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Profits Interest in a Service Partnership: Entrance and Forfeiture Under the 2005 Proposed Regulations

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Profits Interest in a Service Partnership: Entrance and Forfeiture Under the 2005 Proposed Regulations

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I. INTRODUCTION

In May 2005 the Internal Revenue Service (IRS) and the Treasury Department issued proposed regulations and a revenue procedure that covered the federal income tax consequences of partnership equity transferred in connection with the performance of partnership services. A notable context in which the proposed regulations and revenue procedure may apply is the practice of law. For example, a law firm associate may become eligible for the coveted title of "partner" after several years of employment with his law firm. Depending on the law firm's structure, the associate-now-partner may act as a pure "service partner" whereby he will make no further contribution to the partnership other than his continued provision of services. In exchange, the new partner is entitled to an ownership share of the partnership's profits in addition to his regular salary. Thus, with the exception of a higher billing rate and an increased level of authority over the younger associates, the partner's duties remain largely the same as they were when the partner was an associate. Moreover, the time may come when the partner will leave his firm and either retire or seek other employment. As a result, his compensation will cease, and assuming that he has no desire to take clients with him, speaking in terms of tangibles, he will walk away with little more than what he started with—a law degree and a license to practice law.

As simple as the above scenario seems, tax practice in this area has been a topic of debate, confusion, and impending change. Commentators have expressed varying opinions on the subject, and the tax bar has extensively critiqued the recent proposed changes in this area of law. This Comment will focus on two narrow aspects of the scenario described above: (1) the entering of a service partner for a profits interest to a "service partnership," a partnership in which substantially all of its activities involve the provision of services; and (2) the later forfeiture by the partner of the profits interest. The purpose of this Comment is to describe the current law and methods of practice in this area. In addition, this Comment will highlight and analyze areas of importance that a practitioner should understand if the proposed methods become final. Finally, this Comment will conclude by noting a few areas that are in need of clarification by the IRS and the Treasury Department before finalization of the proposed scheme.

1. See infra text accompanying note 40.
II. ANALYSIS OF CURRENT LAW

A. Entrance of a New Partner

The existence of a service partnership depends on the people who come together to participate in the joint venture. Unlike a venture into the sale of goods, service partnerships do just what the label entails—provide services for a fee. Therefore, the individuals are the focus of the partnership's success and growth. Furthermore, the ability to attract highly skilled and qualified individuals (or those that have shown the potential to become highly skilled and qualified) is essential to the service partnership's success. In this context, one of the most attractive aspects of many service partnerships is the prospect of sharing in the partnership's profits. "Making partner" in a law firm can be thought of as a great achievement, not so much from the personal practice development standpoint, but rather, because of the ability to share in the profits of the partnership. Therefore, the entrance of a new partner is not only an event of substantial significance to the service partnership's success, but consequently, it is also an area in which the service partnership and the partner may seek a tax practitioner's advice.

Currently, the entrance of a new partner by way of a profits interest given in exchange for services is governed administratively by Revenue Procedure 93-27, as clarified by Revenue Procedure 2001-43. These revenue procedures attempted to correct conflicting legal authority as to whether a profits interest is currently taxable as property with a determinable value, or rather, a contractual interest that is too speculative to warrant immediate taxation. Before progressing, a brief description of I.R.C. § 83 is necessary.

1. I.R.C. § 83

Under I.R.C. § 83(a), the fair market value of property received in exchange for services is included in income in the year in which the rights of the service provider with respect to the property are "substantially vested," i.e., either transferable or no longer subject to a substantial risk of forfeiture. However, under § 83(b), the service provider may choose, if an election is made, not to apply § 83(a). Rather, the partner may include the fair market value of the property received for services in gross income in the year of transfer and not at such later time when the rights to the property are no longer subject to transfer or forfeiture restrictions. The application of I.R.C.

6. Id. § 83(b).
7. Id.
§ 83(a)–(b) to a profits interest, however, is somewhat ambiguous for two reasons. First, the current definition of “property” as laid out in Treasury Regulation § 1.83-3(e) for I.R.C. § 83 purposes does not specifically include partnership profits interests. It is unclear from the language of the regulation whether the writers intended “property” to include a profits interest based on the fact such interests may be intangible personal property under state law, or instead intended to exclude such interests based on the idea that profits interest should be treated more like a contract right to receive future compensation.

Second, since profits interests, by nature, carry no value other than the expectation to receive money in the future, determining fair market value for either § 83(a) or § 83(b) purposes is a difficult task. Such difficulty is best demonstrated by prior conflicting case law.

2. Campbell and Diamond

In the landmark case of Campbell v. Commissioner, the Eighth Circuit held that a taxpayer could not be currently taxed on profits interest because its value was too speculative. Since the determination of an interest’s fair market value is one of fact, a battle of the experts ensued between the taxpayer and the IRS:

Campbell’s expert testified that the values of the partnership interests were speculative and not in excess of $1,000. His opinion was based on the present values of the cash distributions projected in the offering memoranda. He discounted these values because of the restrictions on transferability and the lack of participation rights in management of the partnerships. He attached no present value to the projected tax benefits because of the substantial risk of disallowance upon likely audits. The Commissioner used the same basic method of valuation, except that he included the present value of the tax benefits in his calculations and used a much lower discount rate resulting in higher present values.

