MEMORANDUM

Compensatory Transfers of Partnership Interests

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INTRODUCTION

The proliferation of limited liability companies (hereinafter "LLCs") taxed as partnerships has raised a wealth of tax issues that have remained unresolved for years. The use of LLCs in the high-technology and emerging business sector has caused tax practitioners to attempt to mimic the compensation arrangements otherwise available in the corporate world. In the context of a corporation, incentive stock options (hereinafter "ISOs") and nonqualified stock options are effective lures for attracting and retaining key employees. Although ISOs apply only to corporations by way of statutory mandate in §421 of the Internal Revenue Code,[1] nonqualified stock options are not a statutory creation specifically applicable to corporations. Similarly, outright transfers of ownership interests, ownership grants subject to vesting, the issuance of options to acquire ownership interests, and phantom stock plans are compensation programs capable of being applied across all business entities. This provides LLC and partnership practitioners with a broad array of tools for assisting management in attracting and retaining employees in an effort to duplicate the compensation arrangements available to corporations.

A transfer of a partnership[2] interest to a service provider as compensation for services may involve a current, or eventual, transfer of an interest in the partnership's future profits and future appreciation (hereinafter a "profits interest"), an interest in the partnership's existing capital (hereinafter a "capital interest"), or both.[3] Interestingly, the partnership form of doing business thus provides, by way of a grant of a profits interest, a form of compensation not available to a corporation (although a phantom stock award would be somewhat analogous).

In mimicking typical corporate plans, partnership and LLC practitioners are creating compensation plans which impose vesting requirements and authorize the issuance of options to acquire partnership interests. The management objective behind vesting requirements is to entice potential partners to excel in their performance for the benefit of the business, or to reward long-term commitment to the business operations. An option to acquire a partnership interest is typically granted by the partnership to a service provider to enable such person to acquire either a capital or profits interest in the partnership at a specified price, which may be exercisable over a period of time. Call options of this type are particularly favorable to service providers because this type of option effectively shifts a portion of the present and future values of the partnership in excess of the exercise price from the other partners to the service provider.

The tax consequences relating to the exercise of options in the partnership context has been the subject of some debate of late. The basis for disagreement is grounded, in part, on the inability to agree on the tax consequences of even fairly simple compensation plans and the lack of litigated cases providing guidance on things as straightforward as which Code sections should apply. Although the tax consequences to the participants in the partnership compensation context are fairly settled under some circumstances, it is worthwhile to review the principles applicable to outright transfers of partnership interests in an effort to understand the more debatable and uncertain tax consequences arising in more sophisticated plans.

TYPES OF PARTNERSHIP INTERESTS

Capital Interest

A partnership or LLC which attempts to mirror a conventional outright grant of stock to an employee will issue an interest that entitles the employee to an immediate share of the underlying capital of the partnership and a right to future profits and appreciation — i.e., a capital interest. A capital interest can generally be identified as having been granted by determining whether the service provider would receive a distribution with respect to the partnership's assets if the partnership were liquidated on the date the capital in-

[1] All section references herein are to the Internal Revenue Code of 1986, as amended (sometimes referred to as the "Code"), and the regulations thereunder, unless otherwise stated.

[2] For purposes of this article, the term "partnership" is intended to include limited liability companies (which are not disregarded entities) and all forms of partnerships (such as general partnerships, limited partnerships, limited liability partnerships and limited liability limited partnerships) which have not elected to be taxed as corporations.

[3] Because a capital interest almost always carries with it an interest in future profits and future appreciation, the term "capital interest" as used herein will represent an interest in both the partnership's capital and future profits and appreciation.

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terest was received.[4] Upon receipt of a capital interest in a partnership in exchange for services performed for the partnership, the service provider will have received property representing compensation income.[5] Since the enactment of §83 in 1969, most practitioners agree that §83 is the logical source of authority to apply to determine the tax effects to the service provider on the receipt of a capital interest, including any other compensation-like property or benefits from a partnership.[6] The service provider should recognize income in an amount equal to the fair market value of the capital interest received less any amount paid by the service provider for such interest.[7] The analysis under §83 provides for income recognition at the time the award is made if the capital interest is transferable or is not subject to a substantial risk of forfeiture.[8]

Due to the application of §83(h), the partnership should be entitled to a deduction equal to the amount of income recognized by the service provider (unless the compensatory transfer was for an expense required to be capitalized by the partnership). Regs. §1.83-6(a)(1) holds that the timing of the deduction is in the year in which the service provider includes the property in income.[9] The deduction should be allocated among the partners present prior to the issuance of the capital interest to the service provider. Discussed later in this article is whether the partnership recognizes gain or loss upon the issuance of such a partnership interest and whether the capital accounts of the partners should be "booked-up."

Profits Interest

The recipient of an interest in partnership profits ordinarily will not be subject to tax on receipt of the profits interest. The method for identifying whether the recipient has received a profits interest is if, upon a hypothetical liquidation of the partnership immediately after the issuance of the interest, the service provider would not receive a distribution.[10] The service provider's capital account would reflect a zero balance as of the date the award was issued. Without having received an interest in the current underlying economic value of the partnership, service providers have historically taken the position that the award of a profits interest does not result in taxable income.

The Internal Revenue Service (the "Service") and the courts have struggled with the appropriate tax treatment to govern the receipt of a profits interest. At first blush, the issuance of a profits interest would seem to leave little doubt that the employee or independent contractor has received a property right of some value capable of causing the recipient to become subject to immediate taxation. In fact, in *Diamond v. Comr.*,[11] the Seventh Circuit held that the receipt of a profits interest in exchange for services is taxable to the service provider at the time of receipt if the interest is capable of being valued (which it was in Mr. Diamond's situation). Subsequent to *Diamond* and the enactment of §83, some courts have applied §83 in analyzing the taxability of transfers of profits interests to service providers who were not previously partners in the issuing partnership.[12]

These courts have generally found that the issuance of a profits interest is taxable only if the fair market value of the interest can be reasonably ascertained. The most recent case governing the taxability of a grant of a profits interest is *Campbell v. Comr.*[13] wherein the Eighth Circuit (reversing the Tax Court's application of §83) ultimately concluded that the taxpayer was not subject to tax on the receipt of the profits interest because the interest was of speculative value. Although the *Campbell* court indicated that the receipt of a profits interest may not represent a taxable realization event, the court did not base its ruling on this ground. Consequently, profits interest recipients are potentially in receipt of a taxable item under the *Campbell* analysis. To avoid reporting the profits interest as taxable income, the service provider must assert that the value of the interest is speculative.

Subsequent to *Campbell*, the Service issued Rev. Proc. 93-27 wherein the Service announced that it would not treat the receipt of a pure profits interest issued in exchange for services rendered to or for the benefit of a partnership in a partner capacity, or in anticipation of becoming a partner, as a taxable event for the partner or partnership if: (1) the profits interest does not relate to a substantially certain or predictable stream of income; (2) the partner does not dispose of

[4] Rev. Proc. 93-27, 1993-2 C.B. 343.

[5] *See U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964); Regs. §§1.61-2(d) and 1.721-1(b)(1).

[6] If the service provider is already an existing partner, the applicability of §83 is less clear. *See* Banoff "Use of Corporate Partner Stock and Options to Compensate Service Partners," 90 *J. Tax'n* 26 (Dec. 1999).

[7] *See Mark IV Pictures, Inc. v. Comr.*, T.C. Memo 1990-571, *aff'd*, 969 F.2d 669 (8th Cir. 1992); *Hensel Phelps Construction v. Comr.*, 74 T.C. 939 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983). *See also* Regs. §1.721-1(b)(1); Prop. Regs. §1.721-1(b)(1) (1971).

[8] §83(a).

[9] The deduction assumes that the services are not properly capital expenditures. Regs. §1.83-6(a)(4).

[10] Rev. Proc. 93-27, 1993-2 C.B. 343.

[11] *Diamond v. Comr.*, 492 F.2d 286 (7th Cir. 1974).

