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Proposed Rules Regarding Transfers of Partnership Interests for Services

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A notice of proposed rule making published on May 24, 2005 (REG-105346-03), and a related IRS notice (Notice 2005-43), set forth proposed regulations and a proposed revenue procedure regarding the transfer of partnership interests in connection with the performance of services. The proposed rules will apply to partnerships and to other entities treated as partnerships for tax purposes.

The proposed rules will affect many everyday real estate partnership arrangements, such as the issuance to an organizer or sponsor of a real estate venture of a "carried" partnership interest providing to the sponsor an interest in partnership profits that exceeds the sponsor's initial share (if any) of partnership capital.

Current Law

Under the current case law and two IRS revenue procedures (Revenue Procedure 93-27 and Revenue Procedure 2001-43), as a general rule no income or gain is recognized by a person providing services to a partnership (a "service provider") if such person acquires, in consideration of those services, an interest in the partnership which is purely a "profits" interest. A profits interest is a partnership interest that entitles the holder to a share of future profits if earned, but with respect to which no distribution would be made if the partnership were to sell its assets for fair market value and then distribute the proceeds in liquidation of the partnership at the time the interest is acquired. The receipt of the interest is not treated as a taxable event for the partner or the partnership.

The same result -- that is, no taxable event at the time of grant or the time of vesting -- applies whether the interest is vested upon grant or is subject to a substantial risk of forfeiture that lapses over time, so long as the recipient of the interest is treated as a partner from the date of grant of the interest and the other requirements of the revenue procedures are met.

Proposed Rules

Under the proposed rules, Revenue Procedures 93-27 and 2001-43 will be declared obsolete. Instead, the basic rule will be that if an interest in a partnership is transferred to a service provider in connection with the performance of services, and is substantially vested upon receipt, Code section 83 applies and the service provider must include in his income the fair market value of the interest minus any amount paid for it, regardless of whether the interest is a profits interest or a capital interest.

If the partnership and its partners have made or contemporaneously make a "Safe Harbor Election" and meet the requirements of that election, the fair market value of the partnership interest for purposes of section 83 will be treated as equal to its "liquidation value." The term "liquidation value" is defined in a proposed revenue procedure included in Notice 2005-43 as the amount that the holder of the interest would receive if, immediately after the transfer, all of the assets of the partnership were sold for fair market value and the proceeds distributed in liquidation of the partnership.

The liquidation value of a pure profits interest would be zero. Thus, the end result of the receipt of such an interest by a service provider should be the same in many cases as under the current revenue procedures, so long as the procedural and other requirements for the Safe Harbor Election are met.

The rules become somewhat more complicated, without necessarily changing the end result, if the partnership interest transferred to a service provider is not transferable and is subject to a substantial risk of forfeiture -- for example, a requirement that the service provider surrender the interest to the partnership for the amount paid for the interest if the service provider ceases during a specified period to provide services to the partnership. In these circumstances, the tax consequences of the transfer of the interest will depend on whether or not a section 83(b) election is made by the recipient of the interest. A section 83(b) election must be made, if at all, not later than 30 days after the date of transfer.

If a section 83(b) election is not made, then, under the rules of section 83 as interpreted by the proposed regulations, the service provider will not be treated as the owner of the interest -- that is, as a partner -- until the substantial risk of forfeiture ceases to exist or the interest becomes transferable. The fair market value of the interest at that time, minus any amount paid for it, will be included in the income of the service provider (as compensation), and he will then be treated as a partner for tax purposes. If a Safe Harbor Election *is* in effect at the time of transfer, the fair market value of the interest will be deemed to equal the liquidation value at the time the risk of forfeiture

lapses (Notice 2005-43, §5.01). If the service provider receives distributions with respect to his interest before the vesting date, those amounts will be treated as compensation paid to an employee or independent contractor as appropriate.

If a section 83(b) election is made by the service provider, then the fair market value of the interest at the time of transfer (as determined without regard to the substantial risk of forfeiture), minus any amount paid for it, is included in the income of the service provider. If a Safe Harbor Election is in effect at the time of transfer, then the fair market value of the interest will be determined on a liquidation basis.

