

# Tax Consequences Of The Issuance Of Options To Acquire Partnership Interests For Services — The Compensatory Quagmire

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**This is another in a continuing series of articles written by members of the ABA Tax Section in which a member of the section teams up with a member from the section's Young Lawyers Forum.**

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**IN MAY 2005**, the Treasury Department issued proposed treasury regulations (the "Proposed Regulations") and a proposed revenue procedure (the "Proposed Revenue Procedure" and, collectively with the Proposed Regulations, the "Proposed Authorities") that provide rules governing compensatory partnership interests. REG-105346-03 (May 24, 2005), 70 Fed. Reg. 29675; Notice 2005-43, 2005-1 C.B. 1221. Before then, the tax consequences of compensatory partnership interests and partnership op-

tions had been unclear. When determining these tax consequences, tax practitioners generally used a combination of general federal income tax principles, rules under section 83 and subchapter K, and common sense. (All section references are to the Internal Revenue Code of 1986, as amended.) At first glance the Proposed Authorities seem to answer the questions related to compensatory partnership interests but, as pointed out by some commentators, further guidance is needed. *See, e.g.,* Winston W. Chang, *Comments on Proposed Partnership Equity Compensation Regulations*, Doc 2006-11829, 2006 TNT 133-56 (hereinafter, “Chang”); Richard R. Upton, *Proposed Regs, Rev. Proc. On Transfers of Partnership Equity Interests for Services: Did the IRS Get it Right?*, Doc 2005-21776, 2005 TNT 215-33 (hereinafter “Upton”); Martin J. McMahon, Jr.; *Recognition of Gain by a Partnership Issuing an Equity Interest For Services: The Proposed Regulations Get it Wrong*, Doc 2005-23275, 2005 TNT 228-18 (hereinafter “McMahon, Jr.”); Lee A. Sheppard, *News Analysis: Massive Giveaway in Partnership Compensatory Options Regs*, Doc 2005-12910, 2005 TNT 118-9; Dennis B. Drapkin, *ABA Taxation Section Comments on Exchanges of Partnership Equity for Services*, Doc 2006-65, 2006 TNT 1-34 (hereinafter “ABA Report”).

This article focuses on the tax issues related to the transfer of compensatory partnership options and, if the Proposed Authorities become finalized in their current form, describes the tax consequences that may apply to such options. (The Proposed Authorities are not effective until the final regulations are published in the Federal Register (the “Final Authorities”), which may occur during the IRS’s 2009 business plan year. *See* Jeremiah Coder, *Some Partnership Guidance to be Pushed to Next Business Plan Year, Official Says*, Doc 2008-8557, 2008 TNT 75-3.) Since compensatory partnership options are only one form of contingent partnership interests, which also include unvested capital interests and unvested profits interests, some of the tax issues discussed be-

low may also apply to contingent partnership interests other than options.

## **I. WHY COMPENSATORY PARTNERSHIP OPTIONS?**

• The first question to consider is whether a partnership option is the appropriate form of compensation for your client. Option holders usually benefit from an increase in value of the partnership assets above the strike price and, upon exercise, they become members of the partnership. Profits interests are economically similar to partnership options in that they also create a compensatory benefit equal to an increase in partnership value from the date of grant while providing the service provider with an opportunity to become a member of the partnership. Moreover, the grant of both partnership options and profits interests are treated as nontaxable events under current law. (For profits interests, see Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191.) However, the differences between profits interests and partnership options may influence your client to choose one form of equity over the other.

### **Options vs. Interests**

Under current law, the holder of a profits interest is treated as a partner of the partnership from the date of transfer (provided the profits interest is vested), whereas holders of partnership options are not treated as partners until the exercise of their options. Accordingly, a partnership may grant partnership options as opposed to a profits interest if it wants to preserve the service provider’s status as an employee. Partnership options and profits interests also differ with respect to taxable gains and losses. The recipient of a profits interest recognizes partnership gains and losses from the date of grant, but the holder of a partnership option does not participate in partnership gains and losses until the date of exercise. Although the delay of income recognition by an option holder seems to be more desirable, the option holder, unlike the holder of a vested prof-

its interest (or, under the Proposed Authorities, an unvested profits interest subject to a section 83(b) election), would treat the increase of the partnership interest received above the strike price as compensation for services, subject to ordinary income tax rates and employment taxes.