[12] *Campbell v. Comr.*, T.C. Memo 1990-162, *rev'd on this issue*, 943 F.2d 815 (8th Cir. 1991) (where the Tax Court applied §83 but the Eighth Circuit on appeal did not reach the same conclusion); *Kenroy, Inc. v. Comr.*, T.C. Memo 1984-232; *St. John v. U.S.*, 84-1 USTC ¶9158 (C.D. Ill. 1983).

[13] 943 F.2d 815 (8th Cir. 1991), *rev'g* T.C. Memo 1990-162.

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the profits interest within two years after receipt; and (3) the profits interest is not in a "publicly traded partnership" within the meaning of §7704. This essentially represents a rule of convenience for the Service given the *Campbell* holding. Thus, profits interest recipients within the scope of Rev. Proc. 93-27 are not taxed under current law based on the mere fact that the interests received by them are difficult to value.

If the safe harbors of Rev. Proc. 93-27 are not satisfied, however, the decided cases may cause the service provider to be taxable on the fair market value of the profits interest received.[14] A typical situation where Rev. Proc. 93-27 does not apply is where the profits interest recipient performed services for a partner of a partnership rather than the partnership itself. However, notwithstanding the inapplicability of Rev. Proc. 93-27, the service provider may continue to assert that the receipt is not subject to taxation because the value of the profits interest is too speculative to be subject to current taxation. Because the service provider typically will report no income associated with the receipt of a profits interest, the partnership would not be entitled to a deduction attributable to the issuance of the profits interest.

By becoming a partner, the service provider's allocable share of items of partnership income and loss will retain the character of such income or loss based on the partnership's treatment of such items. Consequently, the service provider may be taxed at favorable capital gains rates on the partnership's disposition of long-term capital assets. If the service provider fails to obtain partner status on the issuance of a profits interest, all distributions made to the service provider will constitute ordinary income and generally will entitle the partnership to corresponding compensation deductions.

OBTAINING PARTNER STATUS

This article assumes that all awards of partnership interests are in exchange for the performance of services for the partnership and the recipient is treated as a partner for tax purposes. The seminal case of *Comr. v. Culbertson*[15] lays the groundwork for determining whether a person was intended to become a partner in a partnership as opposed to the parties intending to create some other relationship, such as an employment relationship. The Supreme Court concluded that a partnership is not defined for federal income tax purposes with reference to any specific set of factors.[16] However, a key factor in the Court's *Culbertson* decision was whether the parties intended to jointly carry on a business or venture. Because the grant of a profits interest represents only a right to future profits and appreciation, it may be argued that the recipient of a profits interest is not currently a partner in the partnership. This is to be contrasted with the grant of an interest in both the capital and profits of a partnership.

Upon receipt of a capital interest, the service provider generally should become a partner in the partnership for tax purposes.[17] On occasion, service providers receive capital interests which are nonvoting. Notwithstanding any lack of voting rights or management voice, the service provider should be treated as a partner because the service provider's entitlement upon liquidation is subject to entrepreneurial risk. Because of the immediacy of the benefit to the service provider in connection with the receipt of a capital interest, it should not be difficult to have the service provider recognized as a partner for tax purposes. However, when the grant of an interest is subject to substantial restrictions on the use or enjoyment of the interest, or if the award represents a mere interest in the future profits and future appreciation of the partnership, assessing whether such recipient is a partner for tax purposes becomes more difficult.

In *Dorman v. U.S.*,[18] the court considered whether an alleged profits interest holder was a partner. The court held that the service provider was not a partner even though a written partnership agreement was entered into for the operation of a ranch. A close look at the underlying economic arrangement in *Dorman*, however, reveals that the service provider was merely an employee who had an executory right to acquire a partnership interest in the future. The parties had agreed that the service provider was not to be vested in his partnership interest until certain nonrecourse promissory notes were paid. The court ultimately viewed the arrangement as creating either an option to be exercised in the future, or a nonvested ownership interest.

In *Luna v. Comr.*,[19] the court found that a number of factors will be considered in the determination of whether the service provider is considered to be a partner. Among the numerous factors listed in *Luna* are the intent of the parties to create a partnership, a mutual interest in net profits, the filing of partnership

[14] *Campbell*, 943 F.2d 815 (8th Cir. 1991); *Kenroy*, T.C. Memo 1984-232; *St. John*, 84-1 USTC ¶9158 (C.D. Ill. 1983); *Diamond v. Comr.*, 492 F.2d 286, 290 (7th Cir. 1974).

[15] 337 U.S. 733 (1949).

[16] *Culbertson*, 337 U.S. at 742.

[17] Karch, "Equity Compensation by Partnership Operating Businesses," 74 *TAXES* 722 (Dec. 1996) at 725; McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Warren, Gorham & Lamont (1997) ¶3.02[5][b][i].

[18] 296 F.2d 27 (9th Cir. 1961).

[19] 42 T.C. 1067 (1964).

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tax returns, and joint control over or mutual responsibility for the enterprise. While the taxpayer involved in *Luna* contended that he was a partner in possession of an interest akin to a profits interest, under the clear facts of the case, the arrangement was merely an employer-employee relationship.

The foregoing cases were fairly easy decisions to reach given the factual circumstances of the cases. If practitioners provide for written compensation plans and written partnership agreements, followed up by partnership income tax reporting, these facts will be of substantial assistance in concluding that equity plan participants are partners. Further, to the extent profits have been earned, profits interest partners should become responsible for sharing losses under the partnership agreement. All of these factors will support a finding of intent to create a partnership and the sharing of entrepreneurial risk. In GCM 36346, under facts similar to those in the *Diamond* case, the Chief Counsel for the Service proposed treating the profits interest holder as a partner.[20] This GCM may prove significant in asserting that profits interest holders should be treated as partners.

A complicating factor that may often be encountered is where the service provider performs services for a partner of the issuing partnership rather than for the issuing partnership.[21] GCM 36346 viewed the intent to invest the services in the issuing partnership as critical.[22]

If the service provider does, indeed, become a partner of the partnership, then salary-like payments made to the service provider/partner will continue to represent ordinary compensation income and most likely will be considered guaranteed payments. Under §707(c), guaranteed payments are those payments made to a partner for services regardless of the income of the partnership. Payments made to a service provider/partner are typically viewed as guaranteed payments which would not be subject to withholding or employment taxes. The Service has long taken the position that partners are not "employees" for purposes of the federal employment tax.[23] Consequently, once partner status is obtained, that service provider typically will not be viewed as an employee and salary payments made to such partner would not be subject to withholding. With the enactment of §707(a), a more detailed analysis may be required to determine whether withholding would be required on payments considered to be guaranteed payments to a partner.

Section 707(a) contemplates that partners may engage in transactions with the partnership in a capacity other than as a partner.[24] Whether a payment is received in the capacity of a partner is a question of fact. Generally, where a partner is performing broad management services rendered pursuant to the partnership agreement and in furtherance of the stated purpose of the partnership, such services are likely to be considered as rendered in the capacity of a partner.[25] Where, however, the services rendered by the partner are the same services the partner renders as an independent contractor to other persons, the services will likely be found to be rendered in a nonpartner capacity.[26] Consequently, the identity of the service provider/partner and the type of services provided to the partnership by such service provider/partner could dictate whether withholding is appropriate on the salary payments made to such person, irrespective of §707(c).

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[20] GCM 36346 (July 23, 1975). The GCM looks to the factors in Rev. Rul. 75-43, 1975-1 C.B. 383, to determine partner status.

[21] *See* Petkun and Shea, "Using Partnership Profits Interests to Reward Key Employees of the General Partner," 86 *J. Tax'n* 165 (March 1997).

