Bloomberg BNA

Tax Management
Compensation Planning Journal™

Equity Compensation Arrangements for Partnerships and Limited Liability Companies

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A critical element to the success of any organization is the ability to attract, retain and motivate highly talented employees and other service providers. In many instances, equity-based compensation is viewed as an essential element of a successful retention program. With the proliferation of limited liability companies (LLCs) as the preferred choice of entity in the emerging business sector, it is common for employers to attempt to mimic the compensation arrangements utilized by their corporate counterparts. The majority of LLCs formed today, however, are taxed as a partnership for purposes of federal tax law and therefore the tax law applicable to a compensatory transfer of a partnership interest will apply to the transfer of an interest in an LLC. While it is possible for partnerships and LLCs to offer compensatory arrangements similar to those utilized by corporations (e.g., restricted units, performance-based awards and/or stock options), there are a variety of tax issues unique to partnerships that must be recognized and addressed in advance in order to develop a successful retention program while avoiding unintended negative tax consequences.

TRANSFERS OF EQUITY OWNERSHIP INTERESTS

While partnerships are not a new form of entity, the tax consequences associated with the transfer of a partnership interest in connection with the performance of services is still developing. In fact, the tax consequences are, to a certain degree, somewhat more complex and may differ depending on the specific type of ownership interest transferred to the service provider. In the context of equity ownership in a partnership, the three most common forms of incentive awards include the transfer of: (i) a profits interest; (ii) a capital interest; and (iii) an option to acquire a capital interest in a partnership.

Transfer of a "Profits Interest"

A profits interest generally represents the right to share in the future earnings and/or future appreciation in the value of the partnership's assets. While a profits interest is economically similar to a stock option, it has significant advantages over a stock option that have made it the preferred choice of award in the partnership setting. For example, unlike an option holder, the recipient of a profits interest is not required to pay an exercise price to become an owner. Additionally, if properly structured, the recipient of a profits interest will not recognize income on the receipt or vesting of the profits interest. Lastly, and potentially the most

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ISSN 0747-8607

significant tax advantage, upon the disposition or redemption of the profits interest, all or a significant portion of the gain will potentially be taxed as a capital gain.[2]

Transfer of a Profits Interests Is Deemed a Non-Taxable Event. The proper tax treatment of a transfer of a profits interest, however, is not entirely settled and continues to be the subject of litigation. In an attempt to avoid future conflict and provide guidance in this area, the IRS issued Rev. Proc. 93-27, which provides that a transfer of a profits interest in a partnership for services generally will be deemed a *non-taxable event* for the partner and the partnership.[3] For Rev. Proc. 93-27 to apply, the recipient must receive the profits interest for the provision of services to or for the benefit of the partnership and in a partner capacity or in anticipation of becoming a partner. Rev. Proc. 93-27 specifically provides, however, that it does not apply if:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. The partner disposes of the profits interest within two years of receipt; or
3. The profits interest is a limited partnership interest in a ''publicly traded partnership'' within the meaning of §7704(b).

Transfers of Profits Interests Subject to Vesting Schedule. While Rev. Proc. 93-27 was received favorably, tax practitioners were quick to point out that the guidance was far from complete and left many questions unanswered. For example, Rev. Proc. 93-27 indicates that a compliant profits interest award will not give rise to a taxable event for the recipient.[4] In practice, however, employers would commonly make an award of a profits interest subject to a vesting schedule (e.g., vesting conditioned upon continued service for three years) and the guidance contained in Rev. Proc. 93-27 did not specifically address whether it was permissible to delay treating the service provider as a partner until the award vested. In response to this uncertainty, most tax practitioners recommended that the service provider make a §83(b) election at the date of grant.[5] Absent a §83(b) election, appreciation in the underlying assets of the partnership subsequent to the date of grant and through the date of vesting could cause the transfer on vesting to be regarded as a transfer of a capital interest and therefore subject to taxation upon vesting.[6]

To address these concerns, the IRS subsequently issued Rev. Proc. 2001-43[7] to clarify various uncertainties under Rev. Proc. 93-27. Under Rev. Proc. 2001-43, the IRS indicated that the determination of whether an interest granted to a service provider is a profits interest may be tested at the time the interest is granted, even if the interest is not vested at the time or subject to another form of risk of forfeiture. Accordingly, where a partnership grants a profits interest to a service provider under circumstances satisfying the conditions of Rev. Proc. 93-27 and Rev. Proc. 2001-43, the IRS will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event for the partner or the partnership.

More specifically, Rev. Proc. 2001-43 provides that, for purposes of Rev. Proc. 93-27, where a partnership grants a profits interest that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date grant, provided that:

1. The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;
2. Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and
3. All other conditions of Rev. Proc. 93-27 are satisfied.

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[2] The gain on the sale of a partnership interest does not necessarily result in capital gain in all instances. For example, under §751, ordinary income could arise depending on the existence of certain hot assets (e.g., accounts receivables). Similarly, under §736, certain payments may be recharacterized as guaranteed payments in certain service-based partnerships where capital is not a significant income-producing factor. All ''§'' references herein are to the Internal Revenue Code of 1986, as amended, and all Reg. references are to the regulations thereunder, unless otherwise stated.