In addition to these tax differences, a partnership may grant a profits interest as opposed to a partnership option for administrative purposes. For example, to preserve any built-in gain or losses, the partnership only needs to book up its capital accounts once for profits interests, which is at the time of grant, as opposed to each time an option is exercised. Also, since the tax consequences of a profits interest are (slightly) more settled than the those of a partnership option, administrative reporting and record-keeping is easier for profits interests. Nonetheless, a client may still choose to award partnership options as compensation. If a client decides to grant partnership options, the following issues should be addressed.

**II. SECTION 83 VS. SUBCHAPTER K** • Under current law, compensatory partnership options are probably subject to section 83, which generally applies to all transfers of property in connection with the performance of services. Treas. Reg. §§1.61-2(d)(6), 1.83-8(b)(1). Although partnership options (and partnership interests) are not currently included in the section 83 definition of “property” (Treas. Reg. §1.83-3), in *Schulman v. Commissioner*, 93 T.C. 623 (1989), the Tax Court held that section 83 applies to the grant and exercise of compensatory partnership options. Assuming partnership options are taxable under section 83, they would not be taxable on the date of transfer because they generally would not have a “reasonably ascertainable fair market value.” Rather, they would be taxable upon exercise.

Despite the Tax Court’s ruling in *Schulman*, the Proposed Regulations do not specifically include compensatory partnership options in the section 83 definition of “property.” The Proposed Regulations

revise section 83 to apply to transfers of compensatory partnership interests by expanding its definition of “property” to include compensatory partnership interests. Based on the proposed definition of a “compensatory partnership interest,” which includes the transfer of such interest on the exercise of a compensatory partnership option, it appears that compensatory partnership options may be treated separately from compensatory partnership interests. The exclusion of compensatory partnership options from section 83, however, would be inconsistent with current section 83 principles, which apply to nonstatutory stock options with readily ascertainable fair market values on the date of grant. Treas. Reg. §1.83-7. In response to this exclusion, some commentators recommend that section 83 should also apply to compensatory partnership options in the Final Authorities. See the ABA Report, p. 5.

Since section 83 only addresses the compensatory element of such options, practitioners must also apply the rules under subchapter K to determine the partnership tax consequences. The rules of section 83 and subchapter K, however, often conflict or are simply silent on tax principles used by the other. For example, under section 83, a service recipient may deduct compensation paid to a service provider when the compensation is included in her income. §83(h). In the partnership context, where deductions are allocated to members, it is not clear whether the compensation deduction should occur immediately before the taxable event, and therefore be allocated to the historic partners, or immediately after the taxable event, and shared with the new partner. Section 83 also does not address whether the transfer of a compensatory partnership interest creates recognizable income for the partnership transferring the interest under section 721 or whether the partnership transferring the interest must be the service recipient. See Lee A. Sheppard, *IRS’s Maloy Discusses Partnership Compensatory Options Regs*, Doc 2006-10568, 2006 TNT 106-3. Heather

Maloy, IRS associate chief counsel (passthroughs and special industries), has indicated that the government is considering extending the rules of the proposed regulations to transfers by related entities. Furthermore, the fair market value of a service provider's compensatory partnership interest under section 83 (which takes into account minority and liquidity discounts) may conflict with the liquidation value of such property under subchapter K and the IRS guidance issued thereunder. Chang, *supra*. The Proposed Authorities attempt to clarify these issues.

### **Proposed Authorities On Compensatory Partnership Interests**

The Proposed Authorities incorporate principles from both section 83 and subchapter K for purposes of taxing compensatory partnership interests. First, section 83 generally takes precedence over subchapter K with respect to the timing of income inclusion and deductions. Therefore, the historic partners will receive a deduction for the income included in the service provider's income. Also, the Proposed Regulations preclude a partnership gain or loss upon the transfer of compensatory partnership interests in exchange for services under section 721. Prop. Treas. Reg. §1.721-1(b)(3); *See* McMahan, Jr., *supra* (arguing that partnerships should not be allowed a deduction for the transfer of a compensatory partnership interest when such interest is not a taxable event to the partnership). Moreover, if a liquidation value election is made under the Proposed Revenue Procedure, valuation is determined under the same principles provided by the IRS authorities for determining the value of profits interests. *See* Rev. Proc. 93-27 and Rev. Proc. 2001-43. Accordingly, if the Proposed Authorities are finalized, the tax consequences of compensatory partnership interests will be governed by section 83 and subchapter K and the IRS guidance and case law thereunder.

