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Practical Considerations for Issuing Profits Interests, Part 1

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In this report, Beyzaee discusses how profits interests can provide an equity incentive to people providing services to a partnership. The tax treatment to the recipient is favorable, and there are almost endless possibilities in terms of how they are structured. But their use raises several issues, in both implementation and arrangement, that practitioners should be attuned to. And although profits interests have been sanctioned by the IRS for some time, many unanswered questions about their treatment remain.

This report is being published in two parts. This first part discusses the current state of the law governing profits interests. The second part, which will be published June 16, includes practical guidance for establishing these arrangements.

The information contained herein is of a general nature and is based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser. This report represents the views of the author only and does not necessarily represent the views or professional advice of Liner LLP.

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As the prevalence of limited liability companies has increased in recent years, so too has the prevalence of profits interests as a means of compensating employees and other service providers of those companies. This report summarizes the current state of the law governing profits interests and provides practical guidance for establishing profits interest arrangements.

I. What Is a Profits Interest?

Simplistically, a profits interest is a partnership interest or an LLC membership interest that gives the holder the right to share in the profits of the business that arise after the holder acquires the interest. The primary goal of issuing profits interests is typically to give recipients the ability to participate in the growth of the partnership without incurring tax on the receipt of the interest, and to enjoy at least some long-term capital gain treatment (instead of ordinary income treatment) on proceeds they receive on a sale of the partnership or similar liquidity event.[1]

As we will see, the tax treatment of a profits interest is fairly straightforward. What is sometimes difficult is determining whether a partnership interest qualifies as a profits interest that receives this treatment. There is significant flexibility in designing these interests to qualify for the desired treatment. In the more typical arrangements, it is fairly easy to structure qualifying profits interests. But several ambiguities arise as the terms of the interests become more exotic. And there are several collateral issues that, although manageable, can be disconcerting to the recipients of the profits interests if they are not prepared for them or expecting them.

[1]For the purposes of this report, I will generally use the terms "partnership" and "partner" in their tax sense. In other words, unless otherwise specified, I mean these terms to mean an entity treated as a partnership for U.S. federal income tax purposes and a person treated as a partner for U.S. federal income tax purposes, respectively. So they also will include LLCs treated as partnerships for U.S. federal income tax purposes and their members, respectively.

II. Tax Treatment of Profits Interests

Under current law, the treatment of a profits interest depends on whether it is what I will call a safe harbor profits interest or a non-safe-harbor profits interest. By safe harbor profits interest, I mean an interest that is described in Rev. Proc. 93-27, 1993-2 C.B. 343, which provides that the receipt of the interest is not a taxable event for either the recipient or the partnership. Profits interests that are not described in that revenue procedure are instead governed by a line of authorities that are both controversial and equivocal. Partnership interests that qualify as profits interests under that line of cases (but not Rev. Proc. 93-27) are what I mean by non-safe-harbor profits interests. Because Rev. Proc. 93-27 tries to address some of the issues that arose in those cases, we will begin with a review of the early authorities before getting into the details of Rev. Proc. 93-27.

A. Pre-Revenue-Procedure Authorities

''Profits interest'' is not defined or referred to in the code or regulations. Rather, it has developed as a term describing a type of partnership interest that taxpayers and practitioners have argued is not taxable upon receipt. Only with Rev. Proc. 93-27 was the term assigned a specific meaning, and even then, the definition applied only for the purposes of Rev. Proc. 93-27.[2] Accordingly, we will first look at the various authorities addressing this issue to try to build our definition of the term.

Section 721 is clear that no gain or loss is recognized to a partner or a partnership for a contribution of property to the partnership in exchange for an interest in the partnership. But the statute does not discuss the treatment when a person receives an interest without contributing property. The first regulations issued under this section in 1956 said,

> To the extent any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services (or in satisfaction of any obligation), section 721 does not apply. The value of an interest *in such partnership capital* so transferred to a partner as compensation for services constitutes income to the partner under section 61.[3]

Early on, taxpayers latched on to this language to argue that the reference to a share in partnership profits and to an interest in partnership capital was meaningful only if it were indicating that there was a distinction between the treatment of the two.[4]

In the earliest case to address profits interests, *Hale v. Commissioner*, the Tax Court appeared to adopt this interpretation.[5] The taxpayer in *Hale* received for its contribution of future services to the partnership a right as a partner to participate in the partnership's future profits.

The court observed in a footnote, ''Under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. Sec. 1.721-(1)(b), Income Tax Regs.''[6] Oddly, the court went on to conclude that when the taxpayer sold the interest about 10 months later, it was an assignment of the right to receive future income, which resulted in ordinary income to the taxpayer on the proceeds. That conclusion effectively disregarded the profits interest as a true partnership interest and instead treated it as an unfunded and anticipatorily assigned promise to pay.

A few years later, in *Diamond v. Commissioner*, the Tax Court repudiated that interpretation of the regulation and found that the taxpayer was taxable on the receipt of a profits interest.[7] In *Diamond*, the taxpayer received an interest in 60 percent of the profits of a partnership for the services of identifying and arranging the acquisition of real property by the partnership. Within three weeks, the taxpayer sold that interest to the other partner for $40,000. Without referencing *Hale*, the court concluded that although reg. section 1.721-1(b)(1) suffered from ''opaque draftsmanship,'' it did not prevent the taxpayer from being taxed on the receipt of a profits interest.[8] And because there was nothing that would otherwise exclude the value of the interest from being included in income, the court found that the value would be taxable to the taxpayer under section 61. Further, the court held that because the taxpayer was able to sell the interest for $40,000 a mere three weeks after receiving it, the interest had that value at the time it was issued.

The taxpayer in *Diamond* appealed to the Seventh Circuit, which affirmed the Tax Court on what appear to be rather narrow grounds. The court of appeals spent much time reviewing the legislative history and commentators' views on the treatment

[2] Rev. Proc. 93-27, para. 2.

[3] Reg. section 1.721-1(b)(1) (emphasis added).

[4] *See* William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 5.02[6] (2007, with updates through May 2014).

[5] T.C. Memo. 1965-274.

[6] *Id*. at n.3. The regulation citation by the Tax Court appears to be a typographical error. It almost certainly was meant to read ''1.721-1(b).''

[7] 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

[8] 56 T.C. at 546.

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of profits interests but did not find them conclusive. Accordingly, without describing the basis for its holding, the Seventh Circuit found it ''sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision that the receipt of a profit-share with determinable market value is income.''[9] In doing so, however, the court observed: ''There must be wide variation in the degree to which a profit-share created in favor of a partner who has or will render service has determinable market value at the moment of creation. Surely in many if not the typical situations it will have only speculative value, if any.''[10]

In a memorandum prepared shortly thereafter, IRS general counsel considered a revenue ruling that would have addressed the treatment of profits interests.[11] As proposed, the ruling explicitly declined to follow *Diamond* to the extent that it held that the receipt in an interest in future profits of a partnership for services performed would be taxable. But it would have added the requirement that the recipient be a ''joint venturer or partner . . . as distinguished from an employee or an independent contractor.'' Also, the ruling would have denied this treatment to profits interests that shared in the unrealized appreciation of assets of the partnership, such as unrealized receivables. But IRS general counsel decided not to comment on the ruling and deferred consideration of the issue.

The issue remained dormant until late 1983, when it was raised again in *St. John v. Commissioner*.[12] In *St. John*, the IRS argued that the recipient of a profits interest must include the fair market value of the interest in income when received and that the FMV could be higher than its liquidation value. The court seems to have agreed with the first proposition, but it disagreed with the latter. It determined that the success of the business was ''undetermined and speculative,'' so the liquidation approach was the proper method of valuing the interest. In doing so, it quoted the language from the Seventh Circuit's decision in *Diamond* that many profits interests ''will have only speculative value, if any.''[13] Accordingly, the court agreed with the taxpayer that he was not taxable on the receipt of the interest.

A few months later, the Tax Court took up the question again in *Kenroy Inc. v. Commissioner*.[14] But there the IRS agreed with the taxpayer that the value of the profits interest issued to the taxpayer was its liquidation value in a liquidation of the partnership. The dispute was over the valuation of the partnership's assets. The court agreed with the taxpayer's valuation and on that basis concluded that the profits interest had a zero liquidation value. So it held that the taxpayer was not taxable on the receipt of the interest. The court specified that this case was distinguishable from *Diamond*, but aside from describing the facts and its conclusion in *Diamond*, the court did not explain why it was distinguishable.[15]

In 1986 the Tax Court addressed the issue again in *National Oil Co. v. Commissioner*, in which the dispute was whether the taxpayer received a capital interest in a partnership.[16] Citing *Hale*, *Diamond*, and the general counsel memorandum, the court asserted that the IRS had already conceded that an interest in future profits was not taxable in the year of receipt. And, finding that the interest the taxpayer received was not a capital interest, the court held that the taxpayer was not taxable on its receipt.

By this time, the law seemed to have settled onto the rule that a profits interest would typically not be included in income upon receipt if it had no liquidation value at that time. In *United States v. Pacheco*, the taxpayer tried to cite *Diamond* in a criminal case as the basis for causing a partnership to deduct an amount representing the FMV of a profits interest granted to him.[17] The Ninth Circuit rejected this, finding that ''*Diamond* involved a rather unique situation and was so limited by the Seventh Circuit.''[18] In fact, the jury in the lower court found that the taxpayer did not rely on *Diamond* in good faith and instead willfully violated the tax laws.

But in 1990, both the IRS and the Tax Court stunned the tax community with *Campbell v. Commissioner*.[19] First, the tax bar was surprised to see that after over 15 years of essentially conceding that the receipt of profits interest was not taxable, the IRS challenged the taxpayer's argument to that effect. It was also surprised to see the Tax Court continue to adhere to the position it took in *Diamond* and conclude that the interest should be valued and that the value should be included in the taxpayer's income.

The taxpayer in *Campbell* appealed to the Eighth Circuit, but a funny thing happened on the way: The IRS conceded in its brief that the Tax Court was wrong when it concluded that a service provider

[9]492 F.2d at 291.
[10]*Id*. at 290.
[11]GCM 36346 (July 23, 1975).
[12]No. 82-1134 (C.D. Ill. 1983).
[13]*Id.*
[14]T.C. Memo. 1984-232.
[15]*Id.* at n.8.
[16]T.C. Memo. 1986-596.
[17]912 F.2d 297 (9th Cir. 1990), *aff'g* No. CR-85-2048 (N.D. Cal. 1986).
[18]912 F.2d at 302.
[19]T.C. Memo. 1990-162, *rev'd*, 943 F.2d 815 (8th Cir. 1991).