[22] PLR 9533008 was a more recent situation where the Service concluded that an employee of a corporate partner in two partnerships did not become a partner in such underlying partnerships. The employee received a portion of the corporate partner's interests in profits of the underlying partnerships and claimed that the receipt of the profits interest was not a taxable event. The PLR indicated that a written settlement agreement (which resolved a dispute between the service provider and the corporate partner) indicated that the parties agreed that there had been no prior written documentation of the service provider's interest in the profits of the underlying partnerships. The settlement agreement further contained an acknowledgement that the service provider was not a partner in the underlying partnerships. Hence, the Service ruled that a profits interest was an unfunded, unsecured promise to pay money in the future and, therefore, was not currently taxable to the service provider. On a subsequent sale of the profits interest, the Service found that the taxpayer recognized ordinary income and not capital gain because the employee received the profits interest in his capacity as an employee and not as a partner, or in anticipation of becoming a partner. *See also Smith Est. v. Comr.*, 313 F.2d 724 (8th Cir. 1963), holding that no partnership was considered formed with respect to a commodities profit sharing arrangement because the parties did not possess an intent to form a partnership.

[23] Rev. Rul. 69-184, 1969-1 C.B. 256.

[24] *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968).

[25] *See Pratt v. Comr.*, 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977); Rev. Rul. 81-300, 1981-2 C.B. 143; TAM 8642003. The legislative history to the Deficit Reduction Act of 1984, however, states that in light of the amendments to §707(a)(2), the transaction in Rev. Rul. 81-300 would be treated as a §707(a) transaction. The legislative history, however, does not elaborate on the reasoning for this assertion. The Service, however, continues to cite Rev. Rul. 81-300 with approval (e.g., TAM 8642003).

[26] *See* Rev. Rul. 81-301, 1981-2 C.B. 144, wherein the Service ruled that the investment advisory services rendered by a partner were rendered in a nonpartner capacity where (i) such services were subject to supervision by the remaining partners, and (ii) such services were of the type the partner normally provided to others as part of its regular trade or business.

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Booking-up Capital Accounts

To ensure that the service provider and the existing partners get the economic deal that they anticipate, the partnership assets and partners' capital accounts should be "booked-up." This is true whether the service provider receives a capital interest or a mere profits interest. The book-up will attempt to establish the current fair market of the business and enable all of the partners going forward to gauge their relative position in increases and decreases in the value and profitability of the business based on the current value, rather than the historic value, of the business. An appraisal should be obtained to give substance to the fair market value determination. Indeed, it would be advisable to have all partners acknowledge their agreement with the fair market value determination and the partners' relative capital account balances by signing the partnership agreement, or an addendum thereto which reflects this information. This process would provide further support for finding the service providers to be partners.

In the case of a book-up upon the issuance of a profits interest, the service provider will have a capital account of zero and the other partners' capital accounts will reflect the prior income and appreciation in the business. The book-up will help demonstrate that the profits interest holder is within the nontaxable ambit of Rev. Proc. 93-27. It also protects the preexisting partners by preventing existing appreciation in the partnership's assets from being transferred to the service provider. In the case of the issuance of a capital interest, a book-up will enable the service provider to understand his economic grant from the other partners and, just as importantly, the historic partners will be able to recognize the slice of existing value that they have given away.

The authorization for a book-up is unclear, however, when a partnership interest is issued in exchange for the performance of services. The regulation most often cited by commentators as authority for a book-up is Regs. §1.704-1(b)(2)(iv)(f), notwithstanding the fact that this regulation does not specifically reference the issuance of an interest solely for services.[27] Revaluations of partnership property (i.e., book-ups) are authorized in connection with contributions of money or other property specifically, but no mention is made of contributions of services. This is quite possibly an oversight of the drafters of the §704 regulations because Regs. §1.721-1(b)(1) specifically recognizes the partnership's ability to issue an interest in connection with the performance of services. If there is no book-up of the capital accounts or the partnership's assets, the service provider who was expecting a profits interest could become entitled to share in prior appreciation and, consequently, be regarded as having been issued a capital interest (thereby defeating the purpose of the partnership's attempt to issue nontaxable interests).[28]

APPLICATION OF §83

Vesting Concepts

Although stock awards are popular compensation tools in the corporate context, awards of stock are more often than not subject to a substantial risk of forfeiture and/or limitations on transferability. This article will focus on the risk of forfeiture aspect of §83. The decided cases discussed above[29] have applied §83 to the transfer of a capital interest to a service provider. In the case of partnerships and LLCs, awards of either capital interests or profits interests may be subjected to risks of forfeiture in the same fashion as corporate stock grants. Section 83(a) generally provides that if property is transferred to any person for the performance of services, the fair market value of such property (less any amount paid for such property) shall be included in income when such property is no longer subject to a substantial risk of forfeiture (or is transferable). Consequently, at the time a capital interest in a partnership is no longer subject to such a risk of forfeiture, the service provider will recognize income in an amount equal to the fair market value of the capital interest on the date the interest becomes substantially vested (less any amount paid for the interest).[30] The entire value of the capital interest would represent compensation income, including any appreciation in value of the interest during the time period in which the capital interest was subject to a substantial risk of forfeiture.

Interestingly, during the period of time in which the capital interest was subject to a substantial risk of forfeiture, the service provider apparently would not be considered to be a partner of the partnership by reason of Regs. §1.83-1(a)(1).[31] On this basis, the allocations provided in the partnership agreement should

[27] Alternatively, authority for a book-up may arguably be found in Regs. §1.704-1(b)(2)(iv)(q).

[28] A book-up could be avoided by clearly drafting the allocation provisions to cause prior appreciation to be allocated to the historic partners; however, this would not create an accurate reflection of the value of the business on the partnership's books and would not provide an accurate measure of the partnership's income or loss on an ongoing basis among the partners.

[29] *See Mark IV Pictures* and *Hensel Phelps*, fn. 7, above.

[30] Regs. §1.83-3(b). *See also* Regs. §1.721-1(b)(1).

[31] Regs. §1.83-1(a)(1) provides that until unvested property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property re-

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be made as if the service provider was not a partner and had not been awarded a capital interest. Presumably, any distributions made to the service provider prior to her becoming substantially vested would constitute ordinary compensation income (because such person should not yet be recognized as a partner for tax purposes). Likewise, salary payments made during this time period (while the interest is subject to a substantial risk of forfeiture) would be considered as being made to a nonpartner and, therefore, subject to employer withholding obligations.

If the capital interest is burdened by a substantial risk of forfeiture, an analysis should be undertaken to determine whether the recipient should not be regarded as a partner merely because §83 postpones the time for including the property in gross income. If the capital interest recipient possesses an interest subject to a substantial risk of forfeiture, it would nevertheless be possible for (i) the Service, (ii) a court, or (iii) the partnership agreement to view the service provider as a partner for federal income tax purposes on a current basis in spite of §83 and the service provider's potential forfeiture of the interest. In such a case, allocations of income made to the service provider/partner during the period of time that the risk of forfeiture is in effect would presumably be reported as income on an ongoing basis. These allocations would build up the service provider/partner's capital account. Then, upon the lapse of the risk of forfeiture (i.e., becoming substantially vested), the capital account balance that had been building up over time would become taxable as compensation income pursuant to §83. The effect of these events would apparently cause the service provider to be subject to double taxation on the value of the interest received (by reporting income on an ongoing basis and, again, on vesting). This double taxation effect indicates that §83 should prevent a service provider from being considered to be a partner for federal income tax purposes prior to the lapse of the risk of forfeiture and the partnership agreement should not provide current allocations to such person. Thus, the presence of a risk of forfeiture should prevent the service provider from being considered a partner of the partnership, unless a §83(b) election is made.

With respect to the partnership, the issuance of a capital interest subject to a substantial risk of forfeiture should not provide an immediate deduction to the partnership under §83(h). The partnership will be entitled to a compensation deduction equal to the amount of income reported by the service provider/partner as the capital interest becomes substantially vested over time. To be explored later is whether the partnership's issuance of the interest at the time of substantial vesting potentially gives rise to a partnership level gain.

Grasping the issues associated with the grant of a profits interest that is burdened by a substantial risk of forfeiture is a little more difficult. An outright award of the typical profits interest should not be subject to taxation under the authority described above. Likewise, an award of a profits interest which is subject to a substantial risk of forfeiture should not be subject to immediate taxation. Again, based on Regs. §1.83-1(a)(1), the service provider should not be considered a partner until some part of her interest is no longer subject to a substantial risk of forfeiture. In most cases, however, the partnership would like the service provider to become entitled to a share of the partnership's profits and appreciation from the date of the award through the period of vesting.