Given that the Eight Circuit sided with the taxpayer’s view that the profits interest was too speculative to tax, this holding eliminated the need to resolve the issue of whether a profits interest is indeed “property” subject to I.R.C. § 83. This result, however, was in marked contrast to an earlier Seventh Circuit case, Diamond v. Commissioner.

In Diamond, the Seventh Circuit held that a profits interest acquired in the month of February of the applicable tax year, and which was subsequently sold three weeks later in March, had a readily determin-

9. 1 WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS 5.02[1] (3d ed. 2004); see also id. ¶ 5.02[6][c] (arguing that profits interests are not property under I.R.C. § 83).
11. 943 F.2d 815 (8th Cir. 1991).
12. Id. (emphasis added).
13. 492 F.2d 286 (7th Cir. 1974).
nable fair market value at the time of acquisition—namely, the value of the subsequent sale.\textsuperscript{14} Consequently, after \textit{Campbell} and \textit{Diamond} a taxpayer could only speculate as to whether a profits interest would have a determinable and taxable value upon acquisition, and whether the interest was subject to § 83.


To rectify the conflicting case law and to provide a workable framework for the taxation of profits interest, the IRS drafted Revenue Procedure 93-27, which states:

\begin{quote}
If 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.\textsuperscript{15}
\end{quote}

In determining whether an interest at issue is a true "profits interest," the revenue procedure requires the reader to infer the definition negatively as it defines a \textit{capital} interest as one "that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and . . . distributed in a complete liquidation of the partnership."\textsuperscript{16} Therefore, a \textit{profits} interest is simply any interest other than a capital interest.\textsuperscript{17} Finally, Revenue Procedure 93-27 notes a few exceptions to the nonrecognition rule. Generally, nonrecognition will not be allowed "(1) [i]f the profits interest relates to a substantially certain and predictable stream of income . . . ; (2) [i]f within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a 'publicly traded partnership'" under I.R.C. § 7704(b).\textsuperscript{18}

With respect to a service partnership as analyzed under the rules of Revenue Procedure 93-27, it is generally the case that "the amount entitled to be received by a service partner for any year . . . is often based in significant part on the perceived contribution of the partner to the firm for the year."\textsuperscript{19} Moreover, as a general matter "it is the universal practice for the new . . . partner not to report any income associated with the receipt of the interest and for the other partners not to claim any deduction associated with the issuance of the interest."\textsuperscript{20} As a result, under the definitions provided in Revenue Procedure 93-27, interests received by a service partner in a service partnership are generally classifiable as \textit{profits} interests, barring any conflicts with the abovementioned rules. Therefore, a practitioner ad-

\begin{itemize}
\item \textsuperscript{14} \textit{Id.} at 288.
\item \textsuperscript{15} \textit{Rev. Proc.} 93-27, 1993-2 C.B. 343.
\item \textsuperscript{16} \textit{Id.}
\item \textsuperscript{17} \textit{Id.}
\item \textsuperscript{18} \textit{Id.}
\item \textsuperscript{19} Hariton, \textit{supra} note 2, at 1327.
\item \textsuperscript{20} \textit{Id.} at 1326.
\end{itemize}
vising a client with an interest classifiable under Revenue Procedure 93-27 can usually draft an agreement that defines the recipient as a partner and the interest as one that does not allow for any distributions to the partner upon liquidation of the partnership other than previously taxed income allocations. Additionally, there is no need for the practitioner to require the partnership to seek out an expert to appraise the fair market value of the interest in a preemptive effort to defend against the kind of IRS attacks seen in \textit{Campbell} and \textit{Diamond}. Rather than having to prove up the fact that the interest is too speculative to be taxed even if it is "property" under § 83(a)-(b), Revenue Procedure 93-27 simply grants nonrecognition to all complying interests.

After the publication of Revenue Procedure 93-27, questions remained as to whether partnership interests falling under the parameters of Revenue Procedure 93-27 that were substantially nonvested at the time of grant but later became vested, were taxable at such later date.\footnote{21} The resolution of this issue was necessary, in part, because if a profits interest is indeed "property" under I.R.C. § 83 then, as noted above, under I.R.C. § 83(a) once such property is either transferable or no longer subject to a substantial risk of forfeiture the fair market value is taxable.\footnote{22} Until such time, the property is deemed to be substantially nonvested under Treasury Regulation § 1.83-3(b).\footnote{23} Therefore, as one commentator opined:

\begin{quote}
If the profits interest was substantially nonvested at the date of receipt, did this postpone the determination of taxability until the interest was substantially vested? ... Additionally, was it necessary to make a Section 83(b) election with respect to the receipt of such profits interest in order to cause current taxability and thus avoid the possibility that the interest would not [comply with Revenue Procedure 93-27] at the first moment of taxability?\footnote{24}
\end{quote}