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would be taxable on the receipt of a profits interest from a partnership to which it provides services. But the IRS reached back to its analysis in the 1975 general counsel memorandum, arguing that a receipt of a profits interest is excluded from tax only if the taxpayer provides the services to the partnership granting the interest. Thus, it argued that the Tax Court found that the taxpayer received the interests for services provided to a person other than the partnerships in which he received interests, so the receipt of the interests should still be taxable. That argument carried little weight with the Eighth Circuit, which chose to disregard it. The court then addressed the taxpayer's other arguments, for which it seemed to have some sympathy. Ultimately, the Eighth Circuit determined that the interests were not taxable to the taxpayer because they were "without fair market value" when issued.[20]

Unfortunately, these authorities provide a mixed message on the appropriate tax treatment of profits interests. But, while the courts have not always clearly explained their analyses, their opinions do provide support for the position that the receipt of a profits interest generally is not taxable if it is not promptly disposed of or otherwise easily susceptible to valuation.

B. Revenue Procedures

Given the uncertain state of the case law and what appeared to be a vacillating IRS position, taxpayers and practitioners were concerned about how profits interests would be treated. Fortunately, not long after the *Campbell* appeal was decided, the IRS stepped forward and issued Rev. Proc. 93-27 to provide guidance on the treatment of the receipt of profits interests. It was short and brought much-needed reassurance to taxpayers that the grant of most basic profits interests would not be taxable. However, it did not address the treatment of unvested profits interests. After years of continued pleas from the tax community, the IRS finally followed up with Rev. Proc. 2001-43, 2001-2 C.B. 191, clarifying that if the profits interests were unvested at the time of grant, the vesting of the units generally would not be taxable. These revenue procedures are still in effect and provide useful guidance for taxpayers.

1. Rev. Proc. 93-27. Rev. Proc. 93-27 appears to have been an attempt to "codify" the courts' nebulous concept of a partnership interest with only speculative value and confirm that the IRS would not treat the receipt of that interest as taxable.

[20]943 F.2d at 823.

That revenue procedure provides the general rule that:

> if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

For the purposes of that rule, a profits interest is defined as a partnership interest other than a capital interest. A capital interest, in turn, is defined as a partnership interest that at the time of receipt would give the holder a share of the proceeds if the partnership's assets were sold at FMV and the proceeds were then distributed in a complete liquidation of the partnership.

However, as discussed below, that treatment does not apply in three situations: (1) when the interest concerns a "substantially certain and predictable stream of income from partnership assets;"[21] (2) when the recipient disposes of the profits interest within two years of receipt;[22] and (3) if the interest is a limited partnership interest in a publicly traded partnership.[23]

2. Rev. Proc. 2001-43. Soon after Rev. Proc. 93-27 was released, practitioners began wondering how these rules would apply for an interest that would otherwise qualify as a profits interest but was substantially non-vested. Eventually, the IRS released more guidance in Rev. Proc. 2001-43, clarifying both that the receipt of a profits interest that is substantially non-vested will still qualify as nontaxable and that the later vesting of the interest will not be taxable. Moreover, the revenue procedure provides that taxpayers to which the new rule applies need not file a section 83(b) election.

That treatment is subject to a few conditions. First, the partnership and the recipient must treat the recipient as the owner of the interest from the date of grant.[24] Second, the recipient must "take into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the [recipient's] income tax liability for the entire period during which the [recipient] has the interest."[25] Third, neither the partnership nor any of the partners may take a deduction for the FMV of the interest at the time of the grant or the vesting of the interest.[26]

[21]*See* Section II.E.1.
[22]*See* Section II.F.1.
[23]*See* Section IV.F (Part 2 of report).
[24]*See* Section II.E.5.a.
[25]*Id.*
[26]*See* Section II.E.5.c.

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C. Proposed Regulations

1. 1971 proposed regulations. In 1971 the IRS issued prop. reg. section 1.721-1(b)(1)(i), which said that for a transfer of a partnership interest, ''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).

2. 2005 proposed regulations. In 2005 Treasury withdrew the 1971 proposed regulations and issued new proposed regulations (the proposed compensatory interests regulations) to address some of the questions associated with the issuance of profits interests.[27] The proposed regulations again do not define profits interests, but they reach a result similar to that provided by the revenue procedures.

First, the regulations provide that all partnership interests (whether profits interests or capital interests) issued in exchange for services will be treated as property under section 83.[28] As a result, the recipient would not be treated as a partner in the partnership until the interest vests, unless the recipient makes a section 83(b) election.[29] The corollary is that the unvested profits interest is potentially taxable upon vesting if the recipient does not make a section 83(b) election. If the election is made, the recipient would need to include the FMV of the interest in income at the time it is received. And the recipient would be allocated income and loss as a partner. If the interest is later forfeited, the partnership must make forfeiture allocations of the partnership's gross tax items to the recipient to adjust for excess income or loss allocated to the partner before the forfeiture.[30]

Second, the proposed compensatory interests regulations provide a safe harbor election for treating the liquidation value of the compensatory partnership interest as the FMV of the interest.[31] This safe harbor appears to be an attempt to conform to the case law for profits interests.[32] To qualify, however, both the partnership and all its partners must agree to the election.[33]

These regulations do not go into effect until they are finalized. However, as discussed below, given the dearth of guidance on many issues related to profits interests, they at least shed light on some areas of uncertainty.

[27]REG-105346-03.

[28]Prop. reg. section 1.83-3(e).

[29]Prop. reg. section 1.761-1(b).

[30]Prop. reg. section 1.704-1(b)(1)(ii)(4)(xii).

[31]Prop. reg. section 1.83-3(l).

[32]Prop. reg. section 1.83-3(e)(1).

[33]Prop. reg. section 1.83-3(l)(1). *See* Section III.F.2 (Part 2 of report).

D. Notice 2005-43: Proposed Revenue Procedure

Concurrently with the issuance of the proposed compensatory interests regulations, the IRS released a proposed revenue procedure (Notice 2005-43, 2005-1 C.B. 1221) with additional rules for applying the regulations' safe harbor for valuing compensatory partnership interests at their liquidation value.[34] The proposed revenue procedure elaborates on other provisions of the regulations and provides some analysis that indicates how the IRS might view existing law.

The proposed revenue procedure clarifies that for a profits interest for which a section 83(b) election has been made, the partnership must make allocations as if the partnership interest were substantially vested. And, going beyond the proposed regulations, section 4.04 of the proposed revenue procedure provides that if the safe harbor partnership interest is forfeited, the holder has ordinary income to the extent the partnership lacks sufficient tax items to make all the forfeiture allocations that could have been made if the partnership had unlimited income and gain.[35] The revenue procedure also clarifies that because a holder of an unvested profits interest is not treated as the owner of that interest, any distribution received regarding that interest while it is unvested will be taxable as compensation. Finally, it provides for the proposed regulations a definition of liquidation value that corresponds to the rule in Rev. Proc. 93-27:

> liquidation value is determined without regard to any lapse restriction (as defined at section 1.83-3(i)) and means the amount of cash that the recipient of the Safe Harbor [Profits] Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.[36]

[34]This report does not address the rules describing the mechanics for making the safe harbor election, because they will apply only if and when the proposed regulations and proposed revenue procedure are finalized.

[35]It is questionable whether the IRS has the authority to impose tax under a revenue procedure when there is no statutory or regulatory basis for that tax.

[36]Consistent with Rev. Proc. 93-27 and the proposed revenue procedure, for the rest of this report, I use the term ''liquidation value'' to mean the amount of cash that the holder of a partnership interest would receive if the partnership sold all its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets and then liquidated (a hypothetical liquidation), as determined without regard to any lapse restriction (as defined in reg. section 1.83-3(i)). *See* Notice

(Footnote continued on next page.)

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E. Areas of Uncertainty

1. Liquidation value and proceeds distributed in complete liquidation. Rev. Proc. 93-27 provides that for a profits interest to qualify for the safe harbor, its holder may not receive a share of proceeds if the partnership's assets were sold at FMV and the proceeds were distributed in a complete liquidation. The determination is generally made when the interest is received. This seems like a fairly straightforward test, but a creative practitioner can devise quite a few profits interests that appear to technically satisfy the requirement yet stretch its apparent intent.

Very simply, the rule appears to be intended to prevent the recipient of the profits interest from sharing in any of the existing value of the partnership. But that is not what the proposed revenue procedure says. Instead, it uses the hypothetical liquidation test, which is not really saying the same thing. What happens, for example, if the partnership agreement does not permit the holder of the profits interest to share in *any* distributions on liquidation but always allows the holder to share in current distributions?

Example 1: Partnership AB has two 50 percent partners, A and B. When AB has a liquidation value of $1,000, it grants C a profits interest, and there is a revaluation of partnership assets upon the grant of the profits interest to give each of A and B a $500 capital account. The partnership agreement for AB provides that *all* current distributions (regardless of whether there are any gains or profits) are to be made on a 45-45-10 basis to A, B, and C, respectively. On a liquidation of the partnership, however, the partnership agreement provides that all proceeds are to be distributed 50-50 only to A and B. Distributions are made at any time upon the consent of A and B.

Under these facts, it is possible that C shares in the existing $1,000 value of partnership AB, regardless of whether the partnership has any profits. Yet, if there were a liquidation of the partnership (whether upon receipt of the profits interest or later), C would be entitled to nothing. Does that satisfy the requirement? On a plain reading, it would, even though C is potentially sharing in the existing value of the partnership. And there is the argument that it is consistent with the requirement because C has no *entitlement* to any value of the partnership and may never share in any value of the partnership.[37] Under these facts, the IRS might be satisfied that the test is met.

If you change the facts a little bit, however, it becomes more difficult.

Example 2: The facts are the same as in Example 1, but the partnership agreement requires the partnership to make a distribution of 10 percent of its assets at the end of every year.

Again, C will never share in any proceeds on liquidation of the partnership. And again, there is no guarantee that C will share in any part of the partnership's existing value.[38] But now there is a much greater likelihood that C will in fact share in that value. Does that cross the line? While this still may not cross the line, some combination of the following facts, which technically satisfy the test, can be expected to elicit a reaction from the IRS:

- C has the right to declare distributions;
- C has the right to veto any liquidation of the partnership;
- C is permitted to share in liquidation proceeds if liquidation occurs at least 10 years after the grant of the profits interest;
- C is permitted to share in liquidation proceeds if liquidation occurs at least five years (or two years) after the grant of the profits interest; or
- C receives a distribution promptly after the receipt of the profits interest and before the partnership has any profits.

Unfortunately, there is no guidance here. None of the guidance involving profits interests issued so far addresses the possibility that the holder of an interest might be able to participate in current distributions even though the holder has no right to participate in a liquidation of the partnership. So a careful practitioner should proceed cautiously with any profits interest that relies too heavily on a literal reading of this requirement.