[3] Rev. Proc. 93-27, 1993-2 C.B. 343. Specifically, Rev. Proc. 93-27 provides, in part: ''. . . [I]f a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.''

[4] Correspondingly, the partnership will not be entitled to a tax deduction.

[5] See discussion of §83(b) below under the heading ''*Transfer of a Capital Interest*.''

[6] To date, there is no definitive authority that holds that a profits interest constitutes ''property'' for purposes of §83. In this regard, some practitioners have advised that the service provider should make a modest capital contribution in exchange for the profits interest (e.g., $1,000) in order to make it more likely that the profits interest constitute ''property.'' The IRS's proposed regulations, if finalized, would provide clearer guidance on this issue (see discussion below under the heading ''*IRS's Proposed Regulations Governing Compensatory Transfers of Partnership Interests*'').

[7] Rev. Proc. 2001-43, 2001-2 C.B. 191.

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Interestingly, the IRS also indicated in Rev. Proc. 2001-43 that the taxpayers to which it applies need not file an election under §83(b). While this position is favorable, it continues to be advisable to file a protective §83(b) election to protect against the possibility that the taxpayer has not otherwise satisfied *all* of the conditions necessary to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43 (e.g., if the service provider unexpectedly disposes of the interest within two years of receipt).

To or For the Benefit of the Partnership. As noted above, one of the criteria that must be satisfied for Rev. Proc. 93-27 to apply is the requirement that the recipient receive the profits interest for the provision of services *to or for the benefit of the partnership*. Neither Rev. Proc. 93-27 nor Rev. Proc. 2001-43, however, specifically addresses awards to employees who provide services to affiliates of the partnership under which the awards are granted.

In PLR 200329001, the IRS addressed the tax consequence of the issuance of unvested partnership interests involving a real estate investment trust (REIT). Under the facts of the ruling, the sole general partner (a REIT) of an operating limited partnership adopted a plan under which the right to acquire a profits interest in the limited partnership would be granted to participating executives of the REIT, the limited partnership and the limited partnership's affiliates. Based on the facts of the ruling, it was clearly evident that the profits interests were to be provided to certain executives who provided services to the general partner as well as affiliates of the limited partnership.[8] While the IRS did not squarely address this issue, the ruling supports the position that services to related entities can satisfy the "*to or for the benefit of*" requirement of Rev. Proc. 93-27.[9]

In a Partner Capacity or in Anticipation of Becoming a Partner. A second key criterion of Rev. Proc. 93-27 is the requirement that the recipient receive the profits interest for the provision of services *in a partner capacity or in anticipation of becoming a partner*. This determination will be based on an examination of the facts and circumstances, and the mere fact that a person holds a right to share in the future profits of a venture does not necessarily mean that such person is a partner. In this regard, the safe-harbor provided by Rev. Proc. 93-27 may not apply if the facts indicate that the recipient has received the profits interest merely as additional compensation in his or her capacity as an employee. While no one factor is necessarily controlling, the express intent of the parties, their subsequent actions[10] and the length of time the employee holds the ownership interest will be key factors in determining whether the safe-harbor applies.[11]

In PLR 9533008, an employee received an interest in a portion of the corporate partner's profits in two partnerships. The employee exercised no control over, and assumed no responsibilities for, the partnerships, had no interest in the capital of the partnerships and had no obligation to share in the losses. In addition, in a written settlement agreement resolving a dispute between the parties, the employee specifically acknowledged that he was not a partner in the underlying partnerships. In light of these facts and the lack of intent to form a partnership, the IRS ruled that Rev. Proc. 93-27 did not apply and that the contingent right to share in profits was merely an unfunded, unsecured promise to pay money in the future. Additionally, as to the tax treatment upon the subsequent sale of the interest, the IRS concluded that the employee recognized ordinary income and not capital gain because the employee received the interest in his capacity as an employee and not as a partner, or in anticipation of becoming a partner.

Book-up of Capital Accounts. It is common practice to book-up the partnership's assets and partners' capital accounts in connection with the grant of a profits interest.[12] The book-up is intended to establish the relative economic positions of the partners with respect to the current fair market value of the business, rather than the historic value of the business.[13] For example, with respect to the grant of a profits interest, the service provider is only entitled to share in future profits and future appreciation and therefore will have a capital account balance of zero. The pre-existing partners' capital accounts, however, will be adjusted to reflect the prior income and appreciation in the

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[8] In PLR 200329001, the limited partnership interests were subject to a vesting schedule and, in addition, the executives were required to make an initial capital contribution at the time of grant. While the ruling confirmed that Rev. Proc. 93-27 and Rev. Proc. 2001-43 applied to the transaction, it left many key issues unanswered.

[9] The IRS's proposed regulations (discussed below under the heading "*IRS's Proposed Regulations Governing Compensatory Transfers of Partnership Interests*"), as currently drafted, are limited to transfers by a partnership of an interest in that partnership for services rendered to the partnership. The IRS has requested comments on the income tax consequences involving transfers where the services are provided to a related entity.