At the time the profits interest vests, the partnership may have generated profits and/or appreciated in value from the date of issuance. Hence, at the time of vesting, the profits interest may have become a combined interest in both profits and capital, and the applicability of §83 at that point in time would be fairly clear. Consequently, as the risk of forfeiture lapses, the service provider will ordinarily be in possession of a partnership interest that has become a capital interest taxable to the service provider as the risk of forfeiture lapses. This will give rise to ordinary income equal to the fair market value of the combined profits and capital interest at the time of vesting (including appreciation in the value of the business).[32] The partnership would presumably be entitled to a compensation deduction in the amount of income recognized by the service provider. Additionally, at the time of vesting, the service provider would then normally become a partner for tax purposes (having a combined interest in profits and capital). Thereafter, allocations of partnership income to the partner would retain their character based on the characterization of such items at the partnership level.

These are bad results for a profits interest recipient. The general idea behind creating an award of a profits interest is that the recipient can avoid paying income tax based upon the grant of the interest. By attaching vesting provisions to the profits interest recipient's award, the service provider may become taxable as the risk of forfeiture lapses. A service pro-

ceived by the service provider shall constitute additional compensation.

[32] It would be possible to structure a compensation plan that would merely entitle the service provider to an interest in future profits and future appreciation, going forward from the time that the risk of forfeiture lapses. However, this type of plan would not reward the service provider with an interest in the profitability and appreciation of the partnership for the period of time between the date of the award and the lapse of the forfeiture provisions.

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vider in receipt of a profits interest award subject to a substantial risk of forfeiture may wish to make an election under §83(b) (a "§83(b) election") to accelerate the property transfer for federal income tax purposes and thereby avoid income recognition as described above.

§83(b) Elections

Service providers who expect to satisfy the vesting requirements that may be associated with a grant of an interest (whether a combined capital and profits interest or merely a profits interest) may be well advised to make a §83(b) election. In the case of a grant of an interest that is a capital interest, the ability to make a §83(b) election seems fairly clear. Again, the decided cases relating to capital interest transfers to service providers support the application of §83 to the transfer of the interest.[33] A §83(b) election accelerates the income recognition event for the capital interest recipient in spite of the existence of the risks of forfeiture. The income to be reported by the service provider is equal to the fair market value of the interest received less the amount paid, if any, for the interest. The filing of a §83(b) election should cause the service provider to become a partner for tax purposes at the time of the issuance of the interest despite the capital interest being "substantially nonvested." [34]

The dictates of §83 should control the service provider's treatment as a partner, but the facts and circumstances as a whole should be analyzed by the practitioner in an attempt to ensure the treatment of the service provider as a partner under traditional principles. By obtaining partner status for the service provider, allocations of income or loss pursuant to the partnership agreement will be capital or ordinary based on the characterization at the partnership level. A §83(b) election will prevent appreciation in the partnership assets during the vesting period from becoming taxed to the service provider as compensation income. At the time a capital interest recipient makes a §83(b) election, the partnership will generally be entitled to a corresponding compensation deduction.

The ability of a profits interest recipient to make a §83(b) election is not entirely clear although the case law would seem to support the ability to make a §83(b) election. The cases seem to conclude that a profits interest represents "property" for purposes of §83.[35] This point becomes critical in situations where risks of forfeiture are placed on the award of a profits interest because a §83(b) election would prevent the appreciation in value during the vesting period from being taxed as ordinary compensation income. If §83 does *not* apply to the award of a profits interest in the first place, it seems there can be no §83(b) election made.

Regs. §1.61-2(d)(6) provides that §83 applies to all transfers of property made in connection with the performance of services after June 30, 1969, unless the transfer of property is excluded from the coverage of §83 by Regs. §1.83-8 (which does not exclude transfers of partnership interests). The §83 regulations apply to property transferred to employees or independent contractors.[36] At the moment of the issuance of a partnership interest for services, the service provider will typically be an employee or independent contractor. Moreover, state partnership acts generally describe a partnership interest as intangible personal property.[37] Consequently, the issuance of a profits interest should be property for purposes of §83 and, therefore, a §83(b) election should be applicable.

As in the case of a capital interest, if a §83(b) election can be made based upon the receipt of a profits interest, the substantial vesting rules of §83(a) will not apply and the property will be includable in gross income at the time of transfer even though the profits interest remains substantially nonvested. This does not mandate that the service provider will be recognized as a partner for tax purposes and practitioners will need to consult other authority for determining whether the profits interest recipient is considered a partner for tax purposes.[38] However, at least with respect to §83, the profits interest should be considered transferred to the service provider at the time the §83(b) election is made.

The Eighth Circuit in *Campbell v. Comr.* did not directly agree with the application of §83 to a transfer of a profits interest to a service provider although the

[33] *See Mark IV Pictures* and *Hensel Phelps*, fn. 7, above.

[34] *See* Regs. §1.83-2(a) providing that if a §83(b) election is made, the substantial vesting rules of §83(a) and the regulations thereunder do not apply with respect to such property, and the property with respect to which the election is made shall be includible in gross income as of the time of transfer even though such property is substantially nonvested.

[35] *Campbell v. Comr.*, T.C. Memo 1990-162, *rev'd on this issue*, 943 F.2d 815 (8th Cir. 1991) (where the Tax Court applied §83 but the Eighth Circuit on appeal did not reach the same conclusion); *Kenroy, Inc. v. Comr.*, T.C. Memo 1984-232; *St. John v. U.S.*, 84-1 USTC ¶9158 (C.D. Ill. 1983). *See also Diamond v. Comr.*, 492 F.2d 286 (7th Cir. 1974).

[36] Regs. §§1.83-1(a), 1.83-3(f), 183-5(b)(1), and 1.83-7(a).

[37] *See, e.g.*, Uniform Partnership Act §502 (1997); Uniform Partnership Act §26 (1914); Revised Uniform Limited Partnership Act §701 (1976); Uniform Limited Partnership Act §18 (1916); Uniform Limited Liability Company Act §501 (1995).

[38] In the case of an S Corporation which created a restricted stock plan for key employees, the Service ruled that the holders of restricted stock that vest immediately pursuant to a §83(b) election will be considered stockholders for S Corporation purposes (presumably required to be allocated of proportionate share of income and loss). PLR 8942091.

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taxpayer ultimately prevailed because the profits interest was incapable of being reliably valued. The Eighth Circuit's decision left open whether a profits interest was indeed property for purposes of §83. The authors of one leading treatise believe that a profits interest does not represent property for purposes of §61 or §83.[39] The Service appeared to champion this position when it issued Prop. Regs. §1.721-1(b)(1)(i)[40] in 1971. Prop. Regs. §1.721-1(b)(1) specifically called for the application of §83 to the award of a capital interest, but failed to reference the application of §83 to the issuance of a profits interest. In GCM 36346, issued in 1977, the Service perhaps equivocated on the treatment of a profits interest as property. The Chief Counsel analogized the receipt of a profits interest to an unfunded, unsecured promise to pay deferred compensation, but also recognized at least that it "is difficult to quarrel with the Tax Court's finding [in *Diamond*] that such an interest is property under Treas. Reg. §1.61-2(d)(1)."[41] A key passage in the proposed revenue ruling within GCM 36346 found that "when an interest in future profits of an enterprise is acquired as compensation for services by someone other than a partner, such interest is not considered property for purposes of section 61 of the Code." This could be an indication that the Service was ready to treat a profits interest as property in a non-*Diamond* situation — that is, where the profits interest recipient was expected to have a continuing interest in the partnership. The proposed revenue ruling in GCM 36346 was never published by the Service. Finally, in 1991, on appeal to the Eighth Circuit in *Campbell*, the Service conceded that the transfer of a profits interest did not represent ordinary income if the services were performed for the issuing partnership.[42] Based on this concession, the Service may not view the transfer of a profits interest as a property transfer for purposes of §83.