2. 'Substantially certain and predictable stream of income.' In Rev. Proc. 93-27, the IRS introduced a concept that had not previously been raised in any of the cases dealing with profits interests: the requirement that the interest not ''relate to a substantially certain and predictable stream of income from partnership assets.''[39] It is easy to recognize the concern that prompted the IRS to include this restriction, but it is hard to see how broadly it might apply.

2005-43, section 4.02. And I use the phrase ''liquidation value of the partnership'' to mean the aggregate proceeds that would be distributed to all partners on a hypothetical liquidation.

[37]This argument puts more stress on the question whether C is actually a partner. *See* Section II.E.5.e.

[38]For example, the partnership might be liquidated before the end of the first year after C receives the interest. Or the partnership might have sufficient profits to cover the current distributions, thereby leaving the existing value only for A and B upon the final liquidation of the partnership.

[39]Rev. Proc. 93-27, section 4.02(1).

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The courts never faced a situation in which a profits interest represented an interest in income that was in any sense guaranteed or highly likely to arise. But the IRS reasonably took the position in Rev. Proc. 93-27 that in that situation, the receipt of the profits interest would likely be taxable, because it would not have ''only speculative value.'' It would be much the same as if that stream of income were directly assigned to the recipient for the services.

Example 3: Partnership AB holds treasury notes with an aggregate face amount of $1,000, five years left to maturity, and a 4 percent interest rate. For services performed for the partnership, AB grants a profits interest to C that gives C 10 percent of any profits earned by the partnership. AB has no other assets or liabilities, is prohibited from acquiring other assets or incurring liabilities, and is required to distribute all cumulative net profits annually.

In this example, it is easy to see that for five years, C is almost certain to receive $4 each year in distributions from AB.[40] Given the facts, this stream of income can easily be valued and has little risk, so it would not have ''only speculative value.'' Accordingly, consistent with the case law, it would be appropriate for the receipt of that kind of interest to be taxable.

The difficulty for taxpayers, however, is that there is little guidance on the scope of the exclusion. Rev. Proc. 93-27 gives examples of ''income from high-quality debt securities or a high-quality net lease'' being covered. What it does not do is provide guidance on what constitutes high quality or on how to test other income streams to determine if they are substantially certain and predictable.

It is also unclear what it means for the profits interest to ''relate to'' that stream of income. On the one hand, when there is a direct link between the income stream and the holder's economic rights, as in Example 3, this standard would likely be met. On the other hand, if the holder's economic right is only a share of what is left after specific expenses that are not substantially certain or predictable are paid, that presumably would no longer trigger the exclusion.

Then again, what happens if a partnership has no expenses but has assets with very speculative value in addition to high-quality debt securities?

Example 4: Assume the same facts as in Example 3, except that AB also owns 100 grams of gold that the partnership is required to hold at least until the maturity of the treasury notes.

Does the fact that C's minimum economic rights are no worse than in Example 3 mean the interest falls into the exclusion? One might read Rev. Proc. 93-27 to say that the economics of the interest have to be entirely tied to the substantially certain and predictable stream of income, meaning the uncertainty regarding the gold would take it out of the exclusion. But it is easy to see why the IRS would argue that because there is essentially a floor on the economics of the interest, it is captured by the exclusion.

That said, if there is a potential for the partnership to incur losses that would affect the economics of the profits interest holder, the exclusion probably does not apply.

Example 5: Assume the same facts as in Example 4, except that AB can sell the gold at any time upon the determination of its partners.

Now there is a risk that before any of the income of the treasury notes can be distributed, AB will sell the gold at a loss. This creates a risk that C will no longer receive a minimum of $4 (or any distributions) in any given year, or any distributions at all. So there is a good argument that the exclusion would not apply.

The examples in Rev. Proc. 93-27 suggest that the mere fact that a business is profitable would be insufficient to bring an interest into the exclusion. In most cases, this would likely be an easy hurdle to overcome. But any practitioner trying to implement an exotic form of a profits interest should be careful not to put too much pressure on this point.

3. Grants by disregarded entities. Another situation in which the application of the revenue procedures remains unclear is when a profits interest is granted by a disregarded entity. Rev. Proc. 93-27 specifies that it applies to services performed to or for the benefit of a partnership. But like all the cases, Rev. Proc. 93-27 predates the adoption of the check-the-box regulations. Rev. Proc. 2001-43, which was the first authority issued after those regulations were adopted, also gives no guidance on this issue. And the proposed compensatory interest regulations merely refer to the transfer of a ''partnership interest'' without addressing whether the same rules apply to the issuance of an interest by a disregarded entity. At first blush, it is not clear that an issuance by a disregarded entity should be treated any differently if the other requirements of the revenue procedures are met. But several considerations cast doubt on that conclusion.

The case law regarding profits interests sheds little light on this issue. *Campbell*, *St. John*, and *Kenroy* all addressed situations in which the taxpayer was granted an interest in the profits of an entity that was already otherwise a partnership with more than one partner for tax purposes. *Diamond* did involve an entity with only one owner other than the recipient of the profits interest.

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[40]($1,000 x 4 percent) x 10 percent = $40 x 10 percent = $4.

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However, the opinions in that case are not useful in addressing this question, since the courts concluded that the service provider was taxable on the receipt of the interest for a reason unrelated to the number of owners.

On a basic level, it would seem unusual for a person who receives an interest from a disregarded entity that is otherwise identical to an interest he receives from a partnership to have those two grants treated differently. That argument does not go very far, however, because the person could, for example, receive an otherwise identical interest from an entity that has elected to be taxed as a corporation — and that would clearly not qualify for profits interest treatment. The question is whether the distinction between a partnership grantor and a disregarded entity grantor is material enough to warrant a different treatment.

Rev. Rul. 99-5, 1999-1 C.B. 434, generally provides that the treatment of the admission of a second owner to a disregarded entity depends on how that person is admitted. If the second owner purchases an interest from the original owner, it is treated under Situation 1 of the ruling as if the second owner purchased assets from the original owner and both contributed the assets to a new partnership. However, if the second owner purchases an interest from the entity, it is treated under Situation 2 of the ruling as if the original owner contributed the entity's assets to a new partnership and the new owner contributed the purchase consideration to the new partnership.

The revenue ruling is not directly applicable to a grant of a profits interest because its facts assume that the new owner acquires its interest for cash consideration. Moreover, a grant of a profits interest does not neatly fall into either situation described by the ruling. The profits interest could be granted by the entity to the service provider, or it could be granted by the original owner to the service provider.[41] In form, those scenarios appear similar to situations 1 and 2, respectively. But in substance, unlike a transfer of an interest for cash (or other property), there is no difference between the approaches: The original owner's post-issuance situation is the same in both. If the form of the grant were respected and the principles of Rev. Rul. 99-5 were applied, it would appear that a grant of an interest by the entity would be treated as an interest issued by a partnership under the Situation 1 principles, and the interest would qualify as a safe harbor profits interest. By the same token, a grant from the existing partner would likely be viewed under the Situation 2 principles as the partner's grant of an interest in the profits of all the assets to the service provider, followed by a contribution by each to the entity. With that Situation 2 treatment, the grant would not satisfy the prerequisites of the revenue procedures. However, because the two ways of granting an interest are substantively the same, it would not be surprising to see the IRS adopt a single treatment of the grant, regardless of the form.

Most taxpayers would hope to see the IRS treat all grants of profits interests under the principles of Situation 1 of Rev. Rul. 99-5 as grants of the interest from a partnership, which could qualify them as safe harbor profits interests. But until there is guidance, taxpayers should consider the potential consequences of the form of the grant.

4. Services performed 'for the benefit of a partnership.' Another area of uncertainty created by the brevity of the revenue procedures is the requirement that the profits interest be received "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner."[42] It is clear that a person that provides services directly to the granting partnership will satisfy this condition, but it is uncertain what is meant by performing services "for the benefit of a partnership."

For the phrase to be meaningful, it must mean something other than just providing services to the partnership, or else it would be superfluous in light of the reference to "the provision of services to" the partnership.[43] In my view, the most natural reading is that services that in any way benefit the issuing partnership would satisfy this requirement. Normally, when an entity compensates a person for performing services, it is treated as compensation for the service provider, regardless of the recipient of the services.[44] Why, then, should the receipt of a

[41]Note that the rule in Rev. Proc. 93-27 does not require that the interest be granted by the partnership — as discussed in Section IV.L (Part 2 of report), on its face, it could apply to a qualifying interest granted by another partner.

[42]Rev. Proc. 93-27, section 4.01.

[43]*Compare* with the preamble to proposed compensatory interests regulations, in which Treasury notes that the proposed regulations apply only to a transfer of a partnership interest in connection with the performance of services for the partnership and requests comments on the tax consequences for "transactions involving related persons." REG-105346-03, 70 F.R. 29676, section 1, "Application of Section 83 to Partnership Interests."

[44]*See* reg. section 1.61-2 (tips as income), section 74 (prizes as income), *Kralstein v. Commissioner*, 38 T.C. 810 (1962) (holding that some proceeds of ticket sales for a testimonial dinner honoring the taxpayer were not gifts and were thus taxable to the taxpayer); *see also Robertson v. United States*, 343 U.S. 711 (1952) ("Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it").

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profits interest be treated any differently depending on the recipient of the services? But it is not clear that the IRS would take such a broad view.

The one place where comparable language arises in the code or Treasury regulations is in reg. section 1.704-1(b)(2)(iv)(f)(5)(iii), which generally permits a partnership to revalue its assets ''in connection with the grant of an interest in the partnership . . . as consideration *for the provision of services to or for the benefit of the partnership* by an existing partner acting *in a partner capacity*, or by a new partner acting in a partner capacity *or in anticipation of being a partner*'' (emphasis added). Although there is some new language, this essentially tracks the text of Rev. Proc. 93-27. The preamble to the proposed version of this regulation indicated that its purpose was to permit a revaluation in connection with the grant of a profits interest.[45] Unfortunately, the preamble shed no more light on what it meant for the services to be performed ''for the benefit of the partnership.''

Probably the closest the IRS has come to answering this question is in LTR 200329001. There it addressed a situation involving a taxpayer that was a general partner of a limited partnership. The taxpayer had an incentive compensation plan that provided restricted stock grants of taxpayer stock to executives of the taxpayer and its affiliates (including the limited partnership). The taxpayer wanted to adopt another incentive plan that would provide interests in the limited partnership to participating executives. Although the ruling is somewhat unclear on this point, it implies that the participating executives were not necessarily executives of the limited partnership and may not have performed any services directly to the limited partnership. Even so, the IRS ruled that under the revenue procedures, the grants of the interest in the limited partnership would not be taxable.[46]

Unfortunately, the IRS did not take the opportunity to explain what constitutes services performed for the benefit of the partnership. But implicit in the ruling is an acknowledgment that interests granted to individuals performing services for a person other than the partnership could qualify for the safe harbor treatment. Indeed, the ruling appears to acknowledge that the services can be performed even for an owner of the partnership, and not just a subsidiary of the partnership, and still qualify.

