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COMPENSATION & FRINGE BENEFITS

THE ENDURING MYSTERIES OF COMPENSATORY PARTNERSHIP INTERESTS

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There is much mystery to the world of compensatory partnership interests, though consistent with the accelerating growth in business conducted through the partnership form, the granting of compensatory partnership interests, in particular profits interests, continues to grow. In some sense this uncertainty creates flexibility, but at the cost of much angst, hand-wringing, and debate as facts are analyzed and risk is assessed. This note is not intended to be a comprehensive overview of all the issues raised, but rather to highlight some of the mysteries that have arisen from the functional yet legally incoherent limited IRS guidance that has been issued, and all from the perspective of a compensation and benefits advisor who has routinely found that my perspective and vocabulary may not translate to the partnership tax experts. Given the wide range of legal uncertainties, partnerships and participants in transactions involving partnerships are advised to obtain expert advice but also warned to expect few definitive answers. Rather, working with compensatory partnership interests has become equal parts technical expertise and risk management.

As background, Rev. Proc. 93-27, 1993-2 CB 343, as clarified by Rev. Proc. 2001-43, 2001-2 CB 191 (collectively referred to as the revenue procedures), forms the basis for much of the federal tax treatment of compensatory partnership options. Rev. Proc. 93-27 provides a "safe harbor" under which the transfer of a compensatory profits interest to a service provider providing services to or for the benefit of the partnership will not result in the recognition of income if the interest is not publicly traded, is not based on a predictable stream of income such as rents, and is not disposed of within two years. Rev. Proc. 2001-43 then extends this to the transfer of a substantially nonvested profits interest, providing that if the recipient is treated as a partner during the vesting period, then no income will be recognized at either the time of transfer or vesting.

Notably, neither revenue procedure answers the essential question of whether Section 83 applies to the transfer of a partnership interest in connection with the performance of services. Courts generally have accepted that the transfer of a capital interest is subject to Section 83 although, as noted later, the application of the Section 83 fair market value standard continues to lack clarity. For profits interests, there was much debate on which Code provisions or tax doctrines governed the taxation of the transfer of a compensatory profits interest prior to the revenue procedures, and while providing for the tax consequences the revenue procedures artfully avoid any conclusions on that issue. Some have inferred that Section 83 does not apply from the language in Rev. Proc. 2001-43 providing that a Section 83(b) election is not required with respect to a substantially nonvested profits interest that otherwise meets the requirements of the safe

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harbor, but the guidance never explicitly states that. Despite the historical debate, I will assume for purposes of this note that it does.[1]

Perhaps the most debated open issue is what it means to fall out of the safe harbor provisions. Is this in fact certain doom resulting in immediate compensation income inclusion at grant, including with respect to a disposition well into the two-year safe harbor requirement resulting in the need for amended returns? Given the uncertainty of partner comings and goings (if for no other reason, death or disability) and often the partnership's business goal of realizing a transaction or liquidity event as quickly as possible, the rigidity of the two-year period confronts nearly every transfer. My sense is that this should be read in the context of the historical court decisions that the revenue procedures address – in particular the crisis created by the Tax Court decision in *Diamond*, which involved the sale of a profits interest three weeks after its receipt by a service provider.[2] Given the significantly longer length of the two-year safe harbor period, the revenue procedures would seem to provide a definitive safe harbor period with dispositions in shorter periods being subject only to a facts and circumstances review, not a holding period requirement to obtain the no compensation income on transfer result. But again, the overall facts and circumstances will dictate the result.

Another issue left unaddressed by the revenue procedures is what it means to hold a substantially nonvested partnership interest with respect to the allocations of the partnership during the vesting period. Although controversial during the development of the Section 83 regulations, that the holder of substantially nonvested property is not the "owner" of the property is well-established in the final regulations.[3] In particular, the holder of substantially nonvested stock that receives income from such stock (such as the equivalent of dividends) must treat that payment as additional compensation. Rev. Proc. 2001-43 provides that the partnership must treat the owner of the substantially nonvested profits interest as a partner, indicating that allocations must be made to that partner. But is this a legal conclusion or simply part of the safe harbor procedure for avoiding a Section 83(b) election? The Tax Court in *Crescent Holdings* determined that the holder of a substantially nonvested capital interest was not the "owner" of the interest and that allocations should not be made to the holder – but is this limited to capital interests?[4]

