation of the partnership and SP would presumably recognize OI.

[83] Complications could arise if the partnership has cash, marketable securities, or contributed assets with built-in gain as of their contribution. *See* Code §§731(a)(1), 731(c), 704(c)(1)(B), and 737.

[84] Code §732(b).

[85] Rev. Proc. 93-27, 1993-2 C.B. 343, §2.01.

[86] Rev. Proc. 93-27, 1993-2 C.B. 343, §2.01.

[87] Jack Levin of Kirkland & Ellis recently brought this issue to our attention.

[88] Treas. Reg. §1.704-1(b)(2)(iv)(*f*) generally requires, as a condition to writing up capital accounts, that there be a contribution of assets for a new or increased partnership interest or a distribution of partnership assets in exchange for a reduced partnership interest.

[89] A partnership agreement with distribution-driven allocations normally provides a set of rules dictating how the assets of the partnership are to be distributed to partners (which rules do not refer to capital accounts). Allocations are then made to capital accounts so that each partner's capital account equals the amount the partner would be entitled to receive on liquidation of the partnership (properly adjusted for unrealized appreciation, nonrecourse and partner nonrecourse deductions, etc.). *See* McKee, ¶10.03

[90] If the $300 preferential distribution is not limited to proceeds from built-in gain assets, distribution-driven allocations may cause first $270 of partnership income from all sources (including ordinary operations) to be allocated to A, B and C, a result that the parties may not intend. Limitation of the preferential distributions to proceeds from disposing of the built-in gain assets is consistent with SP's interest being a profits interest.

[91] Such ambiguity may have been a result of an IRS decision to avoid taking a position on whether Code §83 applies in general to the receipt of a profits interest by an SP. Compare T.D. 8902, 2000-41 I.R.B. 323 (noting the IRS is "currently ... studying the extent to which section 83(a) applies to the issuance of certain partnership interests (i.e., a profits interest in a partnership) in exchange for services" and declining to add a cross reference to Code

§83(f) in Treas. Reg. §1.1223-3 in order to "avoid any implication that section 83(a) applies to all partnership interests issued in exchange for services").

[92] As discussed in Example 2, there is some risk that the partnership would recognize gain ($37.50 on the facts of Example 7) on a slice of its assets.

[93] *See* Example 3 for a discussion of capital accounts, built-in gains and related issues.

[94] A Code §83(b) election must be made within 30 days of the receipt of the partnership interest.

[95] 2001-34 I.R.B. 191.

[96] Note, we believe that this condition requires only that the SP include his or her distributive share of the partnership's tax items based on the terms of the profits interest set forth in the partnership agreement and the rules of Code §704(b). We do not believe that it creates any independent requirement that an SP have a distributive share of all partnership tax items (or of any particular partnership tax item) in order to claim the benefits of Rev. Proc. 2001-43's safe harbor.

[97] *See*, *e.g.*, Rev. Proc. 89-14, 1984-1, C.B. 814, §7.01(5). The technical analysis of the extent to which a taxpayer may rely on a revenue procedure is complex. For additional discussion of this point, see Schneider, IRS Attempts to Clear up Confusion with Substantially Nonvested Partnership Profits Interests – Are we There Yet?, 4 J. Passthrough Entities 33 (2001).

[98] *See*, *e.g.*, comments of David Haglund, IRS senior technician reviewer, at an October, 2001meeting of the D.C. Bar Taxation Section ("Haglund said taxpayers should not worry about falling out of [Rev. Proc 2001-43's] coverage, but he did finally admit that risk-averse taxpayers falling under the revenue procedure may continue to file this election"), reported at 2001 TNT 197-4.

[99] There should be little or no risk that Code §707(a) would apply to SP's continuing profits interest (i.e., SP's profits interest excluding catch-up allocations).

[100] No regulations have been adopted under Code §707(a)(2)(A) dealing with the provision of services to a partnership. *See* Senate Finance Committee Report on the 1984 Act, S. Rep. No. 169, Vol. 1, 98th Cong., 2nd Sess., 226 (1984) (providing a list of factors to consider in determining whether Code §707(a)(2)(A) applies to the provision of services to a partnership).