If the services can be performed for an owner of a partnership, it should also follow that services performed for a wholly owned subsidiary of the partnership (whether held directly or indirectly through other wholly owned subsidiaries) should qualify. If the recipient of the services is wholly owned by the partnership, it is the partnership (and only the partnership) that ultimately benefits from those services. In fact, a grant of that interest by the partnership to that service provider is perfectly rational for this reason.

Whether that subsidiary is a disregarded entity or a corporation should make no difference.[47] If the subsidiary is a corporation, the grant would likely implicate reg. section 1.83-6(d). That regulation provides that if a shareholder of a corporation transfers property to a service provider of a subsidiary, that property is treated as contributed by the shareholder to the corporation and then paid by the corporation to the service provider ''in consideration for services performed for the corporation.''

This overlay does not disturb the principles of Rev. Proc. 93-27. As discussed below, Rev. Proc. 93-27 does not require that the transferor be the partnership itself, so treating a corporate subsidiary as the transferor does not violate the conditions in Rev. Proc. 93-27.[48] Moreover, neither the corporation nor the partnership (nor any of its partners) would be claiming a deduction. And with the partnership having no basis in the interest, the deemed contribution would not inflate the partnership's basis in its equity in the corporation. Likewise, because the corporation would have no basis in the interest, the grant of the interest would not add to any basis in the corporation's assets, even if the services related to a capital asset.

If a profits interest can be granted for services performed for a wholly owned subsidiary, why can't it also be granted for services performed for a partially owned subsidiary? Services performed for a partially owned subsidiary will benefit the partnership in the same way as services performed for a wholly owned subsidiary, with the only difference being the magnitude of the benefit. For a corporate subsidiary, the considerations described above for a wholly owned corporate subsidiary should apply.

[45]REG-139796-02, 68 F.R. 39499 (July 2, 2003).

[46]The ruling also appears to acknowledge that a partner can acquire both a capital interest and a profits interest in a partnership and that the two will be separated for the purposes of applying the revenue procedures.

[47]It is unlikely that the language was attempting to capture services performed for a disregarded subsidiary of a partnership, because the check-the-box regulations that first recognized disregarded entities had not yet been promulgated. Grantor trusts, which for tax purposes are also disregarded as separate from their owners, existed at the time Rev. Proc. 93-27 was issued. However, because an entire subpart of the code governs grantor trusts, it is unlikely that they would have been referenced so obliquely.

[48]*See* Section IV.L (Part 2 of report) for a discussion of grants of profits interests from persons other than the partnership.

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For a partnership subsidiary, there should similarly be no problems, even if the principles of reg. section 1.83-6(d) apply.

It is also reasonable to read the clause as an acknowledgment of the court's holding in *Campbell*. As discussed above, in *Campbell* (and previously in GCM 36346), the IRS maintained that a profits interest avoids taxation only if it is granted to a person providing services to the partnership and not when the services are provided to a third party.[49] The court disagreed and sustained the taxpayer's position that he was not taxable on a profits interest that he received from an affiliate of the partnership that granted the interest. Based on this, the language could be read as including services performed for any affiliate of the partnership granting the interest.

So what about a benefit to the partnership that results from the service provider providing services to an unrelated person? For example, what if the grant were made to an employee of a key customer or key supplier of the partnership? The amount of the benefit to the partnership might be quite speculative, but it is no less so than when the services are performed for an affiliate in which it has no ownership interest.

There is at least a reasonable basis for arguing that the partnership benefits from the grant of the interest, even if there is no direct quid pro quo. If the partnership's suppliers can reduce the cost of production for its products as a result of the services, for example, the partnership might benefit from lower costs. Likewise, if a partnership's customer is able to expand its business as a result of the services performed, that may lead to increased business for the partnership from that customer. If the basis for why the interest is not taxable is that its value is too speculative to be subject to tax, the relationship between the partnership and service recipient should be irrelevant. Whether the interest is in the entity for which the services are performed or in another entity would not affect how speculative that value is. Even so, given the IRS's position in *Campbell* and GCM 36346, it is unclear that the Service would agree with this interpretation of the ''for the benefit of the partnership'' language.

This discussion raises a fundamental question: What level of benefit must the partnership receive to satisfy this test? Would a peppercorn of benefit suffice? Must the benefit be concrete and tangible, or is a speculative benefit sufficient?

Although there is nothing specific in the profits interest area, there is some limited case law addressing what constitutes property when qualifying for tax-free exchange treatment under section 721. In that context, it does not appear that the contributed asset must be ''concrete'' in the sense of being an enforceable, clearly valuable asset in order to constitute property. A prime example is the letter of intent of questionable enforceability that the court in *Stafford v. United States* found to constitute property for section 721 purposes.[50] Other items qualifying as property have included a contractual right to participate in a different partnership and rights to purchase property, which could be argued to include technical know-how, and goodwill.[51]

Given that even assets with fairly speculative value can constitute property for section 721 purposes, it would make sense that even services with speculative value would qualify under the revenue procedures. Indeed, the court in *Campbell* and the IRS in LTR 200329001 seemed to have no concerns that the partnership granting the interest had only an indirect benefit from the services.[52] Moreover, if the basis for not taxing a profits interest on receipt is that the interest is itself too speculative to have any taxable value, it would make sense that services with even a speculative value for the partnership is all that is needed.

Although it is not directly mentioned in Rev. Proc. 93-27, the safe harbor should also apply for services that are anticipated to be performed after the interest is granted.[53] In general, amounts paid in anticipation of services being performed are treated

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[49]*See* Section II.A.

[50]727 F.2d 1043 (11th Cir. 1984), *rev'g* 552 F. Supp. 311 (M.D. Ga. 1982).

[51]*Dillon v. United States*, 84-2 USTC para. 9921 (S.D. Texas 1981) (right to participate in other partnership); *Ambrose v. Commissioner*, T.C. Memo. 1956-125 (contract for purchase of wine); McKee et al., *supra* note 4, at para. 4.02[1] (''Other 'service-flavored' assets that may, under certain circumstances, qualify as property for purposes of section 721 include technical know-how [and] goodwill'').

[52]In fact, quite to the contrary, it is as if an affiliate of the partnership is using the partnership to obtain a benefit for itself. Further, neither LTR 200329001 nor *Campbell* indicate that there would be any other constructive tax events like what are created under reg. section 1.83-6(d), such as deemed contributions or deemed distributions, to account for the use of equity of a partnership to compensate a person performing services for a parent of the issuing partnership.

[53]I have also heard it argued that the phrase ''for the benefit of the partnership'' refers only to services performed for a partnership before the formation of the partnership. If this were the intent, it is hardly clear from the plain text of Rev. Proc. 93-27. A natural reading of the text does nothing to imply that ''for the benefit of'' is indicating only services that are performed before the entity's formation. Moreover, there is no term of art or common usage in the tax profession that would lead even an experienced practitioner to link ''for the benefit of'' specifically to preformation services.

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as ordinary income to the same extent as compensation paid after the services are rendered.[54] The same should be true for profits interests granted: They should not fail to qualify for the safe harbor simply because the services are to be rendered after the grant of the interest.

5. Unvested profits interests. In Rev. Proc. 93-27, the IRS provided that the receipt of qualifying profits interests would not be a taxable event. But it did not address the treatment of the vesting of profits interests that are unvested when initially granted. After years of consternation among taxpayers and practitioners, the IRS finally clarified in Rev. Proc. 2001-43 that if specified conditions were met, neither the grant of an unvested profits interest nor the vesting thereof would be taxable.

To qualify for this treatment, in addition to satisfying the requirements of Rev. Proc. 93-27, the following requirements must be met:

> the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; and
>
> upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest.

While these requirements appear straightforward, there are still several questions that unvested profits interests raise.

a. Application of section 83. Although Rev. Proc. 2001-43 gave taxpayers some guidance about how an unvested profits interest should be treated, it surprisingly left two significant questions unanswered: Does section 83 apply to a safe harbor profits interest, and if so, how? Rev. Proc. 2001-43 creates a rule that conflicts with section 83 principles without explaining how the new regime fits together with those principles.

Section 83 generally applies to the transfer of property in connection with the performance of services. Unless the taxpayer makes a section 83(b) election, it also generally makes a taxpayer taxable on that property when it has been transferred to the taxpayer and the property has become substantially vested.[55] Moreover, if a section 83(b) election is not made, the property is still treated as owned by the transferor for tax purposes until the property becomes substantially vested.[56] If a taxpayer instead makes a section 83(b) election for the property, the taxpayer will be taxed at the time of receipt of the property and will be treated as its owner.[57]

Because a safe harbor profits interest is, by definition, granted in connection with the performance of services, section 83 would, on its face, apply.[58] So it appears that without Rev. Proc. 2001-43, section 83 would not result in the holder being treated as a partner before the profits interest vests.[59]

In contrast, Rev. Proc. 2001-43 says that "for the purposes of Rev. Proc. 93-27 . . . the service provider will be treated as receiving the interest on the date of its grant." However, it does not address whether the service provider will be treated as owning the interest from the date of its grant for section 83 purposes. It also references reg. section 1.83-3(b) for the definition of substantially non-vested. But it then provides that "taxpayers to which [Rev. Proc. 2001-43] applies need not file an election under section 83(b)." Further, it says that the IRS "will not treat the event that causes the interest to become substantially vested . . . as a taxable event for the partner or the partnership."

Taken in its totality, the regime set forth in Rev. Proc. 2001-43 that treats the holder as having received the unvested interest at the time of grant even without a section 83(b) election contrasts so much with the result under the section 83 rules that one can argue that it implicitly supersedes those rules. However, the explicit references to section 83 concepts without a specific statement that section 83 does not apply leaves much doubt on the issue. For example, it might be argued that Rev. Proc. 2001-43 is simply treating the holder as if it had made a

[54]*McCormack v. Commissioner*, T.C. Memo. 1987-11. *See also* reg. section 1.451-1(a) and Rev. Rul. 69-92, 1969-1 C.B. 138. For these purposes, I am referring to bona fide compensation and not a loan or advance, which may yield a different result.

[55]Reg. section 1.83-1(a).

[56]*Id.*

[57]Reg. sections 1.83-2, 1.1361-1(b)(3); Rev. Rul. 83-22, 1983-1 C.B. 17.