Whatever analogy may be made to the treatment of substantially nonvested stock under Section 83 breaks down quickly, which means Section 83 and its regulations that are built around stock also break down when applied to partnership interests. Stock can be transferred to an employee and made subject to a forfeiture condition with minimal consequences to the other owners of the same stock. If the stock is subsequently forfeited, the stock generally returns to the corporation as treasury stock and while the other owners may experience an increase in value similar to a stock buyback it has no direct tax consequence to them. The same can be said for other property transferred to a service provider. For example, while the service provider may enjoy the use of a car that is transferred to the service provider but is substantially nonvested, absent a Section 83(b) election that use would be taxed as additional compensation since the service provider does not have "ownership" of the car.[5] If the service provider subsequently forfeits the car, there is no tax consequence to either the service provider or the service recipient or its owners.

In contrast, the allocated interests of a partnership must equal 100% every year. Accordingly, the transfer of a partnership interest will have consequences to all of the other partners. There is not a practical ability in real time to treat the partnership interest as transferred to the service provider but not owned by the service provider. Either the substantially nonvested interest held by the service provider results in treatment as a partner on the partnership tax return, or it does not unless and until it is substantially vested. At least this issue may be addressed by the holder making a Section 83(b) election – for a variety of purposes the IRS has

[1] See, e.g., *Sol Diamond*, 33 AFTR2d 74-852, 492 F.2d 286 (CA-7, 1974) (Section 721 did not prohibit the receipt of a profits interest for services resulting in recognition of income); Gen. Couns. Mem. 36,346 (July 25, 1977) (Section 83 does not apply to a profits interest because it is analogous to an "unfunded, unsecured promise to pay"); *Campbell*, 68 AFTR2d 91-5425, 943 F.2d 815 (CA-8, 1991) (Section 83 applies to the transfer of a capital interest, but avoiding determination as to transfer of a profits interest); *Crescent Holdings LLC*, 141 TC 15 (2013) (Section 83 applies to the transfer of a capital interest even though partnership interests are not mentioned in Section 83 or the accompanying regulations).

[2] 56 TC 530, aff'd, 33 AFTR2d 74-852, 492 F.2d 286 (CA-7, 1974).

[3] See Reg. 1.83-1(a)(1).

[4] *Crescent Holdings LLC*, 141 TC 15 (2013).

[5] See Reg. 1.83-1(a)(1).

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treated the holder of substantially nonvested property that makes the election as the "owner" of the property.

However, the revenue procedures also do not address what happens if the partnership interest is subsequently forfeited. If the service provider has been treated as a partner, then presumably some combination of income, deductions, gains, and losses have been allocated to the partner, and potentially for several years. If that same service provider did not make a Section 83(b) election and is to be treated as having never "owned" the interest, that would require amended partnership returns to undo all of those allocations. But no one finds that feasible given the resulting need for amended partnership and partner returns and potentially further cascading consequences, even if amended returns are available because the period during which the substantially nonvested partnership interest was held was sufficiently short to avoid closed years. Rather, the assumption is that any corrective allocations will be made beginning with the partnership year in which the forfeiture occurs, meaning the consequences of the forfeiture may fall on the existing partners who may or may not have been partners during the previous years (and not on any partners who left during those previous years). Even then there is not consensus on exactly how any corrective allocations are to be made. Also, for a service provider that did make a Section 83(b) election and recognized any income (for example, the recipient of a capital interest), query whether any corrective allocations reflecting the forfeiture comply with the Section 83(b) requirement that no deduction be allowed with respect to such forfeiture.

The making of a Section 83(b) election on the grant of a compensatory partnership interest then raises valuation issues. Typically the holder of a profits interest making a protective Section 83(b) election indicates "zero" as its fair market value in case it falls out of the safe harbor of the revenue procedures. This is based not on the interest actually having no value, but rather on the court decisions finding that the profits interest at issue had only speculative value and therefore required no income inclusion at grant.[6] Nowhere else, absent the treatment of stock options which were codified in Section 83(e)(3), however, does Section 83 permit the transfer of property with an obvious value to fail to result in the recognition of compensation income. More importantly, if a zero income inclusion is based on the particular partnership interest having a speculative value, does that mean that some partnership interests will have a nonspeculative value? While the revenue procedures create a safe harbor for all profits interests, they do not indicate whether this is a legal conclusion or a procedural aspect of the safe harbor. This in turn leads to the angst described above about what will happen if the profits interest falls out of the safe harbor, including whether the Section 83(b) election may be amended if necessary to reflect a nonspeculative value or instead is void.