In an attempt to bring a profits interest within the application of §83, some practitioners have suggested that a service provider make a small capital contribution in exchange for the profits interest so that the ownership interest received would represent both a capital interest (to the extent of the capital contribution by the service provider) and a profits interest. By doing so, the service provider would perhaps fall within the cases holding that §83 applies to the transfer of a capital interest, instead of being forced to rely on the profits interest authority. The Service, however, could attempt to bifurcate the issuance of the interest[43] to counteract the taxpayer's efforts in this regard.

Even if the service provider overcomes all the hurdles necessary to become substantially vested in the partnership interest, the other partners may want to ensure that the service provider cannot maintain ownership of her partnership interest if she no longer provides services to the partnership. That is, if the "employment" relationship with the partnership terminates, the partnership or the other partners may wish to acquire the partnership interest held by the former service provider. If the service provider must relinquish her partnership interest for less than its fair market value at the time of termination, this may bring into question whether a transfer of property had actually occurred under §83. The regulations under §83 specifically provide that no transfer may have occurred where property is transferred under conditions that *require* its return upon an event that is certain to occur (e.g., termination of employment).[44] One key fact that the Service will take into account in determining whether a transfer occurred is whether the repurchase price is substantially less than fair market value.[45]

In most partnership situations, the partnership (or the partners individually) will either purchase the interest for its fair market value at the time of the termination from employment or, at the least, the capital account balance at the time of termination. The capital account balance will reflect income allocated to the service provider upon which taxes would have been paid. A positive balance represents an entitlement of the service provider to an amount of money that may be received from the partnership (but has not yet been received) on a tax-free basis.[46] In many plans, the conclusion is reached that a fair purchase price would be an amount at least equal to the capital account balance of the terminated service provider. Accordingly, partners routinely are required to sell their interests back to the partnership under a formula purchase price. For purposes of §83, a formula purchase price may or may not be respected by the Service in determining whether property is being repurchased at a

[39] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Warren, Gorham & Lamont (1997) ¶5.02[1].

[40] Prop. Regs. §1.721-1(b)(1)(i) provides "if the partnership interest is transferred after June 30, 1969 (except to the extent paragraph (b) of §1.83-8 applies) then 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."

[41] GCM 36346 (July 25, 1977). The ultimate position in the GCM is that when a profits interest is received in exchange for services performed by a partner in a nonpartner capacity, the receipt of such an interest is not taxable, but the profits subsequently received (including gains on a sale) are compensation income.

[42] *Campbell*, 943 F.2d at 818.

[43] *Cf. U.S. v. Stafford*, 727 F.2d 1043 (11th Cir. 1984).

[44] Regs. §1.83-3(a)(3) and (7) (Examples 3, 4 and 5).

[45] Regs. §1.83-3(a)(5).

[46] §731(a).

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price substantially equivalent to fair market value.[47] Nevertheless, the existence of a right to purchase at the capital account balance probably does not rise to such a level as to warrant a finding that the interest should be treated as not having been transferred, particularly where the partnership's repurchase right is structured as an option to purchase or, alternatively, as a right of first refusal.

OPTIONS

In Notice 2000-29, 2000-23 I.R.B. 1241, the Service stated that:

> In a variety of situations, partnerships issue options or convertible debt that allow the holder to acquire by purchase or conversion an equity interest in an entity classified as a partnership for federal tax purposes. . . . Often, these instruments are exercised or converted when the partnership interest to be received is more valuable than the sum of consideration previously transferred to the partnership plus any consideration transferred upon exercise or conversion.

The Service sought public comment on the treatment of the exercise of an option to acquire a partnership interest and the exchange of a convertible debt instrument for a partnership equity interest. The crux of the issue is whether the historic partners should be taxable on the appreciation in the partnership's assets based on a deemed sale of a portion of the partnership's assets when the option is exercised or when the debt is converted. This issue is not a new one. It is the same issue that arises when a partnership interest is issued for less than a fair market value purchase price — i.e., when an interest is issued in exchange for the performance of services. If nonrecognition of gain applies, it is feared that appreciation in the assets during the option period could be allocated to the optionholder without the existing partners recognizing gain.

As recognized by the Service in Notice 2000-29, options to acquire partnership interests are becoming more common. Options may be issued in either a compensatory or noncompensatory setting. This article focuses primarily on the grant of options in the compensatory context. Options in the partnership context bear the same characteristics typical in other settings. An option granted to a service provider would typically allow a holder to purchase a specified interest in the partnership's capital and profits at a specified price during a specified period. The exercise price for the option may be below, equal to, or greater than the fair market value of the underlying partnership interest at the time of the grant of the option.

Tax Effects on Issuance

The tax consequences relative to the issuance of the option itself should be fairly noncontroversial. It is the tax effect upon exercise of the option that creates controversy. The grant of an option to acquire a partnership interest with an exercise price below fair market value should not be considered an event triggering immediate tax consequences to the service provider, unless the exercise price was substantially below the current fair market value of the partnership interest (i.e., a "deep in the money" or "deep discount" option).[48] An exercise price that is too low may cause the underlying partnership interest to be considered to be issued at the time of the award of the option.

The issuance of an option to acquire stock in a corporation was clearly intended to be covered by §83. Regs. §1.83-7 contains the word "stock" in the heading, but the body of the regulation broadly describes the application of §83 to the issuance of an option to acquire property without reference to the specific type of property underlying the option. Further, there is no announced position by the Service that §83 would be an inappropriate source of authority to determine the taxation of the issuance of options in a partnership context.

Practitioners will most commonly be faced with the situation where an option to acquire a partnership interest will not have an ascertainable fair market value at the time of the grant. Consequently, the service provider will not recognize taxable income upon receipt of the option.[49] Section 83 provides for complimentary effects to the employer by postponing a compensation deduction until the time that the option recipient recognizes income.[50] Because an option without a readily ascertainable fair market value is not considered property under §83(e)(3), the service provider could not make a §83(b) election to accelerate the time at which such a compensatory transfer occurs for federal income tax purposes.

Tax Effects on Exercise

The exercise of an option triggers the time at which the property transfer to the service provider is consid-

[47] Regs. §1.83-5.

[48] *See* Rev. Rul. 82-150, 1982-2 C.B. 110 (deeply discussed option in foreign personal holding company stock treated as actual ownership of stock); O'Neil and Schenck, "Using Discount Stock Options as Executive Compensation," 72 *J. Tax'n* 348 (June 1990).

[49] §83(e)(3); Regs. §1.83-7(a).

[50] §83(e)(3) and (h); Regs. §1.83-7(a).

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ered to occur for federal income tax purposes. Only upon exercise are the various components of §83 capable of being applied. The income required to be recognized by the service provider at the time of exercise is equal to the difference between the fair market value of the partnership interest received on the date of exercise less the option exercise price. It would be possible to structure a compensation plan which provided for options to acquire a profits interest at the time of the exercise of the option. Under those circumstances, the exercise would effectively provide the service provider with an interest in the future profits and future appreciation of the partnership, going forward from the date of exercise. In such a case, the service provider would acquire a "capital interest" in the partnership in an amount equal to the exercise price paid for the partnership interest. Accordingly, the safe harbor of Rev. Proc. 93-27 would arguably apply and the service provider would not be required to recognize any income upon the exercise of this type of option. Because this type of option would not bestow upon the service provider any appreciation in the value of the business occurring during the period of time between the grant of the option and the date of exercise, this type of option would not be the type most often encountered.