In response, the IRS drafted Revenue Procedure 2001-43 to address these issues. Generally, if a partner receives a nonvested profits interest, that partner will be treated as receiving the interest on the date of its grant and not at the time the interest later becomes (if at all) substantially vested.\footnote{25} In other words, if restrictions on transfera-

\begin{footnotes}
\item 21. Steven I. Klein & Stephen R. Looney, \textit{Profits Interest Substantially Nonvested at Time of Grant Treated as Received as of Date of Grant}, 3 BUS. ENTITIES 49, 49–50 (2001).
\item 23. Treas. Reg. § 1.83-3(b) (as amended in 2005); Klein & Looney, \textit{supra} note 21, at 49–50.
\item 24. Klein & Looney, \textit{supra} note 21, at 49–50.
\item 25. Rev. Proc. 2001-43, 2001-2 C.B. 191. It is assumed that (1) Revenue Procedure 93-27 is satisfied; (2) the partnership and the new partner will treat the service provider as the owner of the partnership interest from the date of its grant and the partner will take into account his distributive share of partnership income, gain, loss, deduction, and credit associated with that interest; and (3) in the event the interest becomes substantially vested, neither the partnership nor the part-
\end{footnotes}
bility exist, or there is a risk of forfeiture, the removal of these restrictions that "vest" the interest in the property does not trigger later recognition since the "test" of ownership of the interest is on the date of grant.26

Interestingly, Revenue Procedure 2001-43 avoids the applicability of the I.R.C. § 83(b) election by explicitly providing that no election under § 83(b) will have to be made in order for the year-of-grant rule to apply.27 Arguably, since the receipt of a nonvested interest in property received for services in the year of transfer is determined only with an election under § 83(b) to avoid inclusion under § 83(a) upon later vesting, by implication, the IRS's administrative stance asserts that the provisions of § 83 do not apply to partnership profits interests that fall under Revenue Procedure 93-27 and Revenue Procedure 2001-43.28 If I.R.C. § 83(a)–(b) did apply, then the IRS's stance in Revenue Procedure 2001-43 could be seen as circumventing Congress by not requiring the I.R.C. § 83(b) election, even if Revenue Procedure 93-27's nonrecognition rule would negate the need for a fair-market-value determination. Thus, by administratively creating a default rule for nonvested partnership interests that supplants an arguable affirmative requirement under the Internal Revenue Code, the IRS provided (rightly or wrongly) that when the revenue procedures apply, I.R.C. § 83(a)–(b) do not.

The application of both Revenue Procedure 2001-43's stance on vesting and Revenue Procedure 93-27's stance on recognition allows a taxpayer to avoid the issues that arise under I.R.C. § 83(a)–(b): principally, whether a profits interest has an immediately determinable fair market value, whether the interest has become taxable at a later date when vested, and whether the subsequently vested interest has a determinable fair market value. Indeed, a service partnership could be structured so that most, if not all of the partners are service partners whose profits interests are effectuated by performance and subject to forfeiture if the partner's services to the partnership cease. Therefore, both nonrecognition treatment and classification as a nonvested interest seem appropriate since the value of the interest is at least somewhat speculative and the partner must continue to provide services.29

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26. Id.
27. Id. “These two revenue procedures effectively create an extra-statutory regime that ignores most of the generally applicable § 83 rules for nonvested property.”
1 MCKEE ET AL., supra note 9, ¶ 5.03[1].
28. See Hariton, supra note 19, at 1326. “[I]n many cases the recipient files a ‘protective’ section 83(b) election in case the interest is viewed as outside the scope of the [e]xisting [r]evenue [p]rocedures.” Id. at 1317.
29. See id. at 1328. Under Treasury Regulation section 1.83-3(c)(1),
At least one commentator has criticized the appropriateness of this result:

Saying that no partner is vested (because of nontransferability and the implicit requirement that retention of the partnership interest is conditioned on the future performance of substantial services) proves too much. A partnership that has no vested partners is a nothing. Law firms are not nothing—who pays the associates and nonlegal staff?30

However, this criticism appears meritless under current law. Even if one fails to accept the idea that it is possible to have a partnership without vested partners, Revenue Procedure 2001-43's date-of-grant test does not require the practitioner advising such a partnership to make a § 83(b) election to combat later vesting, or even advise a client contemplating later vesting of the consequences of not making the election. Thus, as it stands, the inquiry as to whether it is possible to have a partnership with no vested partners seems moot under Revenue Procedure 93-27 and Revenue Procedure 2001-43.

To conclude, under the parameters of Revenue Procedure 93-27 and Revenue Procedure 2001-43, the general rule is that no gain or loss is recognized to the partner or the partnership upon the transfer of a nonvested partnership interest. Rather, in most cases the interest is automatically treated as received on the date of grant, and there is no requirement that an affirmative election under § 83(b) must be made.

B. Forfeiture of a Profits Interest

Also vitally important to the existence of most service partnerships is the notion that a partner may walk away from the partnership and forfeit his profits interest. This occurrence is expected when the very existence of many profit interests, as noted above, depends on the partner's continued rendition of services to the partnership. Thus, when the partner no longer wishes to perform services during any particular year, barring any state partnership law restrictions, the partner may cease the provision of such services.

