CCH®

VOLUME 14, NUMBER 1
AUGUST 2005

THE M&A Tax Report

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

Partnership Option Regulations: Share the Wealth?

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These days, LLCs and partnerships seem frequently to be involved in merger and acquisition activity. The days of C corporations being the only players in M&A deals are clearly gone. In fact, in smaller transactions perhaps LLCs and partnerships now dominate. Frequently, these LLCs and partnerships have options outstanding to both partners and nonpartners who are performing services for the LLC or partnership ("service providers"). Understanding how the IRS treats these options can be important in determining the tax affects of a merger or acquisition.

Over the past few years, there has been considerable debate whether partnership options should be treated in a fashion similar to corporate options. After all, there is already an established body of law dealing with corporate options.

Proposed Rules

In an attempt to clarify the partnership option arena, the IRS recently issued proposed regulations relating to the tax consequences of transferring partnership interests in exchange for services. [*See* REG-105346-03.] The proposed regulations provide that Code Sec. 83 (the Code section often applicable to corporate options) applies to partnership options, and it has proposed additional rules to coordinate Code Sec. 83 with partnership taxation principles.

The new rules are generally taxpayer friendly and provide that a partnership will not have to recognize gain or loss on the transfer (or vesting) of an interest in a partnership in connection with the performance of services. Nonetheless, the service provider generally will have income, and the partnership will have a corresponding compensation deduction, equal to the fair market value of the transferred interest.

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However, because partnership interests can be difficult to value, a partnership and the service provider can elect to use liquidation value as the fair market value of the interest. The mechanics of this election are found within Notice 2005-43, which the IRS issued simultaneously with the proposed regulations.

Code Sec. 83 and Partnership Interests

Code Sec. 83 generally applies to a transfer of property in connection with the performance of services. The courts have held that a partnership capital interest is "property" for this purpose. [*See S. Schulman*, 93 TC 623, Dec. 46,181 (1989).] Historically, however, the application of Code Sec. 83 to profits interests has been the subject of controversy. [*See, e.g., Campbell*, 59 TCM 236, Dec. 46,493(M), TC Memo. 1990-162, *aff'd in part and rev'd in part*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815 (1991), at note 7; *St. John*, DC Ill., 84-1 USTC ¶9158 (1983).]

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH INCORPORATED, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Despite the historical controversy, the IRS now believes that there is no substantial basis for distinguishing among partnership interests for purposes of Code Sec. 83. After all, the IRS suggests that all partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Thus, the proposed regulations provide that any partnership interest (either capital or profits) is property within the meaning of Code Sec. 83, and that Code Sec. 83 governs the transfer of any partnership interest in connection with the performance of services.

Options received by a service provider can be either vested or nonvested. Nonvested options usually vest over time and frequently provide financial incentives for the service provider. Although the receipt of a vested option is generally a recognition event, the receipt of a nonvested option generally isn't, since technically the service provider has received anything but an expectancy. Thus, a person who receives a nonvested partnership interest (*e.g.*, an option) in connection with the performance of services generally does not have income until vesting.

Code Sec. 83(b) allows a service provider who receives a nonvested interest to elect to include in gross income the fair market value of the property at the time of transfer less any amount paid for such property. Taking this into income now, as opposed to at the time of vesting, may be beneficial if it is believed that the value will increase by the time vesting occurs.

If a nonvested partnership interest is transferred in connection with the performance of services and a Code Sec. 83(b) election is made, then the holder of the nonvested partnership interest will be treated as a partner. On the other hand, if a Code Sec. 83(b) election is *not* made, the service provider will not be treated as a partner until the interest becomes vested. These rules are similar to the rules pertaining to substantially nonvested stock in a subchapter S corporation.

Changing Gears?

These principles differ from prior IRS authority under Rev. Proc. 93-27 [1993-2 CB 343] and Rev. Proc. 2001-43 [2001-2 CB 191]. Under those revenue procedures, if a profits interest is transferred in connection with the performance of services, the holder of the profits interest may be treated as a partner even if no Code Sec. 83(b) election is made, provided that certain conditions are met. Notice 2005-43 [IRB 2005-24, 1221] contains a proposed revenue procedure which will obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43 when finalized.