### **III. TIMING OF INCOME INCLUSION AND PARTNERSHIP DEDUCTION** • Under sec-

tion 83, service providers must recognize ordinary income equal to the fair market value of property transferred in connection with services when the property is transferable or is not subject to a substantial risk of forfeiture. However, under section 83(b), a recipient of restricted property may elect to accelerate income inclusion to the date of grant as opposed to the date when the property becomes transferable or is no longer subject to a substantial risk of forfeiture. The benefit of accelerating income inclusion is that any increase in the value of the compensatory property after the date of grant is not treated as ordinary income but is treated as capital gains.

A service provider's income inclusion for non-statutory options under section 83 occurs either upon grant, provided such options have a readily ascertainable fair market value, or upon exercise or other disposition. Treas. Reg. §1.83-7(a). An option has a readily ascertainable fair market value if it is actively traded on an established securities market, or transferable by the holder and immediately exercisable for unrestricted property. Assuming section 83 applies to partnership options, such options will seldom be taxable upon grant because most partnerships are not publicly traded. Rather, section 83 will apply to the partnership interest transferred upon exercise of partnership options.

### **Who Gets The Deduction?**

According to the Proposed Regulations (Prop. Treas. Reg. §§1.83-6(b) and 1.721-1(b)(2)), the partnership issuing a compensatory partnership interest will not recognize gain upon the transfer or substantial vesting of such interest, but it will receive a deduction equal to the amount of compensation income that the service provider recognizes as income. Code §83(h). *See* McMahan, Jr., *supra* (discussion criticizing that partnerships do not recognize gain or loss on the transfer of compensatory partnership interests but are allowed a deduction; suggesting that the transfer must either be a rec-

ognition event or the deduction is limited to a pro rata portion of partnership's aggregate basis of its assets). Under current law, however, it is not clear how a partnership's compensation deduction is allocated. Section 83 allows a deduction for the "person for whom were performed the services," which seems to imply that only the partners of the partnership are entitled to the deduction. According to the preamble to the Proposed Regulations, however, the partnership's deduction for compensatory partnership interests is allocated to the historic partners only. §706(d)(1). Although the Proposed Authorities do not specifically address a partnership's deduction of compensatory partnership options, a similar rule would probably apply.

#### **IV. VALUATION OF COMPENSATORY PARTNERSHIP OPTIONS**

• Provided the compensatory partnership options do not have a readily ascertainable fair market value upon grant, the amount of compensation included in the service provider's income (and the partnership's corresponding deduction) under section 83 equals the fair market value of the partnership interest received upon exercise of the option less the exercise price. Alternatively, the Proposed Authorities allow the partnership and the service provider to elect to value the compensatory partnership interest using its liquidation value. The liquidation value equals the amount that the service provider would receive if, immediately after the transfer, the partnership sold its assets for fair market value and liquidated. As a condition to making the liquidation value election, the partnership and its members must agree in a legally binding document, such as the partnership agreement, to comply with the terms of the election. The liquidation value election is not available if the value of the compensatory partnership interest is obvious (such as interests that are related to a substantial stream of income, transferred in anticipation of a subsequent disposition, or publicly traded).

Except for the procedural requirements of a liquidation value election, such election does not change the current law governing the valuation of profits interests. Since profits interests only share in the future profits and appreciation of the partnership, and not in the existing value of the partnership, their liquidation value is zero. It is not clear whether a partnership and a service provider may elect to use the liquidation value for compensatory partnership options. If the election is allowed, such value presumably would be similar to the liquidation value of a profits interest because option holders also share in the future appreciation of the partnership without immediately participating in the partnership assets.