[58]*See Crescent Holdings LLC v. Commissioner*, 141 T.C. 15 (2013) ("section 83 applies to the transfer of a partnership capital interest in exchange for the performance of services").

[59]*Id. See also* reg. section 1.1361-1(b)(3) ("For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of section 1.83-3(f)) and that is substantially nonvested (within the meaning of section 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b)").

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section 83(b) election. If that were the case, why didn't the IRS simply say it?

The problem with this uncertainty is that, as discussed below, property subject to section 83 is often subject to special rules on subsequent events. To avoid complicating the discussion too much, I will assume for the sake of the following analysis that the approach taken in the proposed compensatory interests regulations is what the IRS intended. So I will assume that under Rev. Proc. 2001-43, safe harbor profits interests are subject to section 83 and that their holders are treated as having made a section 83(b) election regarding the interest. I will then note where appropriate how the results might differ if the profits interests are not treated as being subject to section 83.

b. Service provider taking into account distributive share. It seems fairly straightforward for the service provider to be treated as the owner of the interest under the first safe harbor requirement for unvested interests. This presumably means reflecting the service provider as a partner on the partnership's tax returns, issuing the service provider a Schedule K-1 reflecting its distributive share of partnership tax items, treating salary and other guaranteed compensation paid to the service provider from the partnership as guaranteed payments, applying all federal income tax tests that look to the ownership of the partnership by treating the service provider as a partner, and the service provider reporting its income and filing its tax returns consistently with the foregoing.

A wrinkle arises, however, with the part of the first requirement that the service provider "take into account the distributive share of partnership [tax items] . . . for the entire period during which the service provider has the interest." Does that mean that tax items must actually be allocated to the service provider during that time? Or is it sufficient that the service provider reflect the tax items on its return if any of them are allocated to it?

As discussed below, one can imagine creating a profits interest that is not entitled to receive any distributions (currently or in liquidation) while the interest is unvested.[60] Assume for now, also, that there is no catch-up mechanism for that unvested profits interest for any distributions made while it was unvested. A reasonable set of allocation provisions might provide that any income associated with amounts that are distributed would be allocated only among the partners that participate in those distributions. In some cases, this allocation approach would result in all net income being allocated to the recipients of the distributions, leaving nothing allocated to the profits interests. Indeed, because the holder of the interest is not entitled to any distributions unless and until the interest vests, it would appear reasonable under the general allocation principles to allocate *no* income or loss to that holder.[61]

These types of allocation rules could be consistent with the service provider being treated as the owner of the interest: The service provider could be issued Schedules K-1, any salary could be reported as guaranteed payments, and so on. And because the service provider will have no right to any value in respect of the interest before vesting, it would appear that any profits or losses of the partnership would have no economic effect on the service provider's interest. So, as acknowledged in the proposed compensatory interests regulations, how could any allocation of tax items have substantial economic effect or be in accordance with the partners' interests in the partnership?[62]

The proposed revenue procedure asserts the rule that the partnership must allocate tax items to the holder as if the interest were fully vested, but it does not explain what that means. Specifically, it does not address how this applies when an unvested interest has different economic rights than a vested interest. One possibility is that it means that for the purposes of allocations, the parties should assume that the interest is fully vested in all respects, including its economic rights. In other words, you assume that the holder is entitled to the distributions it would receive if the interest were actually vested (even if the holder is not entitled to any distributions while the interest is unvested). Or it could just mean that even though the interest is unvested, you look at the actual economic rights of the unvested profits interest (which may be limited because it is unvested) and make allocations on that basis.

Many practitioners take the first approach, treating the interest as having all the economics it would have had if it were vested. If the partnership makes no distributions while the interest is unvested and the interest ends up fully vesting, that approach will generally provide a reasonable result.

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[60]*See* Section III.D.3 (Part 2 of report).

[61]*See* prop. reg. section 1.704-1(b)(4)(xii)(a) ("allocations of partnership items while [an unvested compensatory profits interest for which a section 83(b) election has been made] is substantially nonvested cannot have economic effect"). *Cf*. reg. section 1.704-1(b)(2)(ii)(a) ("In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."); and reg. section 1.701-1(b)(3).

[62]*Id*.

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Example 6: Partnership AB has two 50 percent owners, A and B. At the beginning of year 1, AB issues C an unvested safe harbor profits interest that does not share in any distributions (current or in liquidation) until it vests (which happens at the end of year 4) and does not get a catch-up of any distributions made while unvested. The profits interest shares in 10 percent of all gains and profits over the existing $4,000 liquidation value of the partnership (diluting each of A and B to 45 percent of those gains and profits), and there is a revaluation of partnership assets upon the grant of the profits interest to give each of A and B a $2,000 capital account. C does not make a section 83(b) election for the profits interest. The partnership uses a target method of allocating income (targeted to a hypothetical book liquidation of the partnership) and treats all unvested interests as having the economics of vested interests for the purposes of the hypothetical book liquidation. In year 1, the partnership has $1,000 of net profits. In years 2 through 4, the partnership has no net profits or gross profits, and there is no built-in gain or loss that arises after the grant of the profits interest. C's profits interest fully vests at the end of year 4, and the partnership liquidates at that time, distributing $2,450 to each of A and B and $100 to C.[63]

In year 1 of Example 6, the partnership would allocate $450 to each of A and B and $100 to C, bringing their respective capital accounts to $2,450, $2,450, and $100.[64] Although this shifts income away from A and B to C in the short term, the allocations over the remaining life of the partnership match up with the partners' economics.

But if there are distributions in which the interest does not participate because it is unvested, there will be a mismatch between the income allocated to the holder and the economic rights of that holder.

Example 7: The facts are the same as in Example 6, but in year 2, the partnership distributes $1,000 — $500 to each of A and B. On the liquidation of the partnership at the end of year 4, $2,000 is distributed to each of A and B, and nothing is distributed to C.

As in Example 6, here the partnership would again allocate $450 to each of A and B and $100 to C, bringing their respective capital accounts to $2,450, $2,450, and $100. After the distributions in year 2, A's and B's capital accounts will each be reduced to $1,950. So at the time of liquidation, C's $100 capital account will exceed its zero liquidating distribution, and each of A's and B's capital accounts of $1,950 will be below its $2,000 liquidating distribution. Thus, current income is shifted away from A and B to C even though C has not participated in any of the economics.

If the partnership in Example 7 had had profits or losses after year 1, this mismatch between the tax allocations and the economics could have been corrected by adjusting the subsequent allocations. Even if the service provider must be allocated tax items as if the interest were vested, the distribution is an unexpected event that requires corrective allocations to properly be accounted for.[65] Without the subsequent profits and losses, A and B would have gain on the liquidation, and C would have a loss on the liquidation, which would partially correct that mismatch.[66] However, the gain and loss would probably have a mostly capital character instead of the ordinary income character of the current income, meaning A and B would likely have an overall reduced tax burden and C would have an overall increased tax burden.[67] Because a service provider in C's position will often have a lower effective tax rate than the other partners, this may effectively reduce the overall tax burden attributable to the business of the partnership, a result the IRS certainly would not like.[68]

A more problematic situation is if the profits interest is later forfeited before it vests.

Example 8: The facts are the same as in Example 7, but C's profits interest is forfeited in year 3 before its vesting.

What happens to C's $100 capital account and accompanying basis? Under reg. section 1.83-2(a), C would have no loss (C would be allowed a loss only for the difference between the amount paid for the

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[63]*See* Section II.E.6 for a discussion about whether such an interest is a partnership interest.

[64]In a hypothetical book liquidation of AB (in which the profits interest is treated as vested), the $5,000 of proceeds would be distributed $2,450-$2,450-$100 to A, B, and C, respectively: First, $4,000 would go $2,000 to each of A and B, while the remaining $1,000 would go $450 to each of A and B, and $100 to C. The $450-$450-$100 allocation would bring their respective capital accounts from $2,000-$2,000-$0 to $2,450-$2,450-$100 to match A's, B's, and C's respective shares of the hypothetical book liquidation proceeds.

[65]*Cf.* reg. section 1.704-1(b)(2)(ii)(d) (flush language, regarding the requirement to eliminate deficit capital accounts resulting from certain "unexpected" allocations "as quickly as possible").

[66]If the partnership had distributed property rather than cash on the liquidation, the mismatch would continue until the partners disposed of the property they received. *See* sections 731(a) and 732(b).

[67]Indeed, because C could not carry back the loss to the prior year, it would get the benefit of that loss only if it has subsequent income against which it can apply the loss.

[68]*See* reg. section 1.704-1(b)(2)(iii)(b) (treating "shifting allocations" as not substantial).

profits interest and the amount received upon forfeiture, which is zero in this example).[69] Effectively, the basis attributable to income allocated to C is disregarded. So C would never be able to offset the income previously allocated to it — an awfully harsh result.

It is also unclear what should happen to the partnership and the other partners upon any forfeiture. Ordinarily, the forfeiture of a compensatory grant of unvested property is taxable to the grantor under section 83 only if a deduction, reduction of gross income, or an increase in basis was allowable for the transfer of the property.[70] If an unvested safe harbor profits interest is granted, none of these is allowable for the transfer of the interest, so there should be no tax to the partnership or the partners because of section 83.[71]

Still unaddressed, however, is the capital account of the service provider resulting from income allocations made to the service provider. It is not clear that there is a way to make allocations that would correct for that capital account. Because the service provider is no longer a partner, the partnership could not specially allocate losses to it (or away from the other partners) to eliminate that outstanding capital account. By the same token, there would never be ''extra'' taxable income or gain that could be allocated to the remaining partners to make up for the income that was allocated away from them to the former partner.[72]

As a result, it is appealing to treat that capital as just being shifted to the other partners, thereby matching up their capital accounts with their economics. The topic of capital shifts and their taxation is complex and beyond the scope of this report. Suffice it to say that the law is unclear on whether that treatment is appropriate. If it is a capital shift, that might result in the other partners being taxed on the value of the service partner's capital account, effectively catching them up for the income that was previously allocated away from them to the service partner.[73]

But if capital shift treatment is inappropriate, because special allocations would not resolve the mismatch, the remaining partners' missing income or gain would be recognized only when they sell their interests or the partnership is liquidated. Thus, under this view of what it means to make allocations to the interest as if it were vested, the service provider is effectively overallocated income and the other partners could be effectively underallocated income for the period up to the forfeiture of the interest.