Unlike the delineated tax consequences of bringing in a new income only partner under Revenue Procedure 93-27 and Revenue Procedure 2001-43, the tax consequences of forfeiture of an income only interest are unclear. After the issuance of Revenue Procedure 2001-43

[a] substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied . . .

Treas. Reg. § 1.83-3(c)(1) (as amended in 2005). In many cases, a partnership interest is likely nontransferable as well.

30. Upton, supra note 2, at 813.
a prominent law firm newsletter proffered the following: “What is the tax treatment upon forfeiture of the profits interest? The revenue procedure is silent on this point. It is not clear whether the partnership recognizes income (and/or whether the service partner is entitled to a deduction) if an unvested profits interest is forfeited.”

Some practitioners believe that the reason that Revenue Procedure 2001-43 did not address forfeiture was due to “concern that forfeiture raises capital shift issues [the IRS was] not yet prepared to definitively address.” Presumably, when a profits interest partner is allocated items of income, under normal partnership capital accounting, the partner would experience a basis increase in the partnership until those items are actually distributed. This begs the question of what happens if a partner walks away from undistributed partnership allocations. Some believe that if Revenue Procedure 2001-43 applies in a forfeiture situation, the service provider should be able recognize a loss equal to his or her basis in the interest. This result is warranted only if Revenue Procedure 2001-43's stance of not requiring the § 83(b) election can be taken so far as to hold that § 83(b) does not apply at all to interests that fall within the revenue procedure's parameters. This is because, in addition to the election mechanism, § 83(b) provides that “if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.” It appears that the § 83 regulations do not contemplate the forfeiture of a service provider's interest where basis increases have occurred during ownership of the interest due to proper inclusion in of the partner's distributive share of the partnership's income. Thus, a literal reading of § 83(b) may preclude a service provider from obtaining any deduction for forfeited basis attributable to the distributive share of partnership income. One commentator has criticized this result:

These results are clearly inappropriate and almost certainly unintended: the Section 83 Regulations do not address partnerships or partnership interests, so it is not surprising that they fail to make clear that a service provider who forfeits a partnership interest may claim a loss to the extent such loss is attributable to prior inclusions of properly allocated partnership income.

34. Swartz, supra note 32, at 45.
35. Id.; I.R.C. § 83(b) (2006).
36. Banoff, supra note 33, at 144.
37. Id.
38. Id.
Although speculation and commentary on whether the result is "appropriate" is clearly justified, for the risk-averse client it simply is insufficient that the client's legal advice has to be limited to the fact that, "in the absence of an election under Section 83(b), the IRS should not be in a position to argue that the loss limitation rule of Section 83(b)(1) is applicable." Rather, the application of § 83 and its loss-deduction limitation should be conclusive. Furthermore, even though Revenue Procedure 2001-43 does not require the § 83(b) election, it might be presumptuous to assume that it necessarily follows that § 83(b)'s deduction limitation is inapplicable. It is under this framework of ambiguity that the IRS and the Treasury Department have proposed to apply I.R.C. § 83 to a transfer of a partnership interest in exchange for services provided to a partnership.

III. ANALYSIS OF THE PROPOSED METHOD

In the event the 2005 proposed regulations and proposed revenue procedure are finalized, "Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, ... will be obsoleted." As one commentator pointed out, the new regulations "stand[] in marked contrast to the administrative practice under Revenue Procedure 93-27, as supplemented by Revenue Procedure 2001-43."  

A. Entrance of a New Partner—I.R.C. § 83 Applies

The first notable change is that Proposed Treasury Regulation § 1.83-3(e) states that "property" includes a partnership interest for purposes of I.R.C. § 83. Moreover, the regulations' preamble states that "[t]he proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests." The preamble recognizes the
contentious application of § 83 to a profits interest by specifically citing Campbell as a source of controversy, but states that "the Treasury Department and the I.R.S. do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83." Thus, "all of the rules in these proposed regulations and the accompanying proposed revenue procedure . . . apply equally to partnership capital interests and partnership profits interests."  

Although the treatment of a profits interest as "property" may be criticized on the grounds that a service partner is more like a person who merely enters into a contract to receive future compensation, the preamble to the proposed regulations appears, at the very least, to eliminate the ambiguity as to whether the provisions of § 83 apply to a partnership profits interest. Thus, by lumping all partnership interests into § 83 and abolishing both Revenue Procedure 2001-43 and Revenue Procedure 93-27, a partnership profits interest is property subject to section § 83's fair market valuation and election scheme.

1. I.R.C. § 83(b) Election—Do or Die

To take the latter first, the initial trap for the unwary in the proposed regulations is compliance with I.R.C. § 83(a) or (b). As noted above, under I.R.C. § 83(a), a person receiving property in exchange for services is required to include the fair market value of such property in income when his rights in the property become substantially vested under Treasury Regulation § 1.83-3(b). Again, since a profits interest in a service partnership is generally forfeited when the partner no longer provides services to the partnership, the interest is nonvested under Treasury Regulation § 1.83-3(b). Therefore, § 83(a) has no immediate tax effect. In this respect, the proposed regulations do not necessarily differ from the prior revenue procedures. However, the unwary practitioner may decide, quite reasonably, that because the profits interest is nonvested under Treasury Regulation

45. Id. See also McKee et al., supra note 9, ¶ 5.02[6][c]; Treatment of a Recipient of a Partnership Interest for Services Under Proposed Regs., 5 Fed. Tax Coordinator Second Series (RIA) ¶ B-1409.2 (Nov. 17, 2005).