[10] For example, Rev. Proc. 2001-43 requires that the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of grant and that the service provider take into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest.

[11] *See, also*, Rev. Rul. 75-43, 1975-1 C.B. 383, and GCM 36346 (July 25, 1977) for a list of the various factors that the IRS will consider to determine partner status.

[12] *See* Reg. §1.704-1(b)(2)(iv)(f). The authority for a book-up in connection with the issuance of a partnership interest in exchange for the services is found in Reg. §1.704-1(b)(2)(iv)(f)(5)(iii).

[13] This is also true in connection with the grant of a capital interest. In this instance, a book-up will enable the service provider to understand the value of his economic grant from the other partners and, just as importantly, the historic partners will be able to recognize the existing value that they have transferred to their new partner.

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value of the business through the date of grant. Accordingly, a book-up is important in order to protect the pre-existing partners from inadvertently transferring existing appreciation in the partnership's assets to the recipient of the profits interest. Of equal importance, a book-up will help to ensure that the grant of the profits interest is a non-taxable event and otherwise demonstrate that the award satisfies the safe-harbor conditions of Rev. Proc. 93-27.

Transfer of a "Capital Interest"

A capital interest typically entitles the partner to an immediate interest in a portion of the underlying assets of the partnership and the right to share in the earnings, profits and losses of the partnership and appreciation in the value of the partnership's assets. The tax consequences of the grant of a capital interest are essentially the same as any transfer of property for services as provided under §83, and can be summarized as follows:

Shifting of Capital Accounts From Existing Partners. The transfer of a capital interest in connection with the performance of services generally involves a "shifting" of the capital accounts among the partners. The tax consequences of the transfer of a vested capital interest are generally determined under §83, as follows:[14]

1. The employee or independent contractor will recognize income upon the grant of the capital interest equal to the excess of the fair market value of the partnership interest received over the price paid, if any;

2. The partnership will be entitled to a deduction upon the grant equal to the amount of compensation recognized by the employee or independent contractor;[15] and

3. The partnership *may* recognize gain equal to the excess of the fair market value of the partnership interest transferred over the partnership's basis in the underlying assets.

Recognition of Gain by Partnership. Both §721 and §1032 provide that partnerships and corporations do not generally recognize gain or loss upon the issuance of an equity interest for property (including cash), but neither Section specifically addresses the consequences of issuing an equity interest for services. The regulations under §1032, however, do provide that a corporation will not recognize gain on the transfer of its stock in connection with the performance of services.[16] Unfortunately, there is no similar regulation under §721 that precludes a partnership from recognizing gain on the transfer of a partnership interest in connection with the performance of services. To date, the IRS has not furnished any binding guidance on this issue.[17]

Grant of a Restricted Capital Interest. In a compensatory situation, it is common for the partnership to make the grant of a capital interest subject to a vesting schedule (similar to restricted stock). Under this alternative, the tax consequences would be substantially similar to the consequences outlined above, except that income recognition will occur upon *vesting* (or the making of a §83(b) election by the employee), rather than upon issuance.

Allocation of Income With Respect to a Restricted Capital Interest. In a matter of first impression, the United States Tax Court recently addressed whether the transferee of a nonvested partnership interest must include in gross income the undistributed profit or loss allocations attributable to a restricted partnership capital interest. Under the facts of *Crescent Holdings, LLC v. Commissioner*,[18] an executive received a 2% restricted membership interest in an LLC taxed as a partnership. Notwithstanding the fact that the executive's membership interest was not vested and the executive had not made a §83(b) election, the executive received a Schedule K-1 allocating income to him during tax years the unvested interest remained outstanding (and received distributions to cover the associated tax liability). Analyzing the award as a transfer of property under §83, the Tax Court concluded that the transferor of the interest (i.e., the LLC) should be treated as the owner of the unvested interest and that the profits and losses associated with the 2% interest should be allocated on a pro rata basis to the existing partners.[19]

It is worth noting that the executive resigned prior to the vesting of any portion of his 2% membership interest. If the executive had vested in his award incrementally, it would have been proper to allocate profit and loss to the executive to the extent the award was vested. Similarly, if the executive made a §83(b) election, it would have been proper to fully allocate the applicable share of profit and loss to the executive regardless of the fact that the award remained subject to a substantial risk of forfeiture.

Inherent Risk in Making a §83(b) Election. Under §83(b) and Reg. §1.83-2(a), the recipient of restricted

[14] Recent case law has consistently found that §83 applies to the transfer of a partnership capital interest. *See, e.g., Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15, 2013 BL 333809 (Dec. 2, 2013).

[15] Where the transfer occurs in connection with the performance of services, Reg. §1.83-6(a)(1) provides that a deduction is allowed *to the person for whom the services were performed.*

[16] The regulations under §1032 expressly provide for nonrecognition by characterizing the transaction as (i) a deemed issuance of the stock for cash under §1032, followed by (ii) delivery of the cash to the service provider. Reg. §1.1032-(1)(a).

[17] The IRS's proposed regulations (discussed below under the heading "*IRS's Proposed Regulations Governing Compensatory Transfers of Partnership Interests*"), as currently drafted, provide that no gain should be recognized.