Given these difficulties, it is not obvious that simply treating the profits interest as having the same economics as if it were vested when allocating income is the right approach. It would be better to allocate income to the service provider only to the extent it actually participates in distributions and economics while the interest is unvested. Then, because the service provider will continue to be a partner after vesting, make appropriate corrective allocations to line up the capital accounts if and when the interest vests, similar to the corrective allocations made when noncompensatory partnership options are exercised.[74]

This approach would be consistent with the proposed compensatory interests regulations, which do not prescribe a particular method for allocating items regarding unvested interests. Instead, they simply provide that ''allocations . . . while the interest is substantially nonvested will be deemed to be in accordance with the partners' interest in the partnership'' as long as specified ''forfeiture allocations'' are made if the interest is forfeited.[75] With this approach, there would probably be no forfeiture allocations to make, but including a requirement to make them should not be problematic.

Finally, it would likely simplify the process of aligning capital accounts if the partnership were permitted to revalue its assets upon the vesting of a

[69]*Cf*. New York State Bar Association Tax Section, ''Report on the Proposed Regulations and Revenue Procedure Relating to Partnership Equity Transferred in Connection With the Performance of Services'' (Oct. 26, 2005) (the holders of forfeited profits interests that have basis attributable to undistributed allocations of income ''have effectively reinvested in the partnership and that reinvestment should be treated as an amount paid for the partnership interest in determining the amount of loss permissible under Section 83''). If section 83 does not apply, C should receive a $100 loss upon the forfeiture of the interest — the basis it has resulting from the net income allocated to it. Section 165(a).

[70]Reg. section 1.83-6(c). If section 83 does not apply, there appears to be no taxable event to the partnership or the other partners upon the forfeiture of the profits interest. *But see* the discussion of capital shifts in the text below.

[71]If the partnership or a partner claims a deduction for the value of the profits interest granted (thereby preventing it from qualifying for safe harbor treatment), the result is likely different.

[72]Because there is no distribution to the service provider on the forfeiture, it would not be a revaluation event under reg. section 1.704-1(b)(2)(iv)(f)(5)(ii). And even if there were a revaluation as a result of the forfeiture, there would be no taxable income or gain associated with that revaluation to allocate to the remaining partners.

[73]*See* Steven R. Schneider and Brian J. O'Connor, ''LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles,'' 92 *J. Tax'n* 12 (Jan. 2000), for a discussion of this issue.

[74]Reg. section 1.704-1(b)(4)(x).

[75]Prop. reg. section 1.704-1(b)(4)(xii).

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profits interest in the same way a revaluation is permitted when a noncompensatory partnership option is exercised.[76]

Example 9: The facts are the same as in Example 6, except (1) when C's profits interest vests at the end of year 4, the partnership's assets have an aggregate FMV of $6,000 (including the reinvestment of the $1,000 of net profits into the business); and (2) the partnership does not liquidate until the end of year 5.

In this example, it would make sense not to allocate any of the income earned in year 1 to C, but instead, when C's profits interest vests in year 4, allow AB to revalue its assets and allocate $200 of the built-in gain (representing 10 percent of the value of the partnership exceeding $4,000) to C. This would permit the partnership to avoid allocating income items to C while its interest is unvested but still promptly correct the partners' capital accounts upon the vesting of the interest. Upon the later liquidation of the partnership, the tax on the built-in gain allocated to C would be allocated to C under "reverse 704(c)" principles as well.

Unfortunately, it does not appear that the vesting of a profits interest can trigger a revaluation of partnership assets under the existing regulations.[77] Even under the proposed compensatory interests regulations, a revaluation is prohibited if a section 83(b) election has been made for the interest.[78] But it is unclear why it would be problematic to revalue upon vesting, because that could materially change the parties' economic relationships in much the same way as a grant of a profits interest or an exercise of a noncompensatory partnership option. Presumably, Treasury could issue regulations permitting (or requiring) a revaluation after the vesting of a profits interest if it chooses.[79]

c. Forfeiture that makes partnership disregarded. Just as the IRS has not addressed the treatment of a profits interest issued by a disregarded entity, it has not described what happens when the forfeiture of a profits interest results in the partnership having only a single owner and thereby becoming disregarded.[80] The principles of Rev. Rul. 99-6 and LTR 200222026 give some guidance, but uncertainty remains.

Under Situation 1 of Rev. Rul. 99-6, in which one member of a two-member LLC purchases the other member's interest, the purchaser is treated as receiving its share of the LLC's assets as a liquidating distribution and purchasing the selling member's share of the assets. In LTR 200222026, in which the interest of one member of a two-member LLC is redeemed, the other member is treated as receiving the balance of the LLC's assets and liabilities as a liquidating distribution.

Based on these authorities, it appears that the remaining partner would be treated as receiving its share of the partnership assets and liabilities as a liquidating distribution. Likewise, it seems clear that the profits interest holder is treated as simply forfeiting its interest. But how does the remaining partner treat any assets and liabilities that would be attributable to the forfeited profits interest? Those could be treated as either (1) being distributed by the partnership to the profits interest holder and then forfeited to the remaining partner in accordance with Rev. Rul. 99-6, or (2) distributed to the remaining partner as a liquidating distribution in accordance with LTR 200222026.

The Rev. Rul. 99-6 approach has flaws. Unlike the forfeiture of just a partnership interest, this approach could yield the odd result of the service provider forfeiting its share of the partnership's cash to the remaining partner. It is unclear how that deemed forfeiture of cash should be treated or how the service provider's share of any liabilities should be treated. And the portion of any deemed forfeited assets would likely result in a separate, new holding period for the remaining partner and a separate basis (which may be zero if the receipt of those assets is not considered taxable).[81]

In contrast, treating all the assets and liabilities as being distributed to the remaining partner consistent with LTR 200222026 is a clean solution. The rules governing the receipt of the assets and liabilities in a liquidating distribution are generally straightforward, and any capital account disparities are resolved. Moreover, it is unlikely the remaining partner would be treated as having split basis and holding periods in the assets.

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[76]Reg. section 1.704-1(b)(2)(iv)(f)(5)(iv).

[77]Because Rev. Proc. 2001-43 indicates that the interest is treated as received at the time of grant, the service provider would not appear to be treated as being admitted to the partnership under reg. section 1.704-1(B)(2)(iv)(f)(5)(iii), thereby permitting a revaluation of partnership assets. Presumably, Treasury could issue regulations allowing for (or requiring) a revaluation after the vesting of a profits interest similar to that for noncompensatory partnership options.

[78]Prop. reg. section 1.704-1(B)(2)(iv)(f)(5)(iii).

[79]Section 7805.

[80]Because most jurisdictions require a state law partnership to have more than one partner to continue, this could cause a state law termination of the entity as well if the entity is not in the form of an LLC. *See, e.g., Corrales v. Corrales*, 198 Cal. App. 4th 221 (2011) ("When a partner withdraws from a two-person partnership, however, the business cannot continue as before. One person cannot carry on a business as a partnership.").

[81]*See* Rev. Rul. 99-6, Situation 1.

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Other than for simplicity, there seems to be no clear policy reason to choose one approach over the other. Thus, although it is uncertain whether the IRS or a court would agree, it would be reasonable to apply the latter redemption approach in LTR 200222026 to simplify matters. In either case, because it will be receiving a liquidating distribution from the partnership, the remaining partner should be sure to consider any potential tax consequences of that liquidation.

d. No deduction. The second requirement under Rev. Proc. 2001-43 — that neither the partnership nor any partner take a deduction on the grant or vesting of the interest — is not ambiguous or difficult to implement. However, it does create a practical risk for the holder of the interest. The holder is entirely at the mercy of the partnership and the other partners in qualifying for the safe harbor profits interest treatment. Even if the partnership agreement clearly prohibits the partnership or any partner from claiming a deduction, the interest would appear to be disqualified from the safe harbor treatment if a rogue partner decides to claim one anyway.[82]

Obviously, the service partner could pursue contractual or other claims against the rogue partner. But that would be cold comfort to the service provider if the other partner is insolvent or otherwise lacks the resources to make the service provider whole for any tax assessed by the government.

There is little the service partner can do to eliminate this risk. And it is understandable that the IRS did not want to be whipsawed on the issue. But it is unclear why the IRS took the no-deduction approach. In Rev. Proc. 93-27, the IRS simply said that the issuance of a fully vested profits interest was not a taxable event for the partnership (thereby preventing any deduction) rather than conditioning the tax-free treatment to the recipient on the partnership and the partners not taking a deduction.[83] So why the different approach for an unvested profits interest? I think the simpler and better approach would have been to remain consistent with Rev. Proc. 93-27 and simply not allow a deduction to the partnership or the partners rather than make it a condition for qualifying for the safe harbor.

e. Measuring holding period. A recipient's holding period of a profits interest for qualifying for long-term capital gain would generally start on the date the interest is granted.[84] But because of the uncertainty about the application of the section 83 rules, it is unclear how the rule would apply for unvested profits interests. If the section 83 rules apply, reg. section 1.83-4(a) provides that the holding period of unvested property starts when the property vests unless a section 83(b) election is made for the property. So even though Rev. Proc. 2001-43 provides that a section 83(b) election is not required for an unvested profits interest, it is worth considering an election to establish that the grant date of the interest starts the holding period.[85]

6. When is a profits interest a partnership interest? Another question that a profits interest arrangement raises is whether the holder of the interest is actually a partner for tax purposes. A threshold requirement under the revenue procedures for the safe harbor treatment is that the interest be a partnership interest.[86] Unfortunately, however, the revenue procedures provide no guidance on this matter. So taxpayers are thrown back into the quagmire that many practitioners (and perhaps the IRS as well) had hoped would have been resolved by the check-the-box regulations.

The cases that have addressed whether a person is a partner in a partnership have looked to whether the persons ''intended to join together for the purpose of carrying on business and sharing in the profits or losses or both.''[87] To determine the purported partners' intent, courts have considered various factors, including whether the person has contributed capital or substantial services to the partnership, whether the person shares in the profits and losses of the partnership, whether the person

[82]Although the partner may have to file a statement declaring that it is taking a different position than the partnership, the partner is perfectly within its rights to claim a different position. Section 6222(b). Consider, too, whether the treatment for the partnership and all other partners changes if only the one partner claimed a deduction. Do they now have a deduction that they have not claimed? Does that reduce their tax bases in their partnership interests (even if they did not know the other partner claimed the deduction)?

[83]Rev. Proc. 93-27, section 4.01.

[84]*McFeely v. Commissioner*, 296 U.S. 102 (1935).

[85]*See also* Section II.F.2 for other considerations associated with making a section 83(b) election for unvested profits interests.

[86]Rev. Proc. 93-27, section 2.02.

[87]*See, e.g., Commissioner v. Tower*, 327 U.S. 280 (1946) (no partnership between a husband and wife when the husband performed all partnership services and the wife's only contribution was capital funded by her husband); *Commissioner v. Culbertson*, 337 U.S. 733 (1949) (reversing the Tax Court's finding that there was no partnership between a father and his sons because of the lack of contribution of capital or vital services on the part of the sons; case remanded to determine whether the requisite intent to conduct a joint operation was present).