More commonplace will be situations where the service provider would expect to become entitled to a portion of the partnership's underlying capital immediately upon exercise of the option (some amount in excess of the exercise price) as if the option-holder were a partner immediately upon issuance of the award. This type of compensation plan would be more closely analogous to a corporate stock option plan. Ordinarily, the service provider will exercise the option on a date when the fair market value of the interest received exceeds the exercise price. On exercise, because the service provider would then become immediately entitled to a portion of the partnership's underlying capital in excess of the exercise price, §83 would be expected to tax the service provider on the exercise of her option in typical §83 fashion. The end result of the option exercise is that a capital interest is issued to a service provider without the service provider making a property contribution of equal value to the partnership. This analysis would be, by and large, the same analysis applied to an outright grant of a capital interest to a service provider in exchange for the performance of services described above. Correspondingly, upon exercise of the option, the partnership will be entitled to a compensation deduction in the same year in which the service provider reported the income, provided that such an expense is not required to be capitalized by the partnership.[51]

Partnership Treatment

The primary area of uncertainty when an option is exercised (or a partnership interest is issued) is whether the partnership has any tax effects to report other than its deduction. Some commentators have proposed that the partnership should recognize gain or loss upon the issuance of a capital interest. However, there seem to be circulating at least two schools of thought to address whether the partnership itself should have a taxable event upon the exercise of an option to acquire a partnership interest. Neither school of thought is statutorily mandated or raised by governmental regulation. Likewise, no cases have yet addressed the issue.

Capital Shift

One school of thought would view the exercise of an option and resulting issuance of an underlying capital interest by the partnership as a deemed transfer of an undivided interest in the partnership's assets to the service provider, followed immediately by a deemed recontribution of such assets to the partnership.[52] Because capital is said to shift from the historic partners to the service provider, this is sometimes referred to as the capital shift theory.

The rationale for this proposition is grounded in the more general tax principle that a transfer of appreciated property in satisfaction of a debt, or compensation obligation, would require the employer to recognize gain on the difference between the value of the property transferred to satisfy the obligation and the employer's basis in such property.[53] In the corporate context, §1032 protects corporations from ever recognizing gain when issuing shares of the corporation's own stock to its employees in exchange for the performance of services.[54] The general rule requiring employer gain recognition related to transfers of appreciated property in connection with the performance of services in Regs. §1.83-6(b) specifically provides for an exception to gain recognition for corporations in the situation where §1032 applies. Because there is no exception from entity-level gain recognition specified in Regs. §1.83-6(b) when a partnership issues an ownership interest in itself to a service provider (like the exception provided for corporations), it is argued that the partnership is not protected from gain recognition when a partnership interest is transferred in ex-

[51] §83(h).

[52] *See* McKee, Nelson & Whitmire, above, at ¶[5.08 [2][b].

[53] *See* Regs. §1.83-6(b).

[54] Regs. §1.1032-1(a).

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change for services. Presumably, if the §83 regulations merely provided a partnership-level exception from gain recognition, then a partnership would not be required to recognize gain. Thus, the failure to include a partnership-level exception requires that the partnership recognize gain.

Proponents of this theory assert that they are reaching the correct tax result because the basis of the partnership's assets attributable to the service provider match the service provider's basis in her partnership interest.[55] The deemed asset transfer to the service provider from the partnership should cause the tax basis of those assets to obtain a fair market value cost basis under §1012. When those assets are deemed to be recontributed to the partnership, the partnership succeeds to the same basis.[56] Correspondingly, the service provider would obtain a basis in her partnership interest equal to the basis of those recontributed assets (a cost basis).[57] It is asserted that this line of reasoning avoids exposing the service provider to possible double taxation because the partnership's asset basis increase would be allocable entirely to the service provider.[58] Symmetry is achieved between the service provider's basis in her partnership interest and her share of the partnership's assets. At the time of the deemed recontribution of assets, Regs. §1.704-1(b)(2)(iv)(f) would be available to provide the partnership with a clear authorization to "book-up" the capital accounts immediately prior to the transfer of the capital interest to the service provider.

The achievement of symmetry in the service provider/partner's inside and outside basis is of no real significance, however, from an income tax standpoint. Discrepancies between inside and outside basis regularly occur. Antidotes are available to remedy the problems that could arise due to an inequality between inside and outside basis. Section 704(c) and the regulations promulgated thereunder will prevent a service provider from being taxed on income properly attributable to the historic partners. The reverse §704(c) allocation regulations[59] require that, in cases where partnership property is revalued under Regs. §1.704-1(b)(2)(iv)(f) and a book/tax disparity results,[60] the principles of §704(c) apply. The principles of §704(c) are required to apply even in cases where the partnership does not maintain capital accounts in conformity with Regs. §1.704-1(b)(2)(iv).[61] The reverse §704(c) allocations should, therefore, be sufficient to prevent the service provider from being subjected to the risk of double taxation without the need to create a fictitious asset distribution and resulting increase in asset basis.

Proponents of the partnership-level gain theory also believe that gain recognition is supported by the partnership regulations. Regs. §1.721-1(b)(1) provides that if any partner gives up his right to be repaid his "contributions" in favor of another partner as compensation for services rendered to the partnership, the nonrecognition provisions of §721 do not apply. Consequently, when capital shifts from one partner to another, the partnership's protection from gain recognition provided by §721 is thereby lost, according to the explicit terms of the regulation.

Reliance on Regs. §1.721-1(b)(1) and the capital shift argument, in general, begins to fall apart upon a close examination of the applicability of the regulation in the first place. This regulation speaks only to partners giving up their right to be repaid "contributions" and does not directly speak to increases in the partners' capital accounts attributable to income and appreciation.[62] In fact, Regs. §1.721-1(b)(1) does not purport to apply to situations involving a partner giving up his right to be repaid his share of partnership earnings. In pertinent part, this regulation provides "[t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share of partnership profits) in favor of another partner." Thus, it may be a rare case when the transfer of a partnership interest outright, or pursuant to the exercise of an option, would actually result in the historic partners giving up their right to be repaid their "contributions" to the partnership.[63]

Notwithstanding the foregoing, even if the issuance of the partnership interest to a service provider fits

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[55] McKee, Nelson & Whitmire, above, at ¶5.08[2][b].

[56] §723.

[57] §722.

[58] *See* McKee, Nelson & Whitmire, above, at ¶5.08[2][b].

[59] Regs. §1.704-3(a)(6).

[60] It must be admitted that Regs. §1.704-3(a)(6) does not reference a possible book-up occurring under Regs. §1.704-1(b)(2)(iv)(q), which is probably the most likely authorization for a book-up in the case of a transfer of an interest to a service provider. The lack of a technically precise cross-reference by Regs. §1.704-3(a)(6) should not be seriously entertained as an authorization to ignore the principles of §704(c).

[61] Regs. §1.704-3(a)(3).

[62] Regs. §1.721-1(b)(1) does reference a transfer of an interest in partnership "capital" rather than merely a transfer of "contributions"; however, this merely serves to demonstrate that the regulation is inconsistent within itself.

[63] The relevant portion of Regs. §1.721-1(b)(1) provides:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that 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 an obligation), section 721 does not apply. The value of an interest in such partner-

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within the contemplation of this regulation, the regulation specifies the inapplicability of §721—which governs the tax effects on *both* the partnership and the partner—and describes the resulting tax consequences to the service provider in great detail. Regs. §1.721-1(b)(1) explicitly provides: (i) that the service provider recognizes income under §61; (ii) that the amount of income is the fair market value of the interest in capital transferred; and (iii) for the timing of the income recognition event. The regulation, however, neglects to describe any tax effects to the partnership or the other partners. This could readily be viewed as implicit authorization for the partnership's avoidance of gain recognition because §721 is designed to control the tax effects to both the partnership and the partnership interest recipient.

The capital shift that is said to occur is difficult to ascertain if the partners' capital accounts are examined. Part of the difficulty in the analysis is that Regs. §1.721-1(b)(1) was promulgated in 1956 [64] and the capital account maintenance regulations were primarily adopted in 1985.[65] The analysis to be undertaken to ascertain whether a capital shift has occurred should apply in the same fashion to both an outright issuance of a capital interest and to the issuance of a capital interest pursuant to the exercise of a compensatory option. The exercise of an option and the payment of the exercise price should involve two components under general principles of tax law.[66] The first component would be a contribution of cash to the partnership in exchange for an interest under §721. The second component would be, to the extent of the compensatory transfer, a transfer of a partnership interest in exchange for the performance of services. There could be no capital shift for the portion of the transaction treated as a contribution of capital under §721 in exchange for the interest. This leaves the transfer of the interest in exchange for services as being the transaction which could give rise to a capital shift.