[18] 141 T.C. No. 15, 2013 BL 333809 (Dec. 2, 2013).

[19] Reg. §1.83-1(a)(1) provides that until property becomes substantially vested, the transferor of the property shall be regarded as the owner of the property.

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property (e.g., a restricted partnership interest) received in connection with the performance of services may elect to currently include in gross income the excess of the fair market value of the property transferred over the amount paid for such property. If this election is timely made, the excess of the fair market value of the property received over the amount paid for such property is included in gross income at the time of transfer even though such property remains substantially non-vested and subject to forfeiture. No compensation, however, will generally be includible in gross income when such property subsequently becomes substantially vested. A §83(b) election is made by filing a written statement with the IRS, and must be filed not later than 30 days after the date on which such property has been transferred.

Rev. Proc. 2012-29[20] contains guidance concerning the tax consequences of making a §83(b) election, including the tax consequences if the taxpayer forfeits the restricted property on which the §83(b) election was made. The examples contained in Rev. Proc. 2012-29 confirm the inherent risk in making a §83(b) election, including:

- If the property is forfeited, the taxpayer is *not* entitled to a deduction or credit for the income taxes paid as a result of making the §83(b) election; and
- The only instance in which a taxpayer may have a capital loss to report is when the taxpayer actually made a payment for the property. Under these circumstances, the taxpayer can recognize a loss to the extent the amount received upon forfeiture is less than the amount paid for the property. For this purpose, income recognized upon the filing of the §83(b) election is *not* added to the taxpayer's basis for purposes of calculating the loss.

Transfer of an Option to Acquire a Capital Interest

As an alternative to granting an outright capital interest, a partnership may also grant an employee or independent contractor the right (e.g., option) to acquire an interest in the underlying assets of the partnership (i.e., a capital interest). In light of the ability of partnerships to issue profits interests, and the favorable tax treatment afforded a profits interest, it is less common for partnerships to issue options in a compensatory context. Nevertheless, a brief discussion is warranted in light of the fact that options remain a viable tool in a partnership's compensatory arsenal.

Upon exercising the option, the employee will receive an immediate interest in a portion of the underlying assets of the partnership. Under this scenario, the tax consequences of the option will generally be determined under §83 when the option is exercised. Under §83, the grant and exercise of the option will have the following tax consequences:

1. The employee will not recognize income upon the grant of the option because the option ordinarily does not have a readily ascertainable fair market value. Upon exercise, however, the employee will recognize ordinary income in an amount equal to the excess of the fair market value of the partnership interest received over the exercise price;
2. The partnership will not be entitled to a deduction upon the grant of the option. Upon exercise, however, the partnership will receive a corresponding compensation deduction equal to the amount of compensation recognized by the employee; and
3. The partnership *may* recognize gain equal to the excess of the fair market value of the partnership interest transferred over the partnership's basis in the underlying assets (see discussion above).

It is important to note that option grants must now be structured to address the requirements of §409A. Compliance with §409A or an exception thereto is essential to avoid unintended negative tax consequences to the recipient of the option.[21]

IRS's Proposed Regulations Governing Compensatory Transfers of Partnership Interests

In an attempt to clarify the tax uncertainty in this area, the Treasury Department and IRS issued proposed regulations in 2005 governing the tax treatment of the transfer of a partnership interest for services.[22] In addition, the IRS issued Notice 2005-43 which includes a draft Revenue Procedure describing additional rules relating to an elective safe harbor by which a partnership may value a compensatory transfer of a partnership interest.[23] The regulations and Notice will apply to transfers of property on or after the date the final regulations are published.

Application of §83. The proposed regulations clarify a long debated issue by specifically providing that the transfer of a partnership interest in connection with the performance of services is subject to §83, and provide rules for coordinating §83 with partnership tax principles. While courts have consistently held that a partnership capital interest is property subject to §83, the IRS had not previously acquiesced to such treatment (particularly with respect to a profits

[20] 2012-28 I.R.B. 49 (containing sample language that may be used for purposes of making a §83(b) election).

[21] See discussion below under the heading "*Section 409A — Nonqualified Deferred Compensation*."

[22] REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005), subsequently modified by REG-164370-05, 73 Fed. Reg. 64903 (Oct. 31, 2008).

[23] Notice 2005-43, 2005-24 I.R.B. 1221.

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interest).[24] The proposed regulations, however, expressly provide that a partnership interest is property within the meaning of §83, and that the transfer of a partnership interest in connection with the performance of services is subject to §83. The proposed regulations also make clear that §83 applies to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests.

Recognition of Gain by Partnership. The proposed regulations also provide that *no gain or loss* is recognized by a partnership on the transfer or vesting of the partnership interest in connection with the performance of services for the transferring partnership. As noted previously, the resolution of this issue remains uncertain under existing guidance.