46. Id. See also McKee et al., supra note 9, ¶ 5.02[6][c]; Treatment of a Recipient of a Partnership Interest for Services Under Proposed Regs., 5 Fed. Tax Coordinator Second Series (RIA) ¶ B-1409.2 (Nov. 17, 2005).

47. Banoff, supra note 10, at 268.


49. 1 McKee et al., supra note 9, ¶ 5.11[2].

50. Treas. Reg. § 1.83-3(c)(1) (2006) ("A substantial risk of forfeiture exists where rights in property that are transferred are condition-ed, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.").

1.83-3(b) and because no immediate tax effects are apparent under § 83(a) (as is the case with Revenue Procedure 93-27 and Revenue Procedure 2001-43), an § 83(b) election is not needed. This practitioner may reason that because the profits interest may never vest, an § 83(b) election is a waste of time and client money. It is at this juncture that the proposed regulations do indeed stand in marked contrast to the current procedures.

Initially, the proposed regulations act to force an § 83(b) election in most circumstances:

If a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of §1.83-3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under section 83(b).

Therefore, absent a § 83(b) election, the service partner faces a realistic probability that he or she will be treated as either an employee of the partnership or an independent contractor. If so, in addition to employment tax implications, any partnership income, loss, or other items cannot be allocated to the intended partner. What is more, if an allocation is made to a partner that neglected to make the § 83(b) election, presumably the partner will experience ordinary compensation income under I.R.C. § 61. Thus, where Revenue Procedure 2001-43 alleviated potential income inclusion upon later vesting and alleviated the mandated § 83(b) election for recognition purposes, the proposed regulations require an affirmative step that, if neglected, may give rise to unintended consequences, leaving a client markedly unhappy.

Since the § 83(b) election under the proposed regulations appears to be mandatory in the service partnership context, practitioners need to be aware that under § 83(b), an election with respect to any transfer of property “shall be made in such manner as the Secretary prescribes” within 30 days after the date of such transfer. The election may not be revoked except with the consent of the secretary and “[t]he election . . . is made by filing one copy of a written statement with the internal revenue office with whom the person who performed the services files his return.” Therefore, for a valid election (and thus, avoidance of the partner being treated as an employee or independent contractor), the regulations require a taxpayer to file a writ-
ten copy with the IRS within thirty days after a transfer of property. As a result, the proposed regulations require a quick decision and affirmative action if taxpayers wish to mirror the results under Revenue Procedure 93-27 and Revenue Procedure 2001-43.

2. Valuation of a Profits Interest
   a. Resurrecting Campbell and Diamond

   Presuming that a § 83(b) election has been made, the next issue is one of valuation. As noted above, the general rule under § 83(a) requires that the *fair market value* of property received for services is to be included in income when such property is no longer subject to a substantial risk of forfeiture. Alternatively, when the § 83(b) election is made, then § 83(b) requires inclusion in gross income the fair market value of the property in the taxable year the property is transferred. Therefore, where Revenue Procedure 93-27 and Revenue Procedure 2001-43 ignored elections and valuations by providing per se nonrecognition on the date of grant, and thereby eliminated any practical need to value the profits interest on such date, the proposed regulations reject the approach of the two revenue procedures. If a partner is to be treated as receiving property on the date of transfer per the § 83(b) election, § 83(b) then requires an inclusion in income of the fair market value of the property on the date of transfer. Rather than ignoring the valuation of the profits interest via a per se nonrecognition rule, the proposed regulations require both the § 83(b) election and the determination of fair market value. As can be seen, the proposed regulations conclude that the prior revenue procedures’ remedy of the Campbell and Diamond “battle of the experts” approach to valuation is inappropriate. While valuation under § 83(b) may result in a zero-dollar valuation of the partnership profits interest due to its speculative nature, the risk-averse taxpayer and her advisor will usually want to establish a zero value. The proposed regulations offer an elective safe harbor that could ensure that result, but at a cost to both the taxpayer and the advisor.

   b. The Not-So-Safe Harbor?

   To ensure that the issuance of an income only partnership interest does not have immediate income tax consequences to the partner or the partnership, Proposed Treasury Regulation § 1.83-3(l) allows “a partnership and all of its partners [to] elect a safe harbor under which the fair market value of a partnership interest that is transferred in

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60. Id. § 83(b) (emphasis added).
61. See id.
62. See supra text accompanying note 12.
connection with the performance of services is treated as being equal to the liquidation value of that interest." 63 Liquidation value is generally "the cash amount that the holder of the interest would receive if, immediately after the transfer of the interest, the partnership sold all of its assets for cash equal to their fair market values and liquidated." 64 Hence, "[t]he liquidation value of a profits only interest is typically zero when the interest is issued" 65 since the profits interest partner would receive nothing on a hypothetical sale and liquidation of the partnership.