In contrast, the recipient of a grant of a substantially nonvested capital interest must determine its fair market value either at grant in making a Section 83(b) election or at vesting. Under the traditional expression, "fair market value is 'the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed' of all the relevant circumstances."[7] This generally would indicate that liquidation value would not necessarily govern and control premiums and minority owner discounts may apply. However, not only does this complicate partnership tax accounting, but as with any valuation may raise complicated issues on how to ascertain the fair market value (including in a manner that is consistent between the compensation income to the transferee and the deduction available to the partnership).[8]

As business operations and structures have become more complex, even the scope of the fact patterns addressed by the revenue procedures have come into question. The safe harbor applies only with respect to the transfer of a partnership interest to an individual providing services "to or on behalf of" the partnership. How does this apply to a tiered partnership structure? Recently proposed regulations appear to indicate that where, as a result of the waiver of a management fee by a fund manager, a profits interest in a fund is provided to a separate person (presumably an owner of the fund manager), the issuance of that profits in-

[6] See, e.g., *Campbell*, 68 AFTR2d 91-5425, 943 F.2d 815 (CA-8, 1991).

[7] See *Palmer*, 36 AFTR2d 75-5942, 523 F.2d 1308, 1310 (CA-8, 1975) (quoting *Hamm*, 13 AFTR2d 1806, 325 F.2d 934, 937 (CA-8, 1963), *cert. denied*, 377 U.S. 993, 84 S.Ct. 1920, 12 L.Ed.2d 1046 (1964)).

[8] Notice 2005-43, 2005-24 IRB 1221, proposed a process to ensure that the two valuations were required to be the same, not dictating the method of valuation but protecting the IRS against a whipsaw situation.

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terest is not within the safe harbor of the revenue procedures.[9] Is this intended to signal a generally narrow application, or only with respect to an arguably "abusive" transaction such as the exchange of a fee for a profits interest?

The bandage that is the revenue procedures has worked remarkably well because it addresses the most typical case – one in which only a profits interest is granted (and not a capital interest), the services are provided directly to the partnership, the interest is vested at grant or the service provider works through the vesting period, and the service provider does not dispose of the interest within two years of the date of grant. The tax consequences of any deviation from this fact pattern simply are not addressed, and because there is no legal rationale for the stated tax consequences none can be inferred. Although the IRS has not appeared to have challenged the issue with respect to profits interests that are disposed of before the end of the safe harbor's two-year period, the result has still been a plethora of protective Section 83(b) elections and a lot of various viewpoints on resulting risks.

The Treasury and the IRS have made two attempts to provide more guidance in the area. The first occurred in 2005 as a comprehensive attempt to provide a legal basis for many of the conclusions reached in the revenue procedures, culminating in a combination of proposed regulations and proposed revenue procedure.[10] However, that guidance provides that it explicitly cannot be relied upon and, in the face of continuing legislative attention to carried interests and character conversion including proposed amendments to the Code, that guidance has not moved. More recently in 2015, proposed regulations were issued to address the more narrow disguised fees issue raised by the conversion of fee arrangements to profits interests.[11] That set of proposed regulations, however, also has not resulted in final regulations.

So we are left with a situation of exponential growth of partnership structures and the resulting use of compensatory partnership interests, with limited definitive guidance from which little can be extrapolated as a legal conclusion. The revenue procedures responded to the uncertainty presented at the time of their issuance remarkably well, but the world is evolving and the "unusual" issues intentionally left unaddressed are becoming less and less unusual. While guidance is not always a good thing as far as the inherent period of uncertainty following a proposal and the potential to limit flexibility to respond to bona fide business concerns, an equally significant concern is that the Treasury and the IRS not only may fail to agree with some of the conclusions already reached in the marketplace but also may not recognize the extent to which the marketplace has moved in certain directions, and so may try to litigate the marketplace into retroactive compliance with its yet to be disclosed conclusions. With that as a background, participants in transactions involving compensatory interests would be wise to get advice from their trusted advisors. ■

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[9] 80 Fed. Reg. 43652 (July 23, 2015).

[10] 70 Fed. Reg. 29675 (May 24, 2005); Notice 2005-43, 2005-24 IRB 1221.

[11] 80 Fed. Reg. 43652 (July 23, 2015).