Section 83(b) Election. Consistent with the principles of §83, the proposed regulations also provide that if a partnership interest is transferred in connection with the performance of services, and if an election under §83(b) is not made, then the holder of the partnership interest is *not* treated as a partner until the interest becomes substantially vested. Correspondingly, if a §83(b) election is made with respect to such interest, the service provider will be treated as a partner from the date of grant. This approach is in direct conflict with the tax treatment afforded a profits interest under Rev. Proc. 2001-43. Under Rev. Proc. 2001-43, the recipient of an unvested partnership profits interest can be treated as a partner, even if no §83(b) election is made, provided that certain conditions are met.

Valuation of Partnership Interests. In conjunction with the proposed regulations, the IRS also issued Notice 2005-43. This Notice, in conjunction with the proposed regulations, provides substantial guidance regarding the valuation of partnership interests transferred in connection with the performance of services. Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property, disregarding lapse restrictions. However, some authorities have concluded that a profits interest only has a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest.[25]

In order to address the uncertainty in this area and ensure consistency in the treatment of partnership profits interests and capital interests, the Treasury Department and the IRS have determined that it is appropriate to allow partnerships and service providers to value partnership interests based on liquidation value. Accordingly, the proposed regulations contain an elective procedure (safe harbor) by which a partnership can treat the fair market value of a partnership interest as being equal to the liquidation value of such interest, determined without regard to any lapse restriction.[26] The proposed Revenue Procedure contained in Notice 2005-43 provides additional rules that must be followed when electing to follow the safe harbor. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated.

Effect on Prior Guidance. If and when the proposed regulations are finalized, Rev. Proc. 93-27 and Rev. Proc. 2001-43 will become obsolete. Until such time, however, taxpayers may continue to rely on this guidance.

Section 409A — Nonqualified Deferred Compensation

The final regulations under §409A do not specifically address the transfer of an interest in a partnership.[27] Until future guidance is issued, however, taxpayers may continue to rely on the interim guidance provided under Notice 2005-1, Q&A-7[28] and the preamble to the proposed regulations.[29] In this regard, the Notice makes clear that §409A is not limited solely to arrangements between an employer and employee, and may apply to arrangements between a partner and a partnership that provide for the deferral of compensation. Fortunately, the Notice provides that taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest granted in connection with the performance of services under the same principles that govern the issuance of stock.[30] Accordingly,

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[24] *See, e.g., Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15, 2013 BL 333809 (Dec. 2, 2013).

[25] *See, e.g., Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *aff'g & rev'g* T.C. Memo 1990-162.

[26] *See* Prop. Reg. §1.83-3(l).

[27] Section 409A governs the taxation of nonqualified deferred compensation arrangements. A failure to satisfy the requirements of §409A can result in significant negative consequences to the service provider, including the acceleration of income recognition, a substantial interest charge and an additional 20% tax in the year in which such compensation is no longer subject to a *substantial risk of forfeiture*.

[28] Notice 2005-1, 2005-2 I.R.B. 274.

[29] In the preamble to the final regulations, the Treasury and the IRS indicate that they are still analyzing this area and that the final regulations do not provide any additional guidance.

[30] Notice 2005-1, Q&A-7. The Notice also provides that payments that qualify as retirement payments to a partner under §1402(a)(10) will be subject to §409A. Section 1402(a)(10) provides an exception from the self-employment tax (SECA) for retirement payments to a retired partner, provided that certain conditions are satisfied (e.g., lifetime payments). In addition, the Notice provides that §409A may apply to payments covered by §707(a)(1) (payments to a partner not acting in capacity as partner) if such payments would otherwise constitute a deferral of compensation. Similarly, guaranteed payments under §707(c) and

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properly structured equity awards in a partnership should be exempt from §409A.[31]

Disguised Compensation. The IRS's National Office of Chief Counsel recently issued guidance that provides additional insight into the tax analysis that reviewing agents should consider in connection with the issuance of a partnership profits interest for services.[32] While CCA 201348012 provides little to no factual background concerning the award of the profits interest in question, it is interesting in that it provides insight into the manner in which the IRS may analyze the award of a profits interest that falls outside the safe harbor of Rev. Proc. 93-27, as clarified by Rev. Proc. 2001-43. For example, the IRS indicated that further analysis would be required if the facts indicate that: (i) the profits interest was exchanged or disposed of within two years of issuance; (ii) the profits interest was not received in a partner capacity, but rather in an employee capacity; or (iii) the partnership interest was in return for a predictable stream of income.

If the safe harbor of Rev. Proc. 93-27 does not apply, the Office of Chief Counsel indicated that the next step in the analysis would be to determine whether the interest is a bona fide partnership interest. If the interest is a bona fide partnership interest, then §83 would apply to the transfer and the reviewing agent should look at whether the employee paid fair market value.[33] If, however, the award was *not* a bona fide partnership interest, the Office of Chief Counsel indicated that the reviewing agent should look at whether there are §409A concerns (e.g., the interest is a disguised award of non-qualified deferred compensation).[34]

In light of this guidance, it seems clear that a partnership profits interest issued outside of the parameters of the safe harbor set forth in Rev. Proc. 93-27 will be subject to additional scrutiny by the IRS. To the extent the award is found to be disguised deferred compensation and not a bona fide partnership interest, the recipient could be subject to additional income tax and penalties under §409A, as it is unlikely that the award would be properly designed to comply with the requirements of §409A (e.g., distributions could be made sporadically and not in accordance with §409A's requirement that a distribution be paid on a permissible payment date). Additionally, a protective §83(b) election would not protect the taxpayer if the facts and circumstances indicate that there was not a bona fide transfer of property.

