



## Treasury Revisits Guidance on Partnership Interests Exchanged for Services

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On Friday May 20, 2005, the Treasury Department issued long-awaited guidance on the treatment of partnership interests transferred in exchange for services. Generally, the proposed guidance:

- Eliminates the historic distinction between capital and profits interests issued in connection with the performance of services,
- Establishes that section 83 will apply to all partnership interests issued in connection with the performance of services, and that the amount and timing of the service provider's income and the amount and timing of the partnership's deduction will be determined under section 83,
- Clarifies that a partnership does not recognize gain or loss on the issuance of the partnership interest in connection with the performance of services and
- Provides a safe harbor that permits the parties to assume that the fair market value of a partnership interest is equal to its liquidation value—essentially permitting partnerships to continue the current practice of treating the issuance of a “profits interest” as a non-event as long as they satisfy certain administrative requirements.

*If proposed Treasury Department guidance is finalized in its current form, transactions that previously were viewed as tax-free to persons rendering services to partnerships may become currently taxable unless those persons, the partnerships and their partners take affirmative steps to preserve the tax-free treatment.*

these elections under current law, the elections were largely viewed as protective elections rather than an absolute necessity.

- Partnerships having plans in place that contemplate the future issuance of partnership interests in connection with the performance of services should begin to consider whether they want to preserve the current tax treatment.

Preserving the current tax treatment will likely require amendments to existing partnership documents, which may present some logistical challenges depending on the particular circumstances. As a result, deferring this analysis until the last moment may interfere with the smooth operation of the plan.

- Similarly, if parties are currently drafting a partnership agreement that contemplates the future issuance of partnership interests in connection with the performance of services, it would be wise to consider which tax treatment they will want in the future and to draft the documents to take advantage of the appropriate options. Again, depending upon the particular circumstances, it may be difficult logistically to change the documents in the future if the appropriate provisions are not included initially.

### Implications

- The proposed guidance will not affect partnership interests issued prior to the effective date—which is at some uncertain point in the future.
- Unless there are significant changes to the proposed guidance, service providers receiving “carried interests,” “promotes” and other forms of profits interests after the effective date will need to take affirmative steps to make sure that the receipt of the partnership interest is not a taxable event.
- Service providers receiving unvested profits interests will need to make section 83(b) elections. While many service providers made

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## Discussion

The proposed guidance, in the form of **proposed regulations** and **Notice 2005-43**, proposing a new revenue procedure, revisits earlier guidance and answers some previously unanswered questions. The effect of the new rules is to reverse the earlier guidance provided in **Revenue Procedure 93-27** and **Revenue Procedure 2001-43**, and to apply the rules of section 83 to a partnership's issuance of a profits interest in connection with services. Not surprisingly, the proposed guidance adds new levels of complexity to an area that many thought, with the exception of a few discrete issues, was fairly well settled.

At the same time, the Treasury Department provides partnerships with the flexibility to preserve the status quo as long as the partnerships can comply with certain administrative rules spelled out in the proposed revenue procedure—something that, from a logistical perspective, may not be so easy for existing partnerships to do, and that may require negotiation among the parties involved with newly formed entities. If a partnership does not comply with these administrative rules, the proposed guidance raises the very real possibility that long established practices regarding such arrangements as “carried interests” and “promotes” will cause recipients to be currently taxable and, at the same time, afford the partnership and its partners a current deduction (or, if appropriate, a currently capitalized expenditure).

### *The New General Rule—Section 83 Applies to All Partnership Interests Issued for Services*

Based on the Service's pronouncements in **Revenue Procedure 93-27** and **Revenue Procedure 2001-43**, it was generally accepted that the issuance of a “profits interest” by a partnership in exchange for services did not result in (i) current income to the service provider, or (ii) a current deduction to the partnership. On the other hand, if the partnership issued a “capital interest” in the partnership, to the extent that that capital interest was not subject to a substantial risk of forfeiture (a) the service provider recognized current income, and (b) the partnership was entitled to a deduction (or, where applicable, to a currently capitalized expenditure). If the partnership issued a “capital interest” subject to a substantial risk of forfeiture, then the principles of section 83(b) governed the timing and amount of the service provider's income and the timing and amount of the partnership's deduction (or capitalized expenditure).