The service provider generally will have income, and the partnership will be entitled to a corresponding compensation deduction, on the transferred interest. The rules regarding the timing of the income and corresponding deductions are slightly different under Code Sec. 83 and subchapter K. To resolve this conflict, partnership interests issued to existing partners are treated as guaranteed payments. For new partners, the Code Sec. 83 timing rules will override inconsistent partnership timing rules.

Forfeiture of Compensatory Partnership Interests

When a service provider receives a partnership option, the service provider's capital account is increased by the amount the service provider takes into income under Code Sec. 83, plus any amount actually paid for the interest. If the service provider makes a Code Sec. 83(b) election, not only will he be treated as a partner, but he may also be allocated partnership items that are later forfeited. This could occur, for example, where the service provider quits his job with the partnership prior to vesting.

It's easy to see that the premature departure of a nonvested partner who made a Code Sec. 83(b) election could wreak havoc on partnership accounting. A person who is not an actual partner should not, upon leaving, have been allocated any partnership items. However, "un-allocating" items (it's just not clear how this will work) may be easier said than done.

Because of this inherent uncertainty of ultimately retaining amounts allocated prior to vesting, allocations of partnership items to a nonvested interest do not have economic effect. Nevertheless, these allocations can be treated as being in accordance with the partners' interests in the partnership. However, to do so, the partnership agreement must require that the partnership make forfeiture allocations if the interest for which the Code Sec. 83(b) election is made is later forfeited and other requirements are met. The partner's interest in the partnership safe harbor does not apply, however, if there is a plan that a nonvested interest will be forfeited when the Code Sec. 83(b) election is made.

Technically speaking, forfeiture allocations are allocations to the service provider of partnership income and gain (or deduction and loss) that offset prior distributions and allocations of partnership items relating to the forfeited partnership interest. The new rules generally cause a forfeiting partner to be allocated income to offset any distributions to the partner that reduced the partner's basis below the amount previously included in income under Code Sec. 83(b).

Problems can arise when the forfeiting service provider has previously been allocated losses. In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The rules require the service provider to recapture prior loss allocations not offset by forfeiture allocations. In what seems to be a patently unfair situation, there is no corresponding rule that the remaining partners get corresponding loss allocations.

In other circumstances, the partnership will not have enough deductions and losses to offset fully prior allocations of income to the forfeiting service provider. The IRS notes that it is studying how to deal with this.

Valuation Issues

Code Sec. 83 generally provides that the recipient of property transferred in connection with the performance of services causes income recognition equal to the fair market value of the property. [*See Schulman*, *supra.*] However, some authorities had previously concluded that, under certain facts and circumstances, a partnership profits interest had only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. [*See* Reg. '1.704-1(e)(1)(v); *Campbell, supra*; *St. John, supra*.] [*But see S. Diamond*, CA-7, 74-1 USTC ¶9306, 492 F2d 286 (1974) (holding under pre–Code Sec. 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); *Campbell*, *supra*.]

As noted above, Notice 2005-43 proposes to allow partnerships and service providers to elect to value partnership interests based on liquidation value. The liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, 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.

Proposed Effective Date

These regulations are proposed to apply to transfers of property on or after the date final regulations are published in the Federal Register. Nevertheless, it is not uncommon for the IRS to make final regulations effective earlier, especially when the rules are detailed and provide guidance in a murky area. While these rules are detailed, and provide much needed guidance, the IRS readily admits that the regulations don't contain all of the answers. For example, the proposed regulations do not address transactions involving related persons, such as the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership.

These new rules are unquestionably complicated. It wouldn't be surprising for the IRS to need a few years to digest all of the nuances, at least some of which will be highlighted by practitioner comments. It would seem, though, that until that time, taxpayers might be able to use the principles enunciated in these proposed rules in an attempt to find some order in the chaotic partnership option area.