If a capital shift is to be found, it would seem to be found equally in a partnership that maintains capital accounts in accordance with the §704(b) regulations and/or a partnership that does not follow the §704(b) regulations. If the current capital account maintenance regulations are examined to ascertain whether a capital shift occurs, it may be first noticed that these regulations do not explicitly provide for a book-up or reallocation of capital accounts following the exercise of an option to acquire an interest or the issuance of an interest in exchange for the performance of services. Because the service provider will report ordinary income equal to the value of the partnership interest received (less any amount paid for the interest), it seems logical that the service provider should receive a capital account balance equal to the income reported from the transaction (otherwise, both the economic deal among the partners and the general objectives of the capital account maintenance regulations cannot be tracked in the partners' capital accounts). This incongruity supports the notion that some method must be found to book-up the capital accounts under the capital account maintenance regulations as a result of the issuance of a partnership interest to a service provider, irrespective of whether partnership-level gain arises. Because the partnership-level gain theory deems that a contribution of assets takes place, authorization for a book-up is found in Regs. §1.704-1(b)(2)(iv)(f). If a partnership-level transaction does not, in fact, take place, the book-up could take place under Regs. §1.704-1(b)(2)(iv)(f) by viewing the ability to book-up capital accounts pursuant to the issuance of an interest for services as an oversight by the drafters of the regulations[67] or, alternatively, under the more general authority of Regs. §1.704-1(b)(2)(iv)(q).[68]

By providing a book-up in the capital accounts and recognizing that the partnership is entitled to a deduc-

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> ship capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. (Emphasis added).

The regulation's reference to "another partner" also gives rise to uncertainty. It is unclear whether the reference was intended to mean only historic partners or whether the service provider in receipt of the partnership interest was intended to be considered a partner even though the recipient would likely have been an employee or independent contractor at the time of the issuance of the tory partnership interest. However, it is likely that the reference to "another partner" was intended to cover the service provider who becomes a new partner, given that §721 itself refers to a property contributor as a partner.

[64] T.D. 6175, 1956-1 C.B. 211.

[65] T.D. 8065, 1986-1 C.B. 254.

[66] A good analogy would be bargain sale transactions where part of the sale represents an arm's-length sale transaction and part of the sale involves a gift or compensation element.

[67] The partnership regulations acknowledge that partnership interests may be issued in exchange for services in Regs. §§1.704-1(b)(1)(iv) and 1.721-1(b)(1).

[68] Regs. §1.704-1(b)(2)(iv)(q) states:

> If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles.

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tion on the issuance of a partnership interest, it is not clear that a capital shift occurs at all. As demonstrated by the example below, if capital accounts are booked-up, the capital accounts ultimately will have the same ending balances whether or not a partnership level gain is recognized. This is true because book-ups cause the capital accounts to reflect the value of the partnership, not the amount of gain recognized.

Recall that the exercise of an option should involve two components: (i) the payment of the exercise price in exchange for an interest; and (ii) the transfer of an interest in exchange for the performance of services. The payment for a portion of the interest cannot result in a capital shift; otherwise, any time a contribution is made to a partnership in exchange for an interest, a capital shift would occur. The issuance of a partnership interest in exchange for services will represent income to the service provider and provide the partnership with a deduction. The amount of this income represents the service provider's interest in the partnership's underlying capital and will reside in her capital account. Because this income amount represents the deduction available to the partnership, an identical amount would be expected to be allocated to the historic partners and represent a reduction in their capital accounts. The amount of this reduction appears to be the "capital shift" contemplated by Regs. §1.721-1(b)(1), but the reduction in the capital accounts merely results from a compensation deduction. The reduction in capital accounts that occurs is identical to the result that would occur if the partnership had simply paid cash compensation to the service provider at the time of the exercise of the option.

Example:

Partners A and B each own 50% of the capital and profits of Partnership AB. As compensation for services rendered in the course of the partnership's regular operations, Partnership AB grants Employee C an option to acquire a one-third interest in the capital and profits of Partnership AB for $300. At the time of the grant of the option, Partnership AB has a value of $600, the assets have a basis of $300, and A and B each have a capital account of $300. One year later, when the value of Partnership AB has risen to $2,400, Employee C exercises his option and acquires a one-third interest in the capital and profits interest in Partnership AB for the $300 exercise price. The partnership agreement provides for liquidation based on capital accounts. As a result of the exercise, Employee C will recognize $600 of compensation income. This amount of income, plus the exercise price of $300, would presumably entitle Employee C to a capital account of $900. If a book-up occurs under the regulations, A's and B's capital account would initially increase to $1,200 each (reflecting Partnership AB's fair market value) and then be reduced by $300 each, which is one-half of the compensation deduction per partner.

	A	B	C	Total
Original balance	300	300		600
After book-up	900	900		1,800
FMV at exercise of option	1,200	1,200		2,400
Compensation deduction	(300)	(300)		(600)
Exercise price			300	300
Compensation income			600	600
	900	900	900	2,700

A very summary examination of the capital accounts when a book-up takes place reveals that the historic partners end up with a *larger* capital account balance as a result of the issuance of a partnership interest. It may be difficult to contend that the historic partners suffered a capital shift when their capital accounts end up with a larger balance. The capital shift argument, however, would rely on the fact that the capital accounts were greater just prior to, or contemporaneous with, the issuance of the partnership interest to the service provider as demonstrated in the example above. Nevertheless, in spite of this observation, the historic partners continue to be entitled to their "contributions" and perhaps makes a case for the inapplicability of Regs. §1.721-1(b)(1). The mere fact that a deduction accrues to the historic partners and causes a reduction in their collective capital accounts is not compelling evidence that capital thereby "shifts" and justifies the partnership's recognition of gain.

The "capital shift" which occurs in this scenario has the exact same effect as an actual payment of $600 cash compensation to Employee C when the cash is reinvested by Employee C in the partnership. It would be difficult to contend that the partnership should recognize gain based on a cash payment of compensation. A disparity in tax treatment would be created for partnerships capable of paying cash compensation and those partnerships that had more limited cash resources. Consequently, the capital shift argument in Regs. §1.721-1(b)(1) would not appear to provide strong support to the capital shift theory based on a capital account analysis because the historic partners' capital accounts simply evidence that a compensation deduction has occurred.

Using the example provided above, perhaps it is the tax capital accounts that hold the key to the capital

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shift theory. When Employee C is admitted as a partner, one-third of the assets would be deemed to be distributed to Employee C ($800), having a tax basis of $200. Partnership AB would recognize a gain of $600, increasing A's and B's tax capital accounts by $300 each. The compensation component of the transaction is $600, resulting in a deduction which will reduce A's and B's tax capital account in the amount of $300 each (offsetting the gain). Again, the capital account reductions merely evidence compensation deductions, and A and B remain entitled to their "contributions."

It should be noted that the best case for finding a capital shift is in the tax capital accounts if no partnership gain is recognized. When Employee C is admitted as a partner, a compensation deduction of $600 arises. When the deduction is allocated equally to A and B, a real reduction below their prior capital account balances actually occurs. Here, it may be said that A and B have given up a right to their "contributions" and Regs. §1.721-1(b)(1) applies. This scenario involves no gain recognition to the partnership, however, which is quite possibly why the regulation fails to provide for partnership-level gain.

The purpose of the foregoing capital account analysis is intended to demonstrate that Regs. §1.721-1(b)(1) does not provide support for a partnership-level recognition event when a partnership interest is issued in exchange for the performance of services. Additionally, as stated above, the argument that partnership gain recognition allows the partnership to achieve a step-up in the basis of the assets attributable to the service provider and prevents the threat of double taxation is unconvincing. The reverse §704(c) allocations, which apply §704(c) principles to the revaluations, will protect the service provider from double taxation. The strongest argument in favor of a partnership-level recognition event resides in the general principle that an employer must recognize gain on the transfer of appreciated property in satisfaction of an obligation.[69]

Cash In, Cash Out

The alternate school of thought with respect to the partnership-level tax effects related to the issuance of a partnership interest upon exercise of an option results in no partnership-level recognition event. This approach is commonly known as the "Cash In, Cash Out" theory. The proponents of this theory first deem the partnership as having paid to the service provider an amount of cash equal to the "spread" present in the option at the time of exercise — the difference between the value of the partnership interest received and the exercise price of the option. The service provider is then deemed to have contributed back to the partnership both the exercise price and the cash deemed transferred to her. Because the property used to discharge the partnership's compensation obligation is deemed to be cash (which has a basis equal to its fair market value), no gain or loss is recognized by the partnership upon the exercise of the option and issuance of the interest. The deemed contribution of cash by the service provider would permit the partnership to book-up the capital accounts under Regs. §1.704-1(b)(2)(iv)(f).