The proposed guidance eliminates the current distinction between a “profits interest” and a “capital interest.” All partnership interests issued in connection with the performance of services are treated the same and are taxable in accordance with the general principles of section 83. The consequences, as outlined in the proposed guidance, can be summarized as follows:

- A service provider that receives a vested partnership interest in connection with providing services to the partnership will (1) be taxed on the fair market value of the partnership interest (as compensation) without regard to whether the partnership interest constitutes a profits interest or a capital interest, (2) receive a capital account in the partnership equal to the sum of (a) the amount paid for the partnership interest and (b) the amount that the service provider was required to take into income under the principles of section 83, and (3) be treated as a partner in the partnership for all purposes.
- A partnership that issues a vested partnership interest will (1) be entitled to deduct (or capitalize) an amount equal to the amount included in the service provider's income and (2) treat the service provider as a partner in the partnership for all purposes.
- In the absence of a section 83(b) election, a service partner that receives a substantially nonvested partnership interest in connection with providing services to the partnership will (1) not be taxed on the fair market value of the partnership interest at the time of issuance, but instead will be taxed on the fair market value of the partnership interest (as compensation) at the time of vesting, (2) will not be treated as a partner and will not receive allocations of items of income, gain, loss, deduction and credit prior to vesting, (3) will be required to include any distributions received from the partnership in income as compensation and (4) will receive a capital account in the partnership at the time of vesting equal to the sum of (a) the amount paid for the partnership interest and (b) the amount that the service provider was required to take into income under the principles of section 83.
- In the absence of a section 83(b) election, a partnership that issues a substantially nonvested partnership interest in connection with providing services to the partnership will (1) not be entitled

to deduct (or capitalize) any amounts until they are included in the service provider's income, (2) be entitled to a deduction for any distributions made to the service provider with respect to the partnership interest, and (3) not be permitted to allocate items of income, gain, loss, deduction or credit to the service provider prior to the time that the partnership interest is vested.

- If a service provider receives a substantially nonvested partnership interest and makes a section 83(b) election, the service provider will (1) be taxed on the fair market value of the partnership interest at the time of the section 83(b) election (as compensation) without regard to whether the partnership interest constitutes a profits interest or a capital interest, (2) receive a capital account in the partnership interest equal to the sum of (a) the amount paid for the partnership interest and (b) the amount that the service provider was required to take into income under the principles of section 83 and (3) be treated as a partner in the partnership for all purposes (including the distribution provisions).
- If a service provider receives a substantially nonvested partnership interest and makes a section 83(b) election, then the partnership is (1) entitled to deduct (or capitalize) an amount equal to the amount included in the service provider's income, (2) not entitled to a deduction for amounts distributed to the service provider with respect to the partnership interest and (3) permitted to allocate items of income, gain, loss, deduction and credit to the service provider.
- If, after making a section 83(b) election, the service provider forfeits its partnership interest, then (i) the partnership recognizes income equal to the amount of the deduction that it claimed at the time the partnership interest was issued, (ii) the service provider will receive mandatory allocations of items of income, gain, loss and deduction designed to reverse the effects of prior allocations and distributions and (iii) the service provider is denied a loss upon the forfeiture of its partnership interest.

As with any set of regulations issued by the Treasury Department under the partnership provisions, the proposed guidance contains an extensive set of obscure provisions of mind numbing complexity (including special allocations that take effect upon the forfeiture of a partnership interest) that are required to be included

in the partnership agreement to insure the desired tax treatment. For example, the proposed regulations limit the service provider's capital account for the transferred interest to the sum of (i) the amount paid for the interest by the service provider and (ii) the amount of income recognized by the service provider. Crediting the service provider's capital account with a different amount may cause the partnership to fail the capital account maintenance test contained in the section 704(b) regulations. It is likely that these provisions will start to be included in partnership agreements, at least by reference, if the partnership anticipates that it may issue partnership interests in exchange for services in the future.

#### *The Partnership Does Not Recognize Gain or Loss*

One of the open questions in this area of the tax law concerned the tax treatment of the partnership upon the transfer of a capital interest in a partnership in exchange for services. While practitioners generally agreed that the partnership would be entitled to a deduction for the fair market value of the capital interest, it was unclear whether the partnership was also required to recognize income equal to a corresponding portion of the excess of (i) the fair market value of the partnership's assets over (ii) the basis of the partnership's assets. If the partnership was required to recognize gain, the partnership would be denied the full benefit of the deduction that it would otherwise be entitled to claim in connection with the transfer of the partnership interest in connection with the performance of services. Some practitioners argued that such an approach was inconsistent with the policies underlying section 721 of the Code, while others noted that such an approach was consistent with general tax principles requiring a party to recognize gain when it transferred appreciated property to a service provider in exchange for services.

The proposed guidance answers this question in a largely taxpayer-favorable way. Partnerships (and thus their partners) will not be required to recognize a portion of the gain inherent in their assets upon the transfer of a partnership interest in connection with the performance of services. Consistent with this conclusion, the proposed guidance also provides that the partnership cannot recognize any losses in the event that the partnerships assets have a built-in loss at the time of the transfer. While the regulations are not operative until their effective date, the preamble to the proposed regulations indicates that Treasury determined the nonrecognition position was "more consistent with the policies underlying section 721." As a result, it is

arguable that the Treasury Department has now resolved the uncertainty on this issue with immediate effect.