[101] If Code §707(a)(2)(A) treats the catch-up allocations and distributions as a payment of fee income, presumably SP would recognize such income based on SP's method of accounting -- in most cases, the cash method. Recharacterization under Code §707(a)(2)(A) would seem to preclude treating SP as receiving a fee in-kind under Code §83, in the form of a partnership profits interest (limited to catch-up allocations and distributions) to which Rev. Proc. 93-27 does not apply (on the ground that it is received in exchange for services performed other than in a partner capacity).

[102] Similar issues may arise in a temporal sense. The partnership may have net profits in one year, even though it has an overall net cumulative loss after SP's admission.

[103] *See* Senate Finance Committee Report on the 1984 Act, S. Rep. No. 169, Vol. 1, 98th Cong., 2nd Sess., 226 (1984).

[104] Even if Rev. Proc. 93-27 does not apply, SP may argue that he or she does not recognize OI on receipt of the partnership interest for the reasons discussed in Part A above (i.e., the partnership interest should be valued on a liquidation basis or, alternatively, the FMV of the partnership interest cannot be determined at this time). If SP

nonetheless recognizes OI, someone should receive a Code §83(h) compensation deduction. If the deduction belongs to the partnership, capital account analysis would generally allocate the deduction to SP as discussed above. However, where SP performs services for the corporation, the deduction may belong to the corporation. *See* Treas. Reg. §1.83-6(d) ("If a shareholder of a corporation transfers property to an employee of such corporation ... in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property by the corporation to the employee or independent contractor under [Code §83]"). Such a recharacterization might also raise zero basis issues at the corporate level.

[105] Treas. Reg. §1.701-2.

[106] Even if the partnership is disregarded, it may be difficult to treat SP as owning stock in the corporation, where the corporation has no stock with economics corresponding to the partnership profits interest. Indeed, the corporate equity interest that the partnership profits interest most resembles may be an option or an SAR, instruments SP could generally receive without recognition of OI (although they would generally result in OI on exercise).

[107] For example, where the partnership owns assets other than the stock of the corporation, a business purpose would normally be present.

[108] This may be particularly true where the SP's share of profits varies in a formulaic way with the partnership's profits.

[109] As noted below, a partnership profits interest can provide many of these benefits to SP, in many cases, in a more tax-efficient manner.

[110] In theory, a partnership could grant an option to acquire an partnership interest that would always be a profits interest. For example, the underlying partnership interest could entitle the owner to a share of partnership profits after exercise and could exclude any interest in built-in gain in the partnership's assets as of exercise. Because such an option would not give the holder any participation in partnership growth and appreciation between grant and exercise, it is unlikely to be attractive to service providers.

[111] *See* Treas. Reg. §1.83-7(a). As we noted in Part A above, options on partnership interests in the compensatory setting are not likely to have a readily ascertainable FMV. *See* Treas. Reg. §1.83-7(b).

[112] The partnership agreement must be reviewed to insure that, under its actual allocation, distribution and capital account mechanics (as opposed to the capital account mechanics provided under Treas. Reg. §1.704-1(b)(2)(iv)) that SP receives an appropriate capital account and that a write-up of capital accounts does not unintentionally alter the economics desired by the parties.

[113] A profits interest could be limited to a share of future appreciation in the partnership's assets.

[114] Under Treas. Reg. §1.83-6(b), C's gain would be based on the difference between the OI recognized by SP and C's tax basis in the transferred interest. As discussed in Part B, C's gain should not be based on the FMV of the transferred interest, even if that FMV exceeds liquidation basis.

[115] Compare Treas. Reg. §1.721-1(b)(2) (stating that where capital is shifted to SP, any deduction belongs (i) to the partnership under Code §707(c) if the partnership receives the services and (ii) to the partner, if the partner receives the services).

[116] *See* Treas. Reg. §1.83-6(d).

[117] The safe harbor provided by Rev. Proc. 2001-43 apparently applies only where a partnership grants the profits interest. Thus, although Rev. Proc. 93-27 should apply to a partner-to-partner transfer of a profits interest, if the profits interest transferred is subject to vesting, SP apparently cannot rely on Rev. Proc. 2001-43 and should in all cases make a Code § 83(b) election.

[118] Treas. Reg. §1.83-6(b).

[119] *See, e.g.*, Notice 2000-29, 2000-23 I.R.B. 1241; Regulatory Preamble to T.D. 8902, 2000-41 I.R.B. 323; Regulatory Preamble to T.D. 8883, 2000-23 I.R.B., 115.