#### **Outstanding Partnership Options**

The Proposed Authorities do not address how a liquidation value election would apply while compensatory partnership options are outstanding. (This issue may arise under section 83 and subchapter K when the partnership determines the fair market value of its assets for purposes of issuing additional partnership interests.) Unlike the Proposed Authorities, the Noncompensatory Proposed Regulations revalue the partnership assets to account for any outstanding non-compensatory options by subtracting the exercise price plus the liquidation value of the options from the value of the partnership assets. The Proposed Authorities, on the other hand, treat the obligation to issue compensatory partnership interests as a liability under section 752. A section 752 liability includes contingent obligations and options to the extent such obligations do not create or increase the basis of any asset or give rise to an immediate deduction or an expense. Although a section 752 liability may include compensatory partnership options, the section 752 regulations do not account for a liquidation value election. Under section 752, changes in section 752 liabilities cause a decrease or increase in an item of income or loss for purposes of capital account allocations under section 704(b).

The value of these adjustments under section 752 may differ from the liquidation value attributable to outstanding compensatory partnership options and other contingent interest. Accordingly, some commentators suggest that, if a partnership has an effective liquidation value election, the outstanding options should be valued using the liquidation value safe harbor. See ABA Report p. 4.

## **V. WHEN IS THE SERVICE PROVIDER TREATED AS A PARTNER OF THE PARTNERSHIP?**

• Under federal income tax principles, a service provider will generally not become a partner until the exercise of his or her compensatory partnership options. The Proposed Authorities do not indicate when a holder of a compensatory partnership option would be treated as a partner. However, the Proposed Authorities provide that the holder of a substantially nonvested partnership interest would not be treated as a partner solely by reason of holding such interest, unless the holder makes a section 83(b) election. Arguably, this same reasoning would apply to compensatory partnership options, which have a similar status to nonvested partnership interests, but other factors may cause the holder to be treated as partner.

For example, the Service could use the corporate tax principles that apply to “deep in the money” options to treat similar partnership options as ownership of the underlying partnership interest. (A “deep in the money” option is an option with a strike price significantly less than the fair market value of the underlying property on the date of grant. See *e.g.*, Rev. Rul. 82-150, 1982-2 C.B. 110.) One recommendation offered by the ABA Report to clarify when the holder of a compensatory option would be treated as a partner is to adopt rules similar to those set forth in the Treas. Reg. §1.1361-1(l)(4)(iii). Under these rules, the service provider holding a compensatory partnership option would not be treated as a partner unless, taking into account all of the facts and circumstances, the option is al-

most certain to be exercised and has a strike price substantially below the fair market value of the underlying partnership interest on the date the option is issued, transferred, or materially modified.

Although the Proposed Authorities do not specify when an option holder is treated as a partner, they provide that the anti-abuse rules of the Non-compensatory Proposed Regulations do not apply. The Noncompensatory Proposed Regulations treat an option holder as a partner if the owner has rights that are similar to those of a partnership member. Such treatment as a partner only applies if, at the time of issue, failure to treat the holder as a partner would result in a substantial reduction in the present value of the partners’ and option holder’s aggregate tax liabilities. According to the preamble of the Proposed Regulations, there is less likelihood of similar abuse for compensatory partnership options.

## **VI. CAPITAL ACCOUNTS AND PARTNERSHIP ALLOCATIONS**

• The holder of a partnership option may acquire a partnership interest, which is usually equal to a certain percentage of the partnership’s capital, for a specified price. The intent is to allow the option holder to share in the future appreciation of the partnership above the option exercise price. Partnerships may issue options to acquire capital interests and profits interests, although options to acquire capital interests are more common. Section 83 does not distinguish between partnership capital and profits interests.

Upon the exercise of an option, the service provider presumably would have a capital account balance equal to the exercise price. Immediately before the service provider exercises his or her option, the historic partners may elect to book up their capital accounts to preserve any pre-exercise appreciation in the partnership assets. (Treas. Reg. §1.704-1(b)(2)(iv)(f).) The book up creates a reverse section 704(c) item, which may reduce the value of the service provider’s partnership interest acquired. On the other hand, if a book up is not made, the

service provider shares in the tax consequences of any built-in gain (or losses). A more accurate adjustment to the partnership's capital accounts upon the exercise of an option would be a shift in a portion of the reverse section 704(c) gain (the amount equal to the appreciation of partnership assets above the option price) to the service provider. (This approach has been suggested for noncompensatory partnership options in the Noncompensatory Proposed Regulations.) However, the general federal income tax principles do not provide for such a remedy at this time.