At first glance this seems simple enough—if a partner is to be treated as a partner when he or she receives a nonvested profits interest, a § 83(b) election should be made. Moreover, to avoid any potential fair market valuation and income recognition issues, a safe harbor election should be made under Proposed Treasury Regulation § 1.83-3(l). However, the devil may be within the details of Proposed Treasury Regulation § 1.83-3(l).

When IRS Associate Chief Counsel (Passthroughs and Special Industries) Heather Maloy was questioned in June 2006 as to the effects of not taking the zero-valuation-election method as instituted by I.R.C. § 83(b) and Proposed Treasury Regulation § 1.83-3(l), she responded, "We hope everyone uses the liquidation safe harbor." 66 Thus, without explicitly saying so, Maloy's comment appears to mean that, for certainty's sake, partners and partnerships should elect the safe harbor. However, certainty may come with the loss of simplicity as Proposed Treasury Regulation § 1.83-3(l) institutes a number of requirements for those wishing to comply with Maloy's suggestion. First, the partnership must prepare a document (attached to the year's tax return), executed by a partner responsible for the partnership's federal income tax reporting, which states that the partnership and all the partners are electing to apply the safe harbor to all partnership interests transferred for services while the election is in effect. 67 In addition, either (1) the agreement contains provisions that are legally binding on all of the partners which state that the partnership is authorized and directed to elect the safe harbor and the partnership, and its partners agree to comply with all the safe-harbor requirements; or (2) each partner executes a separate document con-

65. Id.
taining the identical and legally binding provisions.68 Second, the partnership must retain records necessary to indicate the effectiveness of the election and that it remains in effect (including a copy of the election statement and the separate documents signed by the partners, if applicable).69 Finally, under the proposed revenue procedure, IRS Notice 2005-43, the profits interest (and transferees thereof) must generally satisfy the basic requirements that appear to mirror those listed in Revenue Procedure 93-27.70 If any of the aforementioned requirements are not satisfied, the safe-harbor election terminates automatically and a new election will be barred for five years.71

To conclude, the imposition of the proposed regulations attempts to provide some certainty, at least with regard to whether I.R.C. § 83 actually applies to partnership profits interests, but at a cost. Under the proposed method, a § 83(b) election is necessary to avoid a potential classification of the purported partner as an employee or independent contractor. The window for such an election is thirty days. Additionally, § 83(b) will require a valuation of the income only partnership interest immediately after creation of the interest. Generally, because of the speculative nature of such an interest, it is possible that the

68. Id. § 1.83-3(l)(1)(ii)-(iii), 70 Fed. Reg. at 29,681. Query whether state law issues may arise given that these documents are required to be "legally binding." See Hariton, supra note 2, at 1319.
70. See supra text accompanying note 18. A complying interest is any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related 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, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). I.R.S. Notice 2005-43, 2005-24 I.R.B. 1221, 1224 (June 13, 2005).
71. I.R.S. Notice 2005-43, 2005-24 I.R.B. at 1224. Although outside the scope of this Comment, it should be noted that although the application of a liquidation value would seem to resolve the fair market value uncertainties as raised under the Campbell and Diamond dichotomy, even this remains unclear in situations in which determining the liquidation value depends on the valuation of intangible assets such as goodwill and where a service partnership's value in general depends on the continued contribution of services by the partners. See Hariton, supra note 2, at 1327.
interest will have no determinable value. However, in the event the risk averse client wishes to ensure a zero-dollar valuation based on the liquidation value of his partnership interest, compliance with Proposed Treasury Regulation § 1.83-3(1) is required.

B. Forfeiture

As previously discussed, a § 83(b) election will generally be required in the context of a profits interest granted to a service partner. Interestingly, the election also ties in with allocations that occur upon forfeiture—what the proposed regulations refer to as “forfeiture allocations.” First, when a § 83(b) election has been made with respect to a forfeitable nonvested interest, the proposed regulations expressly allow partnership allocations in respect of such an interest. Secondly, because such allocations cannot have economic effect, if the allocations are to be deemed in accordance with the partners’ interest in the partnership, the proposed regulations impose two requirements. One of these requirements is that the partnership agreement mandate that the partnership make “forfeiture allocations” if the interest that was the subject of the § 83(b) election is actually forfeited. Since allocations to a service partner are often based on the services rendered to the partnership, allocations that are deemed in accordance with the partner’s interest in the partnership avoid the otherwise required determination of a service partner’s overall economic interest in the partnership or settling for per capita allocations that may be unrepresentative of the partner’s contribution of services to the partnership.

