IRS Issues Guidance Regarding Unvested Partnership Profits Interests Issued in Exchange for Services

On August 2, 2001 the IRS issued Rev. Proc. 2001-43, addressing for the first time the tax consequences to partnerships and partners when the partnership issues an unvested profits interest to a service partner.

Background
Partnerships (including LLCs taxed as partnerships) frequently grant interests in future partnership profits to employees or other service providers. The tax treatment of such a grant was, for many years, the subject of conflicting case law and therefore uncertain.

In 1993 the IRS issued Rev. Proc. 93-27, announcing that the IRS would treat the grant by a partnership of a qualifying partnership “profits interest” to a person providing services in a partner capacity (or in anticipation of becoming a partner) to or for the benefit of that partnership as a non-taxable event for both the partner and the partnership. Rev. Proc. 93-27 defines “profits interest” as an interest that would not provide the partner with a right to a share of the proceeds if the partnership was immediately liquidated (rather, the interest must be merely a right to participate in future profits or future appreciation in the partnership’s assets or business). Moreover, the revenue procedure specifically excludes situations where the profits interest relates to a substantially certain and predictable income stream, such as income from high quality debt securities or high quality net leases. Also excluded are profits interests where the partner disposes of the interest within two years of receipt, or where the profits interest is a limited partnership interest in a publicly traded partnership, as defined in the Internal Revenue Code.

Rev. Proc. 93-27 provided much needed guidance, but left open the question of how to treat an unvested profits interest. Specifically, it was unclear whether an unvested profits interest was considered a “property” right, such that the recipient partner could make a Section 83(b) election. If a Section 83(b) election could not be made, the later vesting of the interest, at a time when the interest holder would be entitled to a distribution if the partnership was liquidated, could be treated as a compensatory “capital shift” resulting in significant compensation income for the service partner. Such a capital shift could also be an income recognition
event for the partnership. To minimize these risks, most taxpayers who received unvested partnership interests made “protective” Section 83(b) elections, and took the value of the profits interest (typically zero, based on Rev. Proc. 93-27) into taxable income in the year of receipt.

**Rev. Proc. 2001-43**

On August 2, 2001, the IRS issued Rev. Proc. 2001-43, clarifying that Rev. Proc. 93-27 also applies to unvested profits interests. Under Rev. Proc. 2001-43, where a partnership grants a profits interest in the partnership that is substantially nonvested, the service provider will be treated as receiving the interest on the date of grant (in a non-taxable transaction under Rev. Proc. 93-27) provided that:

- the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant;
- the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing his or her income tax liability for the entire period during which he or she has the interest;
- upon the grant of the interest, or at the time the interest vests, 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
- the requirements of Rev. Proc. 93-27 are satisfied.

Significantly, Rev. Proc. 2001-43 provides that taxpayers to which the revenue procedure applies need not file an election under Section 83(b).

It is noteworthy that one of the requirements of the revenue procedure is that the partner and the partnership must treat the service partner as a partner on the date of grant. Therefore, the service partner cannot be treated as an employee of the partnership. As a result, the partner will no longer receive a Form W-2 (rather than earning a “salary” partners instead earn “guaranteed payments”), they will no longer be eligible for certain types of fringe benefits, and they will be subject to the self-employment tax, rather than the FICA tax.

Depending on the facts, to ensure partner treatment, it may be advisable for the partner to make a material capital contribution to the partnership, and to share in partnership loss.

**Unanswered Questions Remain**

Rev. Proc. 2001-43 provides much needed guidance with respect to unvested profits interests, but it raises some questions as well.

**Is the Revenue Procedure retroactive?**

The revenue procedure does not contain an effective date. Nevertheless, the revenue procedure states that it is a clarification of Rev. Proc. 93-27. As such, it should apply retroactively. Taxpayers who received profits interests for services after the issuance of Rev. Proc. 93-27 and in situations that are described in Rev. Proc. 2001-43 have a strong basis for asserting that the new revenue procedure should apply to them, but the answer to this question is not entirely clear.

**What happens if the Revenue Procedure does not apply?**

The revenue procedure only applies if each of its specified requirements is satisfied. What is the result if, for example, the partnership and the partner do not consistently treat the partner as the owner of the partnership interest from the date of grant? Or if the partnership or its partners deduct the fair market value of the profits interest given to the service partner?

The partner and the partnership may find it desirable to obtain written assurances from the other that consistent treatment will be applied, in order to avoid losing the applicability of the revenue procedure. As discussed below, taxpayers who are uncertain whether all of the requirements of the revenue procedure will be satisfied
may wish to make a “protective” Section 83(b) election (although it is uncertain whether such an election would be effective).

**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. If Section 83 applies, the partnership would not recognize income (assuming it took no deduction at the time of grant) nor would the employee be entitled to a deduction.

**Should a protective Section 83(b) election be made?**

Taxpayers who are uncertain whether all of the requirements of Rev. Proc. 2001-43 are satisfied should consider making a protective election under Section 83(b), as should taxpayers whose income is subject to tax in a state that does not follow Rev. Proc. 2001-43. As discussed above, it is uncertain whether Code Section 83 applies to the grant of an unvested profits interest. Nevertheless, as was the case prior to the release of Rev. Proc. 2001-43, a Section 83(b) election may be advisable in situations where the revenue procedure may be inapplicable.
If you have any questions about this Client Alert, please contact David Raab in our New York office, or any of the attorneys listed at the right.