PARTNER vs. EMPLOYEE

Can and Individual Have a Dual Status as Both an Employee and a Partner? The tax consequences associated with partner status may come as an unwelcome surprise for individuals who have historically been classified as employees and who are otherwise unfamiliar with the tax framework governing partners. Wages paid to an employee are subject to income tax withholding and the employee is only responsible for one-half of the FICA tax remitted on the employee's behalf (e.g., 7.65% instead of 15.3%, assuming payments below the taxable wage base). Salary-type payments made to a partner, on the other hand, are not subject to withholding, the partner must make estimated tax payments and the partner bears the entire burden of paying self-employment tax.[35] For these reasons and others, many partnerships continue to treat employees who receive an equity partnership interest as an employee with respect to the individual's wages and participation in the partnership's employee benefit plans. This treatment, however, begs the question of whether an individual can have a dual status as both an employee and a partner, particularly with respect to situations where the individual's interest in the partnership is quite small and the individual has limited or no management responsibility.

The IRS has long taken the position that bona fide partners are not "employees" for purposes of the federal employment tax.[36] Instead, such persons are considered to be self-employed and any salary-type payments made to the service-provider partner will be

the right to received guaranteed payments will be subject to §409A only where the guaranteed payments are provided for services and the amounts are not timely included in the partner's income within the short-term deferral exception.

[31] The burden of compliance with §409A provides an additional reason why options may not be the most desirable form of incentive award for a partnership. The final regulations under §409A set forth a number of requirements that must be satisfied in order for options to be exempt from §409A. For example, the option must relate to *service recipient stock*, the exercise price must be equal to the *fair market value* of the underlying service recipient stock on the date of grant (i.e., no discounted stock options), and the option must not include any feature that allows for the deferral of compensation. In establishing the fair market value, the use of a reasonable valuation method is required and, to ensure compliance, many privately held organizations have elected to retain a qualified independent appraiser to perform annual valuations.

[32] CCA 201348012.

[33] Some authorities have concluded that a profits interest only has a speculative value and should not be taxed at the time of grant. *See, e.g., Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *aff'g & rev'g* T.C. Memo 1990-162.

[34] *See, e.g.,* PLR 9533008 (discussed above under the heading "*Transfer of a Profits Interest*").

[35] The consequences of being classified as a partner versus an employee can also affect the tax treatment under employee benefits plans. For example, premiums paid by a partnership for accident and health insurance, including health savings accounts, represent guaranteed payments if the premiums are paid for services rendered as a partner. The premiums are deductible by the partnership and included in the partner's gross income. A partner, however, may deduct the cost of the premiums on his or her return "above the line" if the §162(l) health insurance deduction requirements are met. Additionally, favorable tax treatment may be lost for other benefits including group term life insurance, cafeteria plan participation and qualified transportation benefits.

[36] *See* Rev. Rul. 69-184, 1969-1 C.B. 256. A thorough discussion of the IRS's reasoning behind Rev. Rul. 69-184 can be found in GCM 34001 (Dec. 23, 1968).

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considered guaranteed payments.[37] The IRS's position set forth in Rev. Rul. 69-184, however, is not necessarily wholly supported by existing statutory authority.

Perhaps contrary to the IRS's position in Rev. Rul. 69-184, §707(a) provides that if a partner engages in a transaction with a partnership other than in the capacity of a member of such partnership, the transaction shall be considered as occurring between the partnership and one who is not a partner (for all purposes). To date, very few cases have addressed the issue of whether an individual can maintain a dual status as both an employee and a partner. In *Armstrong v. Phinney*,[38] the United States Court of Appeals for the Fifth Circuit held that it was possible for a partner to be an employee for purposes of §119 (Meals or Lodging Furnished for the Convenience of the Employer). In addressing the relationship of a partner to a partnership with respect to §707(a), the court noted that ". . . it is now possible for a partner to stand in any one of a number of relationships with his partnership, including those of creditor-debtor, vendor-vendee, and employee-employer."[39]

Subsequently, in *Pratt v. Commissioner*,[40] the same court held that management fees payable to the general partners based on a percentage of gross rentals were not payments described in §707(a) of the Code. Many commentators argue that this decision undermines the court's broad statements in *Armstrong*, as the court found that §707(a) did not apply when directly faced with a situation involving payments to a partner for services rendered to the partnership. This decision, however, is not surprising, as the individuals in question were general partners of the partnership who were providing management services to the partnership in accordance with terms of the partnership agreement. Additionally, the management fees in *Pratt* were never paid (or reported as taxable income) by the general partners. Rather, the management fees were accrued by the partnerships which maintained their books on an accrual basis (while the general partners were cash-basis taxpayers). Accordingly, as the court specifically noted, the general partners were able claim losses which, in an economic sense, did not truly exist.