Accordingly, if the interest is a pure profits interest, a Safe Harbor Election is in effect, and a section 83(b) election is made with respect to the transfer, the service provider will be treated as a partner from and after the date of transfer and no income will be required to be recognized by the service provider by reason of the transfer or the later vesting of the interest. (Of course, the service provider will be required to take into account annually his distributive share of partnership income, whether or not distributed to him.)

Partnership tax allocations that are made while a partnership interest subject to a substantial risk of forfeiture and a section 83(b) election remains outstanding will only be respected if the partnership agreement provides for "forfeiture allocations" to be made if the interest is forfeited. The effect of the forfeiture allocations is, in general, to reverse allocations that were made to the service provider before the forfeiture.

Effective Date

The new rules are proposed to be effective with respect to transfers occurring on or after the date final regulations are published.

Observations/ Potential Issues

It seems likely that most partnerships that transfer partnership interests to service providers will want to make Safe Harbor Elections once the rules become effective. The intention of the IRS seems to be to permit partners and partnerships to achieve, through Safe Harbor Elections (and by having service providers made section 83(b) elections where interests are or may be subject to a substantial risk of forfeiture), tax results in the most common situations that are identical or similar to those that are generally applicable under current law.

Notwithstanding these (good) intentions, there are already numerous apparent issues regarding specific aspects of the proposed regulations and the related IRS notice, and more issues will likely become apparent over time. The issues creating significant concern include the following:

Making the Safe Harbor election for a partnership may be difficult if the election is not specifically authorized under the organizational documents. If the partnership agreement clearly provides a partner of the partnership who has responsibility for Federal income tax reporting with authority to make the Safe Harbor Election on behalf of the partners, and to bind them to comply with all requirements of the safe harbor, then the election may be made by the authorized partner through a document executed by the partner and attached to a partnership tax return for the first year for which the election is intended to be effective.

If the partnership agreement does not provide that authority to a partner in charge of tax reporting, it will generally be necessary to have each partner, including the incoming service provider/partner, consent to the election. This may be highly burdensome to partnerships that have many partners, or that are characterized by difficult relationships among the partners. For example, in a typical real estate partnership, where the sponsor receives a carried interest for his efforts, if the agreement fails to provide explicitly for a Safe Harbor Election the sponsor will need to obtain the consent of each limited partner in order to avoid recognizing income upon receipt of the carried interest.

Certain recordkeeping requirements apply with respect to, for example, the preservation of documents executed to make the election, and the Safe Harbor Election may terminate if appropriate records are not retained. Moreover, an election once made will automatically terminate if the partnership or any partner fails to issue an information report or to otherwise report a transaction in the manner required under the new rules in circumstances where a Safe Harbor Election is in effect.

Even assuming that a Safe Harbor Election has been properly made and remains in effect, a service provider who fails to make a section 83(b) election on a timely basis with respect to an interest received subject to a substantial risk of forfeiture may well have unforeseen and undesirable tax consequences -- such as compensation income based on the liquidation value of the interest when it vests.

There may be difference of opinion between partners, once the new rules become effective, as to whether or not to make the Safe Harbor Election. If a partnership issues an interest to a service provider having a liquidation value greater than the fair market value thereof (after taking illiquidity and other discounts into account), the service provider may prefer that the Safe Harbor Election not be made. Conversely, if the Safe Harbor Election is not made, the recipient of a pure profits interest -- *i.e*, one with a liquidation value of zero -- will have compensation income under the new rules at the time of transfer or at the time of vesting if the interest has any value on the relevant date(s), speculative or otherwise, notwithstanding that there is no assurance that any distribution will ever be made with respect to that interest.

Obviously, issues of equal or greater significance may emerge as practitioners familiarize themselves with these proposed rules and apply them to specific situations. In addition, the Service is expected to receive numerous comments on the proposed rules, which may well result in significant changes to these proposed rules before they are issued in final form. At a minimum, however, it appears to be advisable to draft new partnership agreements and to implement new transactions in a manner that takes into account the possibility that these new rules (or essentially similar rules) will ultimately be issued as final regulations.

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