1. Forfeiture Allocations—General Application

The question of what happens under the proposed scheme if the service provider forfeits his partnership interest after having (1) made the requisite § 83(b) election and (2) reported a distributive share of

72. "If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will later be forfeited.” Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(a), 70 Fed. Reg. at 29,681.
73. Id.
74. Id. § 1.704-1(b)(4)(xii)(b), 70 Fed. Reg. at 29,681.
75. Id. § 1.704-1(b)(4)(xii)(b)(1), 70 Fed. Reg. at 29,681. Although outside the scope of this Comment, the second requirement imposed by the regulations requires that all material allocations and capital account adjustments (under the partnership agreement) that do not pertain to a the substantially nonvested partnership interest that was the subject of the I.R.C. § 83(b) election be recognized under section 704(b). Id. § 1.704-1(b)(4)(xii)(b)(2), 70 Fed. Reg. at 29,681.
income that has not yet been distributed,\(^7\) can be answered with the following hypothetical: First, suppose that a taxpayer acquires a profits interest using the elective safe harbor to value the income only interest at zero dollars immediately after the creation of the interest after making the § 83(b) election. Second, the taxpayer recognizes no income under I.R.C. § 83(b) upon receipt of the income-only interest. Third, he receives a distributive share of the partnership's income over two years (e.g., $15 in year one and $15 in year two). Fourth, he experiences a corresponding basis and capital account increase from the distributive share allocations (e.g., $0 + $30). Finally, he subsequently forfeits the interest in year three.\(^7\) Since the proposed regulations appear to conclusively apply I.R.C. § 83 to a partnership profits interest and require the § 83(b) election,\(^7\) § 83(b)'s deduction disallowance should apply. As noted above, § 83(b) states that “[i]f such election is made . . . and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.”\(^8\)

Although “[t]he [current § 83] regulations quite rightly permit a loss equal to the 'amount paid' for the property,”\(^8\) the term “amount paid” under Treasury Regulation 1.83-3(g) is defined as “the value of any money or property paid for the transfer of property to which section 83 applies.”\(^8\) Thus, since it appears that the proposed regulations do not treat partnership basis resulting from allocations of partnership income as literal “amounts paid” under Treasury Regulation § 1.83-2(a), I.R.C. § 83(b) prohibits a partner from claiming a loss with respect to such basis upon forfeiture.\(^8\) Thus, to avoid § 83(b)'s deduction disallowance, a practitioner should be aware that actual distribution of partnership allocations should be encouraged before any forfeiture occurs.

In the event actual distribution does not occur, it appears that the proposed regulations may provide relief from § 83(b) in the form of forfeiture allocations. Generally, forfeiture allocations are in place to allow a closer reflection of the partnership economic arrangement by adjusting allocable taxable income, adjusting the partnership capital accounts, and mitigating losses disallowed by § 83(b).\(^8\) Forfeiture al-

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\(^7\) See Sheppard, supra note 66, at 1102 (posing a similar inquiry to the associate chief counsel (Passthroughs and Special Industries)); see also Hariton, supra note 19, at 1332.

\(^8\) For additional discussion, see Hariton, supra note 19.

\(^8\) See supra text accompanying note 44.
locations are pro rata allocations to the service provider of gross income and gain or gross deduction and loss for the taxable year of the forfeiture equal to (1) the excess of the amount of distributions to the partner with respect to the forfeited partnership interest over amounts paid for the interest with respect to the forfeited partnership interest, minus (2) the cumulative net income (or loss) allocated to such partner with respect to the forfeited partnership interest.\(^8\)

Returning to the hypothetical proffered above, where a $30 deduction to the partner would probably be disallowed by § 83(b) upon forfeiture, the proposed regulation would seem to treat this scenario as follows: excess distributions with respect the forfeited interest (here, $0) over the contributions for the interest (again, $0) minus cumulative net income allocated to the forfeited interest ($15 in year one and $15 in year two = $30). As can be seen, the calculation results in a negative number. The proposed regulations note the following: “items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.”\(^6\) In addition, the allocations are made to the extent the partnership has sufficient income and gain or deduction and loss to cover the allocations in the year of forfeiture.\(^7\) Thus, in this hypothetical, since the forfeiture allocation is $30, the partnership must have $30 in partnership deductions to allocate to the forfeiting partner. However, in some instances, “the partnership may not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider.”\(^8\) As a result, § 83(b)’s disallowance of forfeiture deduction is at least mitigated, if not completely offset in some circumstances, by the proposed regulations. Therefore, a practitioner advising a client that is contemplating a forfeiture will need to analyze the status of the partnership to determine what the forfeiture allocation will be, whether the partnership items are sufficient to cover the forfeiture allocation, and what character of the forfeiture will be. However, a practitioner should be aware that a few unresolved issues remain with regard to forfeiture allocations.

2. The Crystal Ball—Predicting Sufficiency and Character

IRS Notice 2005-43 provides that if a partner has been previously allocated losses and is thus entitled to forfeiture allocations consisting of income and gain—that is, if the partnership’s gross income for the year cannot cover the forfeiture allocations—the forfeiting partner must recognize ordinary income for the year equal to the amount the

\(^{85}\) Id. § 1.704-1(b)(4)(xii)(c), 70 Fed. Reg. 29,675, 29,681–82 (May 24, 2005).

\(^{86}\) Id. § 1.704-1(b)(4)(xii)(d), 70 Fed. Reg. at 29,682.

\(^{87}\) BITTKER & LOKKEN, supra note 64, ¶ 86.2.5.