The *Pratt* decision decided on appeal was limited to the application of §707(a) and the court did not consider the application of §707(c), although the lower court held that such payments were not guaranteed payments. In response to *Pratt*, the IRS issued Rev. Rul. 81-300,[41] on facts substantially similar to *Pratt*, and ruled that a management fee of five percent of gross rentals was a guaranteed payment under §707(c). One significant distinction between the facts of *Pratt* and Rev. Rul. 81-300, however, is the fact that the management fees were actually paid under the facts of the latter.

It is also worth observing that the foregoing authority was issued prior to the revisions to §707(a) made by the Deficit Reduction Act of 1984 (the "Act").[42] The 1984 Committee Report to §707 sets out various factors that should be considered in determining whether allocations and distributions should be treated under §707(a) as payments to a service partner not acting in his or her capacity as a partner.[43] In this regard, the Committee Report states that the most important factor is entrepreneurial risk, and elaborates on this factor by providing that:

> *An allocation and distribution provided for a service partner under the partnership agreement which subjects the partner to significant entrepreneurial risk as to both the amount and the fact of payment generally should be recognized as a distributive share and a partnership distribution, while an allocation and distribution provided for a service partner under the partnership agreement which involves limited risk as to amount and payment should generally be treated as a fee under sec. 707(a).*[44]

Interestingly, the legislative history to the Act also 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.

Based on a reading of the existing guidance, 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. 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 ren-

[37] Under §707(c), guaranteed payments are payments made to a partner for services regardless of the income of the partnership. To this end, Reg. §1.707-1(c) specifically provides that a partner who receives guaranteed payments is not regarded as an employee of the partnership for purposes of withholding of tax at source, deferred compensation plans, etc.

[38] *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968). In GCM 34001 and GCM34173 (July 25, 1969), the IRS directly questioned the reasoning behind the decision in *Phinney*. Shortly thereafter, the IRS issued Rev. Rul. 69-184.

[39] *Armstrong*, at 663–664.

[40] 64 T.C. 203, *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977).

[41] 1981-2 C.B. 143.

[42] P.L. 98-369. The changes made by Act were made, in part, in response to concerns that partnerships have been used to effectively circumvent the requirement to capitalize certain expenses by making allocations of income and corresponding distributions in place of direct payments for property or services.

[43] The Act also authorized the Treasury Department to promulgate regulations as necessary to carry out the revisions to §707(a). No such regulations have been issued to date.

[44] *See* S. Rep. No. 98-369, at 230 (1984). The IRS, however, continues to cite Rev. Rul. 81-300 with approval (e.g., PLR 8642003).

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dered in a non-partner capacity.[45] Additionally, in situations where the established rate of compensation is contingent solely on job performance and the partner is not subject to entrepreneurial risk, any such payment could arguably be treated as made to an employee if, under all the facts and circumstances (e.g., lack of management authority, subject to termination at will, holds insignificant minority interest, etc.), the transaction is more properly characterized under §707(a) as a payment to a partner acting in a non-partner capacity.

While the IRS's current stated position is to the contrary, it is also fair to observe that the current IRS guidance clearly does not contemplate many of the factual situations resulting from the proliferation of the use of LLCs. In many instances, an employee who receives a compensatory award of a partnership interest will hold a minority interest in the LLC, have no liability for the debts of the LLC, have no significant management responsibilities, and otherwise perform duties subject to the direction, supervision and control of management, particularly in situations where the LLC is manager-managed. Even in situations where the LLC is member-managed, the employee's ownership interest may be so insignificant that the employee will not have the ability to influence management decisions or, alternatively, could be terminated at will regardless of any right to retain the ownership interest. Moreover, in many instances, the value of the partnership interest held by the employee will be insignificant relative to the annual compensation paid to the employee. Under these circumstances, treating the individual as an employee with respect to ordinary salary-type payments does not appear abusive in any manner and, arguably, permissible under §707(a).

It is also worth noting that the IRS's position set forth in Rev. Rul. 69-184 is not uniformly enforced by the IRS. In *Riether v. United States*,[46] the IRS asserted that the taxpayers (husband and wife) owed self-employment tax on their share of distributable income from New Mexico Medical Diagnostic Imaging, LLC (MDI). MDI was jointly owned by the taxpayers and taxed as a partnership for federal tax purposes. In 2006, the taxpayers reported $51,500 in W-2 wages and the remaining $76,986 of distributive income of MDI was reported on a Schedule K-1. MDI withheld federal income and FICA taxes from the W-2 wages *and the IRS did not question the taxpayers' treatment of these wages*.[47] With respect to the Schedule K-1 income, however, the taxpayers did not pay self-employment tax on these monies and the IRS asserted that the taxpayers owed an additional $10,878 in self-employment taxes. In concluding that the taxpayers owed self-employment tax on their share of distributive income from MDI, the court noted that the taxpayers "should have treated *all* the [MDI's] income as self-employment income, rather than characterizing some of it as wages."[48] The court also concluded that the taxpayers were not limited partners within the meaning of §1402(a)(13) and therefore owed self-employment tax on all of their income from MDI.[49]

Commentators have asserted that the court's statement in *Riether* that the taxpayers should have treated *all* the payments received from MDI's as self-employment income is further support for the IRS's position set forth in Rev. Rul. 69-184. This decision, like the decision in *Pratt*, is not surprising as the taxpayers in question managed the partnership and provided services directly in furtherance of the partnership's business in accordance with terms of the partnership agreement. Moreover, §707(a) was never addressed by the court in *Riether*.