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has any managerial role in the partnership, and whether the person files his tax returns consistent with partner status.[88]

An interest in a partnership has been held sufficient to confer partner status on a person even when the person contributed no cash or property to the partnership. For example, in *Wheeler v. Commissioner*, the taxpayer was respected as a partner when he provided substantial services to the partnership, exercised some control over partnership operations, shared in partnership profits (and losses once the venture resulted in a profit on a cumulative basis), and the parties reported the transactions consistent with partnership treatment.[89] Likewise, *Diamond* and its progeny each involved service partners who received only profits interests in partnerships, and the IRS did not challenge (and the courts did not question) the service partner's status as a bona fide partner in any of those cases.

Further, while the IRS has not conclusively ruled on the issue, Rev. Proc. 93-27 itself indicates that a person can be a partner for tax purposes even without putting capital at risk or economically bearing any losses of the partnership before being allocated profits. Likewise, Rev. Proc. 2001-43 concludes that a service provider receiving an unvested partnership interest may be treated as a partner from the date of grant, thereby again implicitly confirming that partnership status does not require a capital investment or upfront sharing of losses. And in neither case does the revenue procedure establish a requirement that the service provider have any voting rights or other right to participate in the management of the partnership.

For some practitioners, these authorities raise a concern about whether holders of profits interests that do not have voting rights or otherwise participate in the management of the partnership are partners. Their concern is that in substance, holders of these kinds of interests have no more than a right in an unfunded, profit-sharing bonus plan.

While I agree that lack of voting or management rights is a negative factor in establishing partner status, I do not think it is fatal under the current law, even with an unvested interest. The ultimate test is essentially whether the parties *intended* to make the service provider a partner and to share profits with the service provider.[90] That intent is clear when (1) the service provider has provided services to or for the benefit of the partnership, (2) the service provider shares in profits, (3) the service provider becomes a partner for state law purposes, and (4) the partnership and the service provider file tax returns reflecting the service provider as a partner. The lack of voting rights or management control does not change that intent, so it should not convert the interest into a mere right in an unfunded, profit-sharing bonus plan.

A common situation that is probably on the border is one in which the profits interest is unvested and shares in no distributions before vesting. Here, the fact that the holder may lose the interest and does not currently share in distributions further weighs against partner status. Nevertheless, as mentioned above, the parties clearly intend that if the interest vests, the holder will share as a partner. The question is whether that qualifier regarding vesting means the parties' intent is not established. Except for currently sharing in distributions, these interests share all the features of more traditional profits interests. Although this is a closer call, I believe that holders of these interests are also partners for tax purposes. Even so, parties that want to reduce the risk on this point can consider permitting unvested profits interests to share as if vested on a liquidation of the partnership — this will give those holders a current right to share in at least some distributions.

That said, if the parties push too far, what is intended to be a profits interest could fail to qualify as a partnership interest. For example, it has been held that the service provider is not a partner when the documentation reflects it as an employee or independent contractor and there are no partnership returns filed reflecting the service provider as a partner.[91] Likewise, if the interest the service provider receives is more of a fixed stream of income (akin to a salary) than a right to participate in the growth or profits of the partnership, the interest might fail to be treated as a partnership interest, even if it is unrelated to a substantially certain and predictable stream of income.[92] Similarly, if the interest is tied to specific assets rather than the business of the partnership as a whole, the holder

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[88]*See, e.g.*, *Tower*, 327 U.S. 280; *Luna v. Commissioner*, 42 T.C. 1067 (1964).

[89]T.C. Memo. 1978-208.

[90]*See Tower*, 327 U.S. 280, and *Culbertson*, 337 U.S. 733.

[91]*Kessler v. Commissioner*, T.C. Memo. 1982-432 (lawyers who received a profits interest in a real estate venture in exchange for services were not partners because the agreement governing the venture indicated that they were employees and the lawyers did not file partnership returns, receive any other compensation outside their profits interests, or share in losses).

[92]*Cf.* Section 707(a)(2)(A); REG-105346-03, 70 F.R. 29676 (''A right to receive allocations and distributions from a partnership that is described in section 707(a)(2)(A) is not a partnership interest. In section 707(a)(2)(A), Congress directed that such an arrangement should be characterized according to its substance, that is, as a disguised payment of compensation to the service provider. See S. Rep. No. 98-169, 98 Cong., 2d Sess., at 226(1984).'').

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might be treated as holding an interest in the underlying assets rather than a partnership interest.[93]

F. Potential Pitfalls

1. Two-year holding period. On its face, the two-year holding period requirement appears potentially inconvenient but otherwise unproblematic. However, a closer look reveals several possible risks for unsuspecting taxpayers.

Consider an individual who receives a fully vested profits interest in a partnership, only to find that the partnership liquidates a year and a half later. Regardless of the circumstances of the liquidation — whether or not foreseeable, approved by the individual, or providing value to the individual — it would disqualify the profits interest from safe harbor treatment.

Similarly, consider an individual who receives an unvested profits interest in a partnership that he ends up forfeiting a year later, before it vests. Or consider an individual who receives a profits interest (vested or not) in a partnership that merges into another partnership (and the resulting partnership is a continuation of a partnership other than the one that had issued the profits interest) or converts to a corporation. Again, in either case, the holding period requirement for safe harbor treatment is not satisfied because the holder has disposed of the profits interest in exchange for a new interest.[94]

While you can argue with the length of the period adopted by the IRS, it is easy to understand why the Service adopted the holding period requirement. Consistent with case law, the IRS did not want a situation in which a person is granted an interest on a tax-free basis, only to see that person turn around and sell it for a capital gain.[95] Those situations, however, beg for a solution other than to simply disqualify the interest from safe harbor treatment.

Obviously, the taxpayer could still resort to case law for support for not paying tax on the receipt of the interest. But it would be helpful if the IRS provided guidance that would not disqualify a profits interest for failing to meet the two-year holding period if (1) the interest is forfeited before ever vesting; (2) the interest is redeemed in a liquidation of the partnership that was unanticipated at the time of the grant; or (3) the interest is exchanged for an interest of equivalent economic value (measured at the time of the exchange) in an entity that continues to hold a majority (or other threshold amount) of the business of the partnership under a transaction in which a majority (or other threshold amount) of the partnership interests are similarly exchanged. In each case, the holder would have to bear the tax consequences arising from the later transaction, but the holder would no longer fear being taxed on the original grant of the interest.

A related question is whether this requirement would be violated if the holder transferred the interest to a disregarded entity — such as a wholly owned LLC, a grantor trust, or a qualified subchapter S subsidiary — before the second anniversary of the grant. The IRS might argue that the transfer is a disposition because the interest has a new legal owner. However, because the assets of these entities are treated as owned by their owner (or grantor) for income tax purposes, the better view is that the transfer would not constitute a disposition of the interest for the purposes of testing the safe harbor.

2. Section 83(b) elections. Rev. Proc. 2001-43 is quite clear that taxpayers receiving unvested profits interests that qualify for safe harbor treatment ''need not file an election under section 83(b).'' Nevertheless, it has become standard practice not only for practitioners to advise their clients to file a section 83(b) election for those grants, but also for partnership and LLC agreements to specifically require recipients of profits interests to make those elections. Why is this?

For several reasons, it is generally a good practice to make the election on a protective basis, even though it does not appear necessary. As noted above, Rev. Proc. 2001-43 only speaks to elections regarding profits interests that qualify for the safe harbor. So if the profits interest ends up not qualifying for the safe harbor (even if it initially appeared that it would qualify or was intended to qualify),[96] the guidance of Rev. Proc. 2001-43 would no longer apply.

In that event, the holder would be subject to general tax principles governing the receipt of unvested property. Under section 83, a recipient of unvested property in connection with the performance of services is generally subject to tax on the

[93]*Cf.* GCM 39211 (Apr. 13, 1984) (concluding that when different portfolios of a trust's assets are represented by different series of shares, each portfolio should be treated as a separate taxable entity); reg. section 1.704-4(f)(2), Example 1 (when a partnership agreement is amended to allocate substantially all economic risks and benefits of specific partnership property to one partner, that property is treated as distributed to that partner for purposes of section 704(c)(1)(B)).

[94]*See* reg. sections 1.708-1(c)(3) (treatment of partnership merger), 301.7701-3(g)(1)(i) (partnership electing to be treated as a corporation); and Rev. Rul. 2004-59, 2004-1 C.B. 1050 (''state law formless conversion'' of partnership into corporation).

[95]Even if the capital gain is short term, that change in character could provide material income tax benefits, not to mention the avoidance of payroll or self-employment tax.

[96]*See* sections II.E.5.c and II.F.1.

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excess of the FMV of the property at the time of vesting over the amount paid for the interest. Unfortunately, existing case law does not address the application of section 83 to the grant of a profits interest. So it is likely that because of the plain language of section 83, the holder of an unvested non-safe-harbor profits interest will otherwise have a taxable event on the vesting of the interest.

Because section 83 applies a value test at the time of vesting rather than at the time of grant, it seems that the test used in *Diamond* and its progeny to establish that the interest is ''without fair market value'' would be applied when the interest vests. If the rule is applied that way, it is likely that the prospects of the partnership's business are no longer undetermined and speculative and that the interest has a positive liquidation value. As a result, even under case law, although the receipt of the interest might not have been taxable at the time of grant, the vesting of that interest would be.[97]

If, instead, the holder were to make a section 83(b) election, the tax event and the valuation event are pushed forward to the time of the grant of the interest. Thus, by making the election, the recipient should be able to apply the case law principles at the time of grant rather than at the time of vesting. And the later vesting of the interest should not be taxable.

Another consideration is that prop. reg. section 1.761-1(b) provides that the holder of an unvested partnership interest transferred in connection with the performance of services (whether or not a profits interests) is not treated as a partner before the vesting of the interest unless the holder has made a section 83(b) election. As drafted, this regulation would not apply to interests granted before it is published in final form. However, final regulations, if adopted, may still allow taxpayers to apply that rule if a section 83(b) election has been made.

