
IRS Proposes Rules on Treatment of Partnership Interests Issued for Services

2005-07-29

The IRS recently proposed new rules on the treatment of partnership interests issued in exchange for services. The new rules—which will only apply to issuances of partnership interests after the date on which the rules are published in final form—would generally allow a service provider to treat the receipt of a profits interest (typically, an interest such as a carried interest in an investment fund that allows the recipient to share in future appreciation and profits, but not in the existing value of the partnership's assets) in the same manner as under current law, but would impose more stringent reporting and consistency requirements on partnerships and their partners.

In general, outside the partnership area, current law under Section 83 of the Internal Revenue Code (the Code) requires a service provider to report as ordinary income the value of any property received for the performance of services, less any amount the service provider pays for the property. When the property is subject to vesting or transfer restrictions, no amount is required to be included in income until the restrictions lapse. Consequently, any increase in the value of the property between the time of grant and the time that the restrictions lapse can increase the amount of ordinary income that the service provider must include. Under Section 83(b) of the Code, the service provider can elect to take the value of the property into income at the time of the grant (notwithstanding any restrictions on the property at that time), thus ensuring that any further appreciation in the property will be treated as capital gain rather than ordinary income.

The issue of whether the law under Section 83 of the Code applies to the receipt of an interest in a partnership has been long-debated. The new rules—in the form of proposed regulations and a proposed revenue procedure (Notice 2005-43)—attempt to end this debate by bringing the rules governing the issuance of partnership interests to service providers more in line with those under Section 83 of the Code governing the issuance of other types of property (such as restricted stock) in exchange for services. Under current law, neither the grant nor the vesting of a profits interest is ordinarily considered a taxable event for the service provider or the partnership, and no filing of a section 83(b) election is necessary (although most partners have continued to file such elections as a precautionary measure). The new proposed rules would instead treat the issuance of a capital or profits in a partnership generally in the manner described above. Thus, a partner receiving a partnership interest would be required to take into income an amount equal to the fair market value

of the interest, either at the time of grant (if no restrictions apply or if a section 83(b) election is made) or at the time the restrictions lapse (if restrictions, such as vesting requirements, initially apply and no section 83(b) election is made). The new rules, when finalized, would repeal the two revenue procedures (Revenue Procedures 2001-43 and 93-27) that govern the taxation of profits interests under current law.

Under the general rule described above, a service provider receiving a partnership interest would be required to take into income the fair market value of the interest. With a profits interest, this fair market value may reflect the possibility of future profits in the partnership, even if the partnership has no current income. The proposed rules, however, provide a safe harbor under which a partner may instead treat the liquidation value (the amount the partner would receive upon sale of all the partnership's assets followed by a liquidation) as the fair market value of the interest. This safe harbor would permit a treatment similar to that claimed by service partners under current law because the liquidation value of an interest only in future profits would be zero. The safe harbor contains limitations similar to those contained in Revenue Procedures 2001-43 and 93-27. For example:

- The interest in the partnership cannot 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.
- The interest cannot be transferred in anticipation of a subsequent disposition (which is presumed if the interest is sold within two years, unless clear and convincing evidence establishes otherwise).
- The interest cannot be an interest in a publicly traded partnership.

The new safe harbor, however, would also impose the following requirements, which do not apply under current law:

- The partnership must elect for the safe harbor to apply.
- The partnership agreement must contain provisions that are legally binding on all the partners, stating that (1) the partnership is authorized and directed to elect the safe harbor, and (2) the partnership and each of its partners (including any service provider) agree to comply with all requirements of the safe harbor.
- If the partnership agreement does not contain the provisions described above, the partnership can still qualify for the safe harbor if each partner executes a separate document containing similar provisions.

In most cases, existing partnerships should not adopt the provisions described above until the regulations are finalized, as the final regulations may alter these requirements. Newly formed partnerships should consider adding provisions to their partnership agreements to address the requirements described above so that amendments would not be required when the new rules are finalized. Because the regulations may be modified before being finalized, any provisions included in agreements now should be broadly worded in an attempt to accommodate these potential modifications. It may also be advisable to include a provision that allows one or a small number of partners to amend the provisions if necessary in order to comply with the final regulations.

Comments to the proposed rules may request a simpler mechanism for electing the safe harbor, but it is difficult to predict whether the final regulations would reflect any such comments.

The new rules also clarify several unresolved questions under current law, such as:

- Under the proposed regulations, a service provider is not treated as a partner until his/her interest vests, unless a section 83(b) election is made—in which case the service provider is treated as a partner from the date the interest is granted. (Under current law, the service provider may be treated as a partner from the date of grant whether or not a section 83(b) election is made.) Not treating the service provider as a partner before the interest vests—in the absence of a section 83(b) election—means that any distributions made to the service provider would be treated generally as compensation income, and that amounts that would otherwise be allocated to the service provider would instead be allocated to the other partners (although treating distributions to the service provider as compensation may give rise to deductions that would reduce the taxable income or increase the taxable loss allocated to the other partners).
- If a service provider who had been treated as a partner later forfeits his/her interest, the proposed regulations require special allocations so that, in effect, any gain or loss allocated to the service provider would be reversed.
- The regulations clarify that no gain or loss is recognized by the partnership or the other partners upon the issuance of an interest to a service provider. Some had believed that the issuance should be treated as a sale by each existing partner of a portion of his/her share of the partnership's assets.

One area not specifically addressed under current law or in the proposed rules is the treatment of transactions involving related persons, such as the transfer of an interest in a lower-tier partnership in exchange for services provided to an upper-tier partnership. Comments have been requested on this topic.

Treasury and the IRS have requested comments on the proposed regulations. It is not yet clear when the rules will be finalized or what changes will be made at that time.