Potential Solutions to Mitigate IRS Position. In light of the uncertainty in this area, practitioners have developed a number of alternative arrangements in an attempt to maintain the status quo. These arrangements are essentially premised on the conclusion that if the employees do not have a direct ownership interest in the entity for which they work, they should continue to be properly classified as employees. These alternatives include, for example:[50]

- A service partner could contribute their ownership interest, or have the ownership interest issued directly, to a separate S corporation or LLC and have the S corporation or LLC act as the partner. Under this approach, it may be possible to have the service provider treated as an employee of the partnership and the S corporation or LLC treated as the partner.
- The formation of a tiered structure. Under this approach, a new partnership (or LLC) is formed and the ownership interests in the operating partnership are issued to the upper-tier partnership. The partnership interests in the upper-tier partnership could then be issued to employees of the operating partnership.

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[45] *See* Rev. Rul. 81-301, 1981-2 C.B. 144 wherein the IRS held that the investment advisory services rendered by a partner were rendered in non-partner capacity where (i) the partner provided similar services to others as part of its regular trade or business, (ii) the partner's services were subject to supervision by the remaining partners, (iii) the partner could be relieved of his duties and rights to compensation upon 60 days' notice, and (iv) the partner was not personally liable to the other partners for any losses incurred in providing the investment services.

[46] 919 F. Supp. 2d 1140 (D.N.M. 2012).

[47] The court noted that the IRS did not question the taxpayers' treatment of a portion of their income as wages, presumably because the taxpayers had paid employment tax on that income through FICA tax withholding.

[48] Citing Rev. Rul. 69-184.

[49] Citing *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011) (partners who perform legal services in their capacity as partner of law firm are subject to self-employment tax and are not limited partners within the meaning of §1402(a)(13)).

[50] It should be noted, however, that the IRS does have some partnership anti-abuse authority wherein the IRS could attempt to recast transactions in an attempt to overcome tax planning designed to insure "employee" status.

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- Finally, another method that arguably may be used to overcome this problem would be to create a separate service corporation (taxed as an S corporation) which would directly employ the service providers. The service corporation would then lease the services of its employees to the partnership. This structure would enable the service providers to hold direct interests in the operating entity while being treated as S corporation employees of the service corporation for employment tax purposes.

For many emerging businesses, however, these structures may be overly complicated and pose an undue burden on limited resources. Unfortunately, unless and until the IRS provides additional guidance in this area, significant uncertainty will continue to exist.

SELF-EMPLOYMENT TAX

Are Salary-Type Payments Subject to Self-Employment Tax? Section 1402(a)(13) provides that in computing ''net earnings from self-employment,'' there shall be excluded the distributive share of any item of income or loss of a *limited partner*, other than ''guaranteed payments'' described in §707(c).[51] Guaranteed payments are payments made to a partner for services rendered and without regard to the partnership's income.[52] Consequently, guaranteed payments represent net earnings from self-employment.

Are Partners' Allocations of Income Subject to Self-Employment Tax? In general, §1402(a) defines ''net earnings from self-employment'' to include an individual's distributive share of income or loss from any trade or business carried on by a partnership of which he or she is a partner. Widely criticized 1997 proposed regulations generally subject most partners to tax on their net earnings from self-employment due to the narrow definition of ''limited partners.''[53] Generally, an individual is *not* treated as a ''limited partner'' under the proposed regulations if he or she: (i) is personally liable for debts or claims against the partnership; (ii) has authority to contract on behalf of the partnership; or (iii) participates in the partnership's trade or business for more than 500 hours during the year. Accordingly, most full-time service providers owning an interest in a partnership would not qualify as ''limited partners'' because they would, among other factors, generally spend more than 500 hours working for the partnership.

Certain individuals may be considered limited partners, however, if they satisfy one of two exceptions provided by the proposed regulations. The first exception is for certain individuals holding more than one class of interest, and the second is generally for holders of only one class of interest who do not meet the qualification of ''limited partner'' status solely by reason of participating in the partnership's trade or business for more than 500 hours during the year. Unfortunately, like many of the issues discussed in this article, this latter exception can get quite complicated in light of the conditions described in Prop. Reg. §1.1402(a)-2(h)(4) and, as a practical matter, presents another unwelcome issue for individuals who have always historically been classified as an employee.

CONCLUSION

This article has provided a summary of some of the recent tax law developments impacting equity incentive compensation arrangements for partnerships and LLCs. While it is possible for partnerships and LLCs to offer arrangements similar to those utilized by corporations, there remains a great deal of uncertainty with respect to the tax issues unique to partnerships. As a result, employers and practitioners will need to continue to closely monitor this area of the law.

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[51] The term ''limited partner'' is not defined by statute or current regulations.

[52] *See* §707(c).

[53] *See* Prop. Reg. §1.1402(a)-2(h).

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