Further, when analyzing a non-safe-harbor profits interest, a court might view the election as another factor indicating the parties' intention to create a partnership with the service provider rather than an unfunded, profit-sharing bonus arrangement. Finally, as noted above, making the section 83(b) election would establish a holding period for the profits interest that starts on the date of grant rather than the date of vesting, even for a safe harbor profits interest.[98]

Taken together, these considerations provide good reason for recipients to make a section 83(b) election for an unvested profits interest, regardless of whether it is intended to qualify for safe harbor treatment. And because making a section 83(b) election appears to strengthen the status of an unvested interest as a valid profits interest, many partnerships contractually require recipients of profits interests to make that election.[99]

That said, the normal considerations for making a section 83(b) election also apply. For example, if the interest ends up not qualifying for safe harbor treatment and a court finds that it has a positive taxable value, the election would require the holder to pay tax on that value upfront, even if the interest is later forfeited or becomes worthless.[100] Moreover, it appears that if there is a forfeiture of the profits interest, the holder would not be entitled to a corresponding loss.[101] So when a recipient is not bound by the partnership agreement to make the election, the recipient should consult with tax advisers before deciding whether to make it.

3. Shifting share of partnership nonrecourse liabilities. Another issue that may be overlooked in the grant of profits interests is the effect on the partners' shares of partnership nonrecourse liabilities and the resulting consequences. Recall that there are specific rules about how partnership nonrecourse liabilities are allocated among the partners under reg. section 1.752-3(a). And recall that a reduction in a partner's share of liabilities, including nonrecourse liabilities, is treated as a distribution of cash to the partner.[102] If some of the existing partners of a partnership have low outside basis in their partnership interests and the grant of a profits interest reduces their share of the nonrecourse debt, those partners could be in for a taxable surprise. This might happen, for example, because of the disguised sale rules if the existing partners had recently contributed appreciated property to the partnership.

Example 10: Under a plan, A and B form an LLC taxed as a partnership, each by contributing property with an FMV of $100 and a tax basis of $70, and encumbered by nonrecourse debt of $40 in exchange for an interest representing 50 percent of all distributions from the LLC. The debts were incurred for personal uses and do not constitute qualified liabilities under reg. section 1.707-5.[103] The

[97]Of course, if the business of the partnership is still quite speculative at the time of vesting and the interest has no liquidation value, the vesting may still not be taxable under case law.

[98]*See* Section II.E.5.e.

[99]*See* Section IV.M (Part 2 of report) for why it matters to the partnership whether it is a profits interest.

[100]Section 83(b).

[101]Reg. section 1.83-1(b)(2).

[102]Reg. section 1.752-1(c).

[103]Also, neither liability was assumed with a principal purpose of reducing the extent to which any other liability

(Footnote continued on next page.)

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next day, the LLC issues C a profits interest that would give C a right to 20 percent of all gains and profits over the existing $120 value of the LLC. Tax allocations are 50-50 before C is admitted but are changed to a target method after C's admission.

What happens to A and B when C is granted the profits interest? Immediately after the formation of the LLC, all the liabilities would be excess nonrecourse liabilities because there would be no partnership minimum gain or taxable gain if the property were disposed of in full satisfaction of the debt and no other consideration.[104] So the liabilities would be allocated among the members under reg. section 1.752-3(a)(3). Given that they are sharing profits and losses 50-50, the liabilities would be allocated 50-50 between them under either of the methods permitted by that regulation.[105] This would result in each of A and B being allocated $40 of the $80 aggregate nonrecourse liabilities of the LLC. Because each member's share of the aggregate liabilities is equal to the liabilities assumed by the LLC from each, there would be no deemed distribution to A or B.[106] Thus, under reg. section 1.707-5(a)(4), the initial formation of the LLC would not result in a disguised sale of property by A or B to the LLC.

However, when C is granted the profits interest, A's and B's shares of the LLC's liabilities are reduced. The $80 of liabilities would need to be allocated under one of the first two methods described in reg. section 1.752-3(a)(3): (1) in accordance with a significant item of partnership income or gain other than section 704(c) gain or (2) in accordance with the manner in which it is reasonably expected that the deductions attributable to those liabilities will be allocated.

Taking those in reverse order, it is difficult to say how the deductions from these liabilities would be allocated. Given the target method of allocations, if the LLC incurs losses throughout the life of those loans, the deductions would be allocated among A and B on a 50-50 basis. But if the LLC is overall profitable or break-even at any time during the life of those loans, the deductions are offsetting income that would otherwise be allocable to A, B, and C on a 40-40-20 basis, effectively making them allocated on the same 40-40-20 basis. What is reasonable to expect will depend on the facts of a given case, but usually the partnership will expect to be overall profitable or break-even by the end of the debt term. Accordingly, in many cases, this approach would likely yield a 40-40-20 allocation of the liabilities for at least part of the time.

Moving back to the first alternative method, the liabilities could be allocated in accordance with another significant item of partnership gain or income. Here again, given the allocation method, all income and gain items will effectively be allocated 40-40-20 if the LLC is immediately profitable. It is only if the LLC first has losses that the LLC will have income and gains allocated only to A and B on a 50-50 basis. As a result, this method will often yield a 40-40-20 allocation of the liabilities.

What does this all mean? It means that if the $80 of excess nonrecourse liabilities is allocated on a 40-40-20 basis, A and B each end up having their share of liabilities reduced by $8.[107] As a result, under reg. section 1.752-1(c), each is treated as receiving a cash distribution of $8. Because that deemed cash distribution is within two years of each of them contributing property to the LLC, the deemed distribution would create a presumption of a disguised sale of property.[108] Because the property contributed by each of A and B has built-in gain, each would end up with taxable gain unless they could establish that there was not a disguised sale.[109]

Of course, existing taxpayers may ultimately be able to establish that the transaction is not a disguised sale under the facts and circumstances test, but that is not a position most practitioners would like to plan into. What is clear is that the effect on the allocation of liabilities should be considered before granting any profits interests.

Recently issued proposed regulations would change the rule for allocating excess nonrecourse liabilities to a ''liquidation value percentages'' approach.[110] Although there is no indication that the IRS was specifically concerned with issues raised in this part of the report, it would appear that the proposed regulations would eliminate the deemed distribution problem. The proposed approach would allocate no nonrecourse debt to a partner whose interest has no liquidation value when the partner is admitted, as in the case of profits interest

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assumed by the partnership is treated as a transfer of consideration under reg. section 1.707-5(a)(4).

[104]Reg. section 1.752-3(a)(3).

[105]Under reg. section 1.752-3(a)(3), the third ''additional method'' involving allocations regarding section 704(c) gain does not apply for the purposes of reg. section 1.707-5(a)(2)(ii).

[106]Reg. section 1.707-5(a)(1).

[107]The $80 of excess nonrecourse liabilities would be allocated $32-$32-$16 among A, B, and C, respectively. This would give each of A and B a $32 share of liabilities of the LLC rather than the $40 share of liabilities allocated to each before the issuance of the profits interest.

[108]Reg. section 1.707-3(c).

[109]They may also find another exception under reg. section 1.707-4, but those may not always be available.

[110]Prop. reg. section 1.752-3(a)(3); REG-119305-11, 79 F.R. 4826-4839 (Jan. 30, 2014).

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grants. So the issuance of a profits interest would not result in a deemed distribution arising from any liabilities being shifted away from the existing partners.

4. Leveraged distributions. That a profits interest holder may be allocated a share of partnership liabilities leads to the question whether a holder of a profits interest can share in leveraged distributions from a partnership even if the partnership has not increased in value since the interest was granted. An aggregate view of partnerships might suggest that the distribution is merely a distribution of the holder's share of the partnership borrowings. But a more careful consideration leads to the same concerns that arise when looking at whether an interest has a liquidation value when it is granted.

Example 11: Partnership AB has $1 million of cash and no other assets or liabilities when it grants a profits interest to a new partner, C. The profits interest gives C 10 percent of all gains and profits exceeding $1 million. The partnership immediately thereafter distributes $300,000 to its partners. Shortly after that, the partnership purchases a building worth $1 million for $700,000 cash and $300,000 of nonrecourse debt secured by the building. The partnership uses a target method of allocating net profits and net losses.

In this example, it would be a stretch to say that C could share in the distribution and still have its interest qualify for safe harbor treatment (or even non-safe-harbor treatment). There simply has been no profit of any kind between the time of the grant and the time of the distribution that would justify C sharing in any of the distribution. Even if the partnership agreement provided that C would not have shared in the existing $1 million value if there were an immediate liquidation but could share in any current distributions, the close temporal proximity between the grant of the interest and the distribution would likely result in a challenge from the IRS.[111]

Example 12: The facts are the same as in Example 11, except that the $300,000 is distributed after the purchase of the building instead of before the purchase.

Because the outcome in this example is economically identical to that in Example 11, why should the result be any different just by delaying the distribution until after the debt is incurred?

As discussed above in Section II.F.3, it appears that the partnership nonrecourse liability would (or at a minimum, could) be allocated in part to C. Under reg. section 1.752-3(a), all the debt in Example 12 would constitute excess nonrecourse liabilities. As a result, it should be allocated in accordance with the partners' shares of partnership profits.[112] In Example 12, it is at least reasonable to treat C as having a 10 percent share of partnership profits. So C would be allocated $30,000 of the liabilities, resulting in a corresponding increase of C's basis in the profits interest by $30,000.[113]

That C now has a share of the liabilities and a positive basis in the profits interest makes some believe it is appropriate for C to share in up to $30,000 of distributions. After all, the distribution of cash up to a partner's outside basis is ordinarily not taxable.[114] But that is a red herring: The existence of the basis affects only whether the holder would have taxable gain on any cash distribution; it has nothing to do with whether the interest qualifies as a safe harbor profits interest.

Indeed, in Example 11, in which the holder almost certainly could not share in the distribution, the debt would be allocated in the exact same way. The debt would be excess nonrecourse debt, and it would be reasonable to treat C as having a 10 percent share of partnership profits, resulting in C being allocated $30,000 of the debt and having the corresponding increase in debt.

In many ways, the fact pattern in Example 12 implicates much of the same analysis as in the question whether the interest has liquidation value.[115] On its face, giving the profits interest holder a right to participate in leveraged distributions in a situation akin to Example 12 does not change the fact that at the time of the grant, the holder would have received nothing on a hypothetical liquidation. The concern, however, is that even though the holder would have a deficit capital account after that leveraged distribution that would necessitate special allocations of income to eliminate, the holder has (as illustrated by the comparison of Example 11 and Example 12) effectively participated in the existing value of the partnership.[116]

Ultimately, it is unlikely that an interest that is permitted to share in leveraged distributions absent an increase in the value of the partnership would be respected as a profits interest. This is particularly true if the distributions arise from financing being contemplated or promised to the recipient at the time of the grant of the interest, or if they go primarily or exclusively to profits interest holders.

[111] *See* Section II.E.1.

[112] Reg. section 1.752-3(a)(3).

[113] Sections 752(a), 722.

[114] Section 731(a).

[115] *See* Section II.B.1.

[116] *See* reg. section 1.704-1(b)(ii)(d) (qualified income offset requirement for unexpected distributions).

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