

In our practice we frequently encounter partnerships and limited liability companies (usually taxed as partnerships) which desire to admit a new partner or member in exchange for services, including past and future services, without creating any tax liability on the part of the new partner or member upon such grant. To date, this has typically been accomplished through the grant of a “profits interest”. This has been a major advantage to using a partnership form of organization rather than a C corporation form.

A “profits interest” is an interest which has a zero capital account and which would be entitled to nothing if the partnership were liquidated on the date of the transfer. Under current rules the grant of a profits interest in a partnership, as discussed below, is not a taxable event provided *inter alia* that the interest is held for two years and that the partnership claims no tax deduction with respect to the grant. Thus it is critical to value all the partnership interests on the date of transfer in order to establish that the new interest does not participate in any of the firm’s value accrued up to the date on which the new interest is created.

The treatment of C corporations is different. In a C corporation, the full fair market value of shares granted as compensation for services is taxable under Section 83 of the Internal Revenue Code (the “Code”) when the right to the shares is vested. Subchapter C of the Code dealing with corporations does not provide special rules for a “profits interest.”

For many years the taxability of the grant of partnership interests in exchange for services was the subject of a number of conflicting tax cases. The Internal Revenue Service sought to bring clarity to this area in Rev. Proc. 93-27 and 2001-43. Under these Revenue Procedures, the grant of a profits interest is not taxable, provided certain criteria are met.

In May 2005, the IRS proposed regulations which, upon promulgation (expected this fall), will again alter the rules in this important area. The proposed regulations seek to more closely align Section 83 of the Code and the existing rules in Rev. Proc. 93-27 and 2001-43 by requiring that both profits interests and capital interests be treated as property for purposes of Section 83 of the Code. Thus, the value of the relevant interest rather than the nature of such interest (*i.e.*, a profits interest versus a capital interest) is now of paramount importance. Under the new rules a partnership or LLC which desires to grant a profits interest to a new partner or member without giving rise to any tax liability of the partner upon grant, will be required to make a Liquidation Value Safe Harbor Election. By making such an election, the partnership or company elects to have the taxable value of the profits interest deemed to be the amount such interest would receive at the time of grant in the event of a dissolution of such firm promptly upon such grant. Any such election must be legally binding on all partners as well as on the partnership and, as under current rules, the election will not apply to partnerships with liquid assets or to publicly traded partnerships. Also, the election would not apply to the transfer of a profits interest “in anticipation of a subsequent disposition.” There is a presumption that a disposition within two years was anticipated prior to the transfer.

If a profits interest is vested at the time of grant, the partner to whom the interest was transferred must under Section 83 include the value of the interest received in taxable income. If the Liquidation Value Safe Harbor Election is made, this value may be zero or close to zero. However, the firm will need to demonstrate that the liquidation value of the firm is in fact zero. This exercise should include a showing that the partnership has no intangible assets which would in turn give an implied value to the profits interest. In many cases this will be difficult to demonstrate. One approach, in order to ensure that the liquidation value of the profits interest at the time of its grant, would be for the firm to “book up” the value of all other partnership interests to fair market value for financial statement purposes immediately prior to the grant of profits interests so that the newly-created profits interest would not participate in the value of the partnership created prior to the date of grant; that value would be attributed to the pre-existing interests in the book-up.

If the profits interest is not vested at the date of transfer, then under the new rules, the new partner or member would be required to make an election under Section 83(b) of the Code in order to take advantage of the Liquidation Value Safe Harbor Election. Although the result of a Section 83(b) election is that the interest becomes immediately taxable, if both elections are properly made and, if appropriate, a book up of the other partnership interests immediately prior to such elections, the value at the date of transfer could be zero or close to zero, again if substantiated by the facts. If a Section 83(b) election is not made, then the partnership interest will be taxable when it vests, at which point the interest may have significant value.

The proposal to require a Section 83(b) election for non-vested profits interests is a significant departure from current rules. Today a Section 83(b) election is not required, although many practitioners feel it is advisable in cases where a partnership interest might be argued to have a capital element at inception. In these cases the Section 83(b) election assures capital gain treatment to the partner on an ongoing basis even if the Revenue Procedures do not apply because the partnership fails to qualify as a profits interest. The new regulations also have detailed rules on forfeiture allocations under which, if a non-vested interest is forfeited, the service provider forfeiting such interest must receive a forfeiture allocation which will in many but not all cases reverse all prior allocations received with respect to the forfeited partnership interest.

The basic tax-planning conclusion is that the grant of profits interests at a nominal value should not be taken for granted; the failure to make the proper election, combined with the absence of appropriate documentation of value, may result in a hefty tax liability to the new partner without any accompanying liquidity with which to satisfy the tax liability. It will be increasingly necessary to demonstrate that the profits interest in question has no claim on partnership capital. The test is a fair market value test. In the case of partnerships with intangibles it may be necessary to do a book up or mark to market prior to transfer of profits interests. This will require careful preparation. It also suggests that partnerships and LLCs should not grant profits interests on a regular and frequent basis, but only with careful advance planning.

The IRS plans a hearing on the new rules in the near future. The proposed regulations may be implemented after the hearing, although the IRS is actively seeking comments, and there are often changes prior to implementation. It should be emphasized that this article is a short summary of complex rules and does not cover many aspects of the new rules. All firms contemplating the grants of profits interests for services need to follow closely the developments in this area which are expected this fall. All new partnerships should consider adding right away provisions permitting adoption of the safe harbor liquidation value election since this election seems likely to be a feature of the final regulations.