#### *The Safe Harbor Election—Preserving the Status Quo*

Although the proposed regulations will change the general rule to provide that the issuance of a profits interest in a partnership in connection with the performance of services is a taxable event under section 83, the Treasury Department has proposed to allow partnerships to make valuation assumptions that effectively preserve the current tax-free treatment of profits interests issued for services. Specifically, the proposed revenue procedure permits partnerships that make an election and qualify under its terms to value partnership interests based on the liquidation value of the partnership interest. Liquidation value is the amount that would be distributed to the service provider if the partnership sold all of its assets for cash equal to the assets' fair market value and the proceeds were then distributed to the partners in liquidation of the partnership. The election provides partnerships with the opportunity to continue to apply the principles of **Revenue Procedure 93-27**, and to treat the issuance of a profits interest as a non-event.

To make this election, partnerships will have to satisfy one of two procedural alternatives:

- The first alternative requires the partnership's partnership agreement to explicitly authorize the partnership to make the election. In addition, the partnership agreement must provide that the partnership and each of its partners (including the service provider) and their transferees agree and are legally bound to comply with the terms of the proposed revenue procedure. Each of these conditions must be effective before the date on which the partnership interest is transferred.
- The second alternative requires that each partner in the partnership (including the service provider) execute a document containing provisions that are legally binding on each partner stating that (a) the partnership is authorized to make the election and (b) the partner agrees to comply with the terms of the proposed revenue procedure. Again, each of these conditions must be effective before the date on which the partnership interest is transferred.

Where the partnership only intends to issue profits interests, it will generally make sense to elect to apply the provisions of the proposed revenue procedure and preserve the ability to issue profits interests on a

tax-free basis. Although there may be instances where the tax consequences to the service provider and the other partners may make it desirable to have the service provider recognize current income upon the issuance of a profits interest, it is our experience that the tax consequences that flow from the election will be consistent with most parties' expectations. However, if the partnership anticipates that it will issue capital interests or some combination of profits interests and capital interests, it is not necessarily the case that electing to apply the proposed revenue procedure will always produce the best answer. By electing to use liquidation value, the parties effectively eliminate their ability to claim valuation discounts when establishing the fair market value of the capital interests in the partnership. Also, while the election can be revoked, once revoked the partnership cannot make a new election for five years.

It is also important to note that the election to apply the principles of the revenue procedure will not relieve the service provider of the need to file a section 83(b) election when it receives a profits interest in the partnership that is subject to a substantial risk of forfeiture. In a significant departure from the current guidance, if the service provider fails to make the section 83(b) election, the profits interest will be treated in the same manner as any nonvested partnership interest (see above). As a result, if the partnership elects to apply the revenue procedure and the service provider fails to make the section 83(b) election, the service provider (i) will take any distributions into income as compensation, (ii) will not receive allocations of income, gain, loss, deduction or credit until the partnership interest vests and (iii) will be taxable on the full liquidation value of the partnership interest (as compensation) at the time the partnership interest vests.

#### **Effective Date**

**T**he proposed guidance will apply to transfers of partnership interests in connection with services on or after the date final regulations are published in the Federal Register. The proposed guidance will not apply to partnership interests issued prior to the effective date—even if the partnership interests vest subsequent to the effective date. While this may be well in the future, it is important to recognize that, since the effective date is tied to transfers of partnership interests, the guidance will apply to partnerships that were formed prior to the effective date. As a result, a partnership formed today (or that already exists) and that contemplates that partnership interests will be issued in exchange for

services at some point in the future, may find the parties' expectations regarding the tax treatment of the interests thwarted unless they plan now. To prevent such an occurrence, the parties should consider the tax treatment they want and, if appropriate, take steps to incorporate the appropriate provisions in advance of the effective date of the proposed guidance.

#### Material Available On-Line

The proposed regulations and Internal Revenue Service material discussed in this bulletin can be retrieved using the links in the following list. Alternatively, that material is available and has the indicated file name and size at <ftp.prmstax.com/part>.

- [Notice of Proposed Rulemaking](#), containing the proposed regulations [pregPartIntServ-050524, 87K].
- [Notice 2005-43](#), containing the proposed revenue procedure [n200543.pdf, 76K].
- [Revenue Procedure 2001-43](#) [rp200143.pdf, 19K].
- [Revenue Procedure 93-27](#) [rp9327.pdf, 32K].

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