Applying the Cash In, Cash Out approach to the example above, upon the exercise of the option, Partnership AB would be treated as paying to the service provider an amount of cash equal to the option spread ($600) to Employee C. Employee C would recognize that amount as income under §61 and Partnership AB would be entitled to a compensation deduction of an identical amount. Employee C would then be treated as having contributed the $600 of deemed cash compensation received from the partnership, plus the $300 exercise price, back to the partnership in exchange for his one-third interest. The capital accounts are identical under either the Cash In, Cash Out theory or the "capital shift" theory because deemed contributions are devised in each case, thereby warranting a book-up under Regs. §1.704-1(b)(2)(iv)(f).

The Cash In, Cash Out approach may also be applied to the issuance of a capital interest as compensation for the performance of services without an option. Under these circumstances, the deemed cash compensation paid to the employee would be an amount equal to the value of the interest received. The service provider would then be deemed to pay the cash back to the partnership in exchange for the issuance of the partnership interest.

The Cash In, Cash Out approach is derived from a corporate analogue. In the corporate context, Regs. §1.1032-3(b)(1) provides that no gain or loss shall be recognized on the disposition of a parent corporation's stock by a subsidiary corporation. Instead, the transaction is treated as if immediately before the subsidiary corporation disposes of the stock of the parent corporation, the subsidiary corporation purchased the parent corporation's stock from the parent corporation for fair market value with cash contributed to the subsidiary corporation by the parent corporation. These particular regulations were adopted specifically to extend nonrecognition treatment under §1032 to a subsidiary corporation using a parent corporation's stock to satisfy the subsidiary corporation's contractual obligations. Regs. §1.1032-3 furthers the nonrecognition mandate contained in §1032 and the regulations thereunder in the context of a corporation using its stock to satisfy its obligations. There are no §721 regulations authorizing a partnership to use its ownership interests in such a fashion.

[69] Regs. §1.83-6(b).

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The Cash In, Cash Out approach is only as strong as the analogy of a corporation issuing its stock for services is to a partnership issuing its interests for services. From a tax policy standpoint, if a partnership should be granted the same protections from gain recognition when it issues ownership interests in itself that are provided to a corporation issuing its own stock, then perhaps regulations should be issued to reach a nonrecognition result. Section 721 bears a remarkable statutory resemblance to §1032. Both statutes provide for nonrecognition of gain when property is contributed in exchange for an ownership interest.

The policy behind Subchapter K, at least with respect to issuances of ownership interests, treats a partnership as an entity and authorizes tax deferral to the entity regardless of whether cash or appreciated property is contributed at any time in exchange for an interest in the partnership. If appreciated property is involved in a contribution, or already held by the partnership when a new partner joins, §704(c) specially applies to ensure that such inherent gain is eventually allocated among the appropriate parties. Gain deferral is explicitly sanctioned by the statutory scheme. In the case of property transfers to the entity, therefore, partnerships are treated the same as corporations.

Like §721, §1032 does not speak to the tax effects of the issuance of an ownership interest in exchange for services. The application of §1032 is statutorily limited to the issuance of stock in exchange for property. Thus, from a statutory construction standpoint, corporations and partnerships are viewed identically when issuing ownership interests. The regulations are necessary to provide a corporation with nonrecognition of gain related to the issuance of stock in exchange for services.[70] The Service views the issuance of ownership interests as unique and not capable of an easily definable recognition event. Because both §721 and §1032 are similar in their treatment of the issuing entity in the case of property contributions, there would seem to be no justification for treating the entities differently in the case of contributions of services. Thus, regulations should be promulgated under §721 to that effect.

At the present time, there is no such regulation and practitioners should look elsewhere to combat the application of Regs. §1.83-6(b), which seems to be the best evidence that gain recognition should occur at the partnership level. Regs. §1.83-6(b) provides a specific exception to recognition of gain in the case of a transfer of property in exchange for services for purposes of §1032.[71] This regulation does not provide an exception under §721. Advocates of the Cash In, Cash Out approach, however, would argue that the drafters of the §83 regulations would not have thought to exclude transfers of partnership interests from gain recognition at the time of the enactment of the regulation because the issue was not commonly occurring at the time; otherwise, an exception to gain recognition would have been provided. The §83 regulations were clearly designed to deal with compensation issues in a corporate context.

The Cash In, Cash Out analogy to a corporate stock issuance fiction is perhaps not even necessary for those practitioners attempting to avoid a partnership-level recognition event. Option exercises, in general (therefore, including noncompensatory options), typically involve a payment in exchange for the partnership interest received. Thus, §721 literally applies to provide nonrecognition to the partnership and to the partner. It would seem that the historic partners in the case of a noncompensatory option would not be required to report a deemed sale of assets based on the exercise of the noncompensatory option. When an option is exercised outside of the employment context, the historic partners have not engaged in an exchange or received any increase in wealth. If this analysis is sound to prevent the historic partners from recognizing gain in the case of a noncompensatory option, it would seem that nothing is gained by creating a deemed asset transfer in the case of the exercise of a compensatory option to acquire a partnership interest. There seems to be no justification for creating a deemed asset transfer in one case, but not the other. In neither case have the historic partners actually received any tangible return on their investment.

The mere introduction of a compensation element, however, is proposed to warrant the treatment of a partnership as an aggregate and result in the deemed transfer of assets by the partners. The corporate analogy remains strong, however, particularly if the Treasury Department would enact a partnership regulation similar to the corporate regulation. This analogy persists in spite of the presence of existing Regs. §1.721-1(b)(1), which merely articulates the tax effects to the recipient of an interest as compensation. The description of the tax consequences to the service provider does not compel a conclusion that the partnership should recognize gain, particularly in light of the policy behind Subchapter K and its provisions for deferral of gain recognition. The failure of the §721

[70] Regs. §1.1032-1(a) provides that a transfer by a corporation of shares of its own stock as compensation for services is considered, for purposes of §1032(a), as a disposition by the corporation of such shares for money or other property.

[71] "Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property." Regs. §1.83-6(b).

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regulations to describe the partnership's gain is persuasive evidence that no gain was intended to arise. If the partnership does not recognize gain, §704(c) will continue to cause the pre-existing appreciation to be taxed to the historic partners.[72]

When Chief Counsel examined the issuance of a capital interest in GCM 36346, the tax consequences arising as a result of the transfer were carefully described. Despite the presence of appreciated assets held by the partnership at the time of the issuance (which caused the interest to be more than a mere profits interest), Chief Counsel did not find that the partnership should recognize gain. Thus, there are numerous indicia that a partnership should be treated as an entity when issuing its interests as compensation for services and that nonrecognition should apply to the partnership when dealing in its own interests.

CONCLUSION

On the whole, the better arguments fall on the side of not taxing a partnership on the issuance of an interest in exchange for the performance of services. Given that the Service has never asserted that partnership-level gain arises on the issuance of a partnership interest in exchange for the performance of services, it would seem to follow that the Service should continue to maintain its implicit nontaxable position. The most simple solution would be for the Treasury Department to promulgate a regulation under §721 providing for nonrecognition of gain or loss, similar to the corporate regulation exempting the issuance of stock in exchange for services from gain recognition.

[72] Even if partnership gain recognition were to arise, gain is said to be recognized only to the extent of the service provider's interest. The partnership will have additional gain to be recognized which would be deferred. The service provider/partner will not be taxed on that gain when it is ultimately recognized because of the continuing application of §704(c). *See* Regs. §1.704-3(a)(6).

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