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Partnership Equity Compensation – Crescent Holdings and Related Issues

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As more and more businesses are operated through entities taxed as partnerships, tax issues relating to partnership equity interests take on greater importance. An issue highlighted by a recent Tax Court case,[1] is the importance of Code Sec. 83(b) elections. Although the case involves a partnership capital interest, for reasons described below, it is prudent that the Code Sec. 83(b) election also be made in connection with receipt of partnership profits interests.

First, a discussion of some pertinent terminology and applicable authorities is in order:

Terminology:

Profits Interest. A profits interest is an interest that gives the service provider a share only in the future profits and growth in value of the partnership. That means that the service provider would receive no distribution if, immediately after the receipt of such interest, the partnership sold all of its assets at fair market value, paid all of its debts, and liquidated.[2]

Capital Interest. A capital interest is one that gives the service provider an interest in the existing value of the partnership. In other words, the service provider would be entitled to a distribution if, immediately after the receipt of such interest, the partnership sold all of its assets at fair market value, paid all of its debts, and liquidated.[3]

Substantially Vested Interest. An interest in a partnership is substantially vested if it is either (i) not subject to a substantial risk of forfeiture or (ii) transferable. A "substantial risk of forfeiture" exists with respect to property when the service provider's "rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."[4] The term "transferable" has a special meaning in this context.[5] Property that is subject to a substantial risk of forfeiture is transferable if it may be transferred free of such risk. Thus, if the property is transferable but the transferee takes it subject to the risk of forfeiture, it is not considered transferable.

Restricted Interest. An interest that is not substantially vested.

Relevant Authorities:

Code Sec. 83. The amount and timing of income for compensatory transfers of "property" is governed by Code Sec. 83. Over the years, there has been some debate about whether Code Sec. 83 applies to the transfer of a partnership interest. According to one commentator, "the extent to which a partnership interest is property for Code Sec. 83 purposes is clouded by the Code Sec. 721 regulations."[6]

Code Sec. 83 states that the amount of income is measured when the service provider's right to the property is substantially vested. At the time of substantial vesting, the service provider recognizes income equal to the difference between the fair market value of the property and the amount, if any, that the service provider pays for such property. If the service provider's rights to the property are not substantially vested, a Code Sec. 83(b) election permits the service provider to include the receipt of property in income upon receipt. The Code Sec. 83(b) election must be made no later than 30 days after the receipt of such property. Reg. § 1.83-1(a)(1), provides that "[u]ntil such property becomes substantially vested, the transferor shall be regarded as the owner of such property." Also, the regulations under Code Sec. 83 provide that if the service provider receives an actual distribution of income from the property before his right is substantially vested, then this income is treated as additional compensation and the transferee must include it in his gross income in the year received.[7]

Rev. Proc. 93-27. The fair market value of a partnership profits interest has been the subject of controversy. Some courts have held that the receipt of a profits interest is a taxable event to the extent the profits interest "has a market value capable of determination."[8] Other courts have held that a profits interest has no fair market value if the value of the interest is purely speculative.[9] Noting the controversy in this area, the IRS issued Rev. Proc. 93-27[10] as a stop-gap measure to deal with the considerable uncertainty that existed at the time surrounding the treatment of profits interests. Rev. Proc. 93-27 provides that the IRS will not take the position that the issuance of a partnership profits interest is taxable to either the partner or the partnership as long as certain requirements are met. Rev. Proc. 93-27 effectively reaches this result by treating the fair market value of a profits interest that meets certain requirements as being equal to its liquidation value, or zero. The interest must be issued "for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner." Although technically not a safe-harbor, Rev. Proc. 93-27 is often referred to as such.

The "safe harbor" does not apply to an interest if:

- The 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;
- The service provider "disposes" of the interest within two years of receipt; or
- The partnership is a publicly traded partnership.

Rev. Proc. 2001-43. Rev. Proc. 93-27 did not specifically address the taxation of profits interests that are not substantially vested at the time of grant. The IRS subsequently issued Rev. Proc. 2001-43[11] to address this issue. It concluded that the proper time to test whether a partnership interest is a capital interest or a profits interest is at the time of the grant of the interest, not at the time of its substantial vesting. Further, if a partnership issues a profits interest that is a restricted interest, no income is recognized upon the substantial vesting of the interest even though its liquidation value at such time may no longer be zero. Importantly, according to Rev. Proc. 2001-43, no Code Sec. 83(b) election is required to take advantage of this treatment. However, both the partnership and the service provider must treat the service provider as the owner of the interest from the date of grant. This means that the service provider is required to take into account the distributive share of partnership income, gain, loss, deduction and credits from the date of grant. In addition, neither the partnership nor any partner may deduct as compensation or wages any amount upon the grant or substantial vesting of the profits interest.

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