\(^{88}\) Banoff et al., supra note 83.
partnership could not cover. However, what Notice 2005-43 does not address is the situation in which a partner has been allocated income items in previous years but the partnership fails to have sufficient deductions to allocate to the forfeiting partner in the year of forfeiture. In such a situation, would falling back on I.R.C. § 83(b) be appropriate to disallow such deductions where forfeiture allocations cannot be made? If so, how can this result be squared with IRS Notice 2005-43's ordinary income requirement just mentioned? A practitioner facing this circumstance may seek to advise a client to postpone forfeiture until the partnership has sufficient deductions to make the appropriate forfeiture allocations. However, extenuating circumstances may not allow postponement of forfeiture. Moreover, because the partnership items are determined in the year of forfeiture, predicting sufficient partnership items to cover forfeiture allocations may simply require a tool that a tax practitioner does not have—a crystal ball.

Finally, the forfeiture allocation provisions cause some inconsistency in the way of character determination. This is because the character of the forfeiture allocations corresponds with the character of the partnership items in the year of forfeiture and not with the actual allocations to the forfeiting partner. In other words, if a partner were allocated items of long-term capital gain in a previous year but forfeits in a later year in which the partnership has long-term capital losses and ordinary deductions, the character of the forfeiture allocation will be a pro rata allocation of the latter. As such, "[t]he pro rata rule seems to place a premium on ease of administration and ease of taxpayer compliance," but is not designed to match the character of the forfeiting allocation to the character of the allocations giving rise to the forfeiture. Therefore, a practitioner will need to perform an analysis as to items of income, gain, loss, and deduction experienced by the partnership in the year of forfeiture, regardless of the character of the allocations to the partner in previous years. However, if a partner wants advice as to the tax affects of forfeiting his interest at the beginning of a year, a practitioner may find that predicting subsequent partnership items may simply be impossible. Also, where the client is not proactive in seeking advice pre-forfeiture, such a character analysis cannot even be attempted after forfeiture, and therefore the partner will be stuck with forfeiture allocations dependent upon the partnership items in that year.

89. I.R.S. Notice 2005-43, 2005-24 I.R.B. 1221, 1224 (June 13, 2005); BITTKER & LOKKEN, supra note 64, § 86.2.5.
90. See, e.g., Hariton, supra note 2, at 1334 ex. 14.
91. Id. at 1334.
As can be seen, when analyzing the proposed regulations and the proposed revenue procedure as they apply to the entrance of a service partner for a profits interest and the subsequent forfeiture of that interest, some level of certainty is gained at the cost of simplicity and consistency. First, the proposed method requires a taxpayer to make an I.R.C. § 83(b) election. This election is necessary for proper recognition of the service provider as a partner by virtue of holding the interest and in turn, will require the imposition of forfeiture allocations in the partnership agreement to ensure that allocations are deemed to be in accordance with the partner's interest in the partnership. Second, in order to ensure a zero-dollar valuation where the § 83(b) election is made, rather than relying on the fact that an income only interest is too speculative and embracing a potential battle of the experts, the proposed regulations provide for a safe-harbor-liquidation method of valuation. This election is available if the partnership prepares a complying document that is legally binding on all the partners and retains necessary records indicating the ongoing effectiveness of the safe harbor. However, while certainty is achieved in the form of a zero-dollar valuation, the proposed method heightens a taxpayer's affirmative duties by requiring: (1) the § 83(b) election within a very short thirty-day window, (2) the drafting of a legally binding document, (3) the institution of appropriate record keeping, and (4) the institution of a forfeiture allocation provision in the partnership agreement. Moreover, the potential for inconsistency exists where a partnership lacks the ability to cover forfeiture allocations—especially if items of income were previously allocated to a partner—and where a partner forfeits allocations that differ in character from partnership items experienced in the year of forfeiture.

Given the foregoing, it is imperative that a practitioner understand how the proposed methods change the current state of the law and what may be required of a practitioner who is advising a client in such a situation. From this perspective, it might be helpful if the Treasury Department and the IRS would clarify the intended result in the event a profits interest is received for services and the liquidation safe harbor method is not complied with. Is a zero-dollar valuation ensured because the interest is too speculative? Will a partner be susceptible to an IRS challenge that a profits interest has a determinable and taxable fair market value? Moreover, it may be helpful to extend the window for the § 83(b) election where a partner faces the harsh result of being treated as an employee or an independent contractor.

Clarification is also needed with regard to forfeiture allocations—namely, whether § 83(b) disallows deductions in the case of a forfeited interest where forfeiture allocations cannot cover previously allocated items of income. Further, to provide certainty, it is advisable that the
Treasury Department establish a method whereby forfeiture allocations correspond to the character of previously allocated items provided that such character is readily determinable. This way a forfeiting partner will know the character of potential forfeiture allocations prior to a determination of the partnership items in the year of forfeiture.

Ultimately, whether the proposed method is an improvement over the method prescribed by Revenue Procedure 93-27 and Revenue Procedure 2001-43 is unclear. Where the application of § 83 was once relatively ambiguous, the attempt to resolve such ambiguity appears to decrease simplicity and consistency. However, if the clarifications noted above are made, perhaps the proposed method will amount to a commendable improvement in the context of service partnership profits interests over Revenue Procedure 93-27 and Revenue Procedure 2001-43.

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