### **What Is Credited To Service Provider's Capital Account?**

Under the Proposed Authorities, the service provider's capital account is credited with an amount equal to (1) the income the service provider recognizes under section 83 with respect to his or her partnership interest (which equals the fair market value of such partnership interest) plus (2) any amount he or she pays to acquire such partnership interest. If the partnership and the service provider make a liquidation value election, the amount credited to the service provider's capital is equal to the liquidation value of the interest received. Generally, the liquidation value (which should equal the service provider's percentage of partnership capital) more accurately reflects the economic deal between the partnership and the service provider as opposed to the fair market value under section 83.

### **Valuation Discrepancies**

Problems arise if a partnership does not make a liquidation value election. *See* Upton, *supra*. The service provider may be credited with a capital account balance of an amount less than his or her partnership interest. The ABA Report provides two recommendations to remedy the valuation discrepancies. First, the ABA Report suggests that the capital account credit should be based on the agreed-upon liquidation value and the section 83 income

amount should be determined based on the fair market value of the interest received. Alternatively, the ABA Report recommends that, after issuance of the partnership interests, the partnership should be allowed to revalue its assets so that the capital account of the service provider will reflect his or her right to share in the partnership capital similar to the reverse section 704(c) allocations provided in the Noncompensatory Proposed Regulations. *See also* Chang, *supra*.

The Proposed Authorities also address the economic effect of allocations of partnership income and loss to contingent partnership interests. According to the Proposed Authorities, the allocation of partnership income and losses to substantially unvested partnership interests do not have substantial economic effect. However, such allocations should comply with the requirements of section 704(b) if the forfeiture provisions (as discussed below) are adopted.

### **VII. FORFEITURES OF COMPENSATORY PARTNERSHIP OPTIONS**

• The lapse of compensatory partnership options is not a taxable event because, with the exception of options subject to section 83, there are no tax consequences on the date of grant. Section 83 governs all other forfeitures. If a service provider makes a section 83(b) election for a compensatory partnership option (provided the option has a readily ascertainable fair market value at the time of grant) or other contingent partnership interest, the service provider is probably precluded from taking a loss with respect to the amount previously included in income. §83(b)(1). The ABA Report, however, recommends that the service provider should be able to take a deduction with respect to any basis in the forfeited partnership interest that was not included in income at the time of grant.

The Proposed Authorities address the tax consequences of any partnership allocations the service provider may have received with respect to his or her contingent partnership interest from the date of

grant until the date of forfeiture. As stated above, the Proposed Authorities provide that allocations of partnership items cannot have economic effect while the service provider's partnership interest is substantially nonvested. However, such allocations will be treated as complying with section 704(b) if the partnership agreement provides for certain forfeiture allocations and all material allocations and capital account adjustments not pertaining to the contingent partnership interest are recognized under section 704(b). This is accomplished by allocating partnership items to the service provider that offset prior distributions and allocations with respect to the forfeited partnership interest. Although the Proposed Authorities are silent on the tax consequences to the historic partners upon a forfeiture, the ABA Report recommends that such partners should not recognize any income due to any loss claimed by the service provider as a result of prior allocations of income and gain. The forfeiture allocations only apply to contingent partnership interests, but the same principles may apply to compensatory partnership options if the option holder received any distributions or allocations with respect to such options.

**VIII. CHARACTERIZATION, EMPLOYMENT TAXES, AND REPORTING** • If compensatory partnership options are governed by section 83, the service provider may recognize ordinary income on the exercise of the option provided the service provider did not make a section 83(b) election (if such election was available) and the service provider receives an unrestricted capital interest. (If the service provider receives a restricted partnership interest, the service provider will probably be taxed under section 83 and as provided under the Proposed Authorities (if such authorities become effective).) The service provider's compensation income is subject to payroll and income tax withholdings at this time.

According to the Proposed Authorities, it is expected that if a substantially vested compensa-

tory partnership interest is transferred to a service provider or a section 83(b) election is made with respect to the transfer, the partnership will report the transfer on Form W-2 or Form 1099-MISC, as appropriate. There should also be a similar expectation of reporting for the exercise of compensatory partnership options. The Form W-2 or Form 1099-MISC should be issued to the service provider by the partnership by January 31 of the year following the calendar year in which the partnership interest is transferred.

**IX. SECTION 409A** • Compensatory partnership options are subject to section 409A, but they may be eligible for an exemption from the requirements imposed by such section. Section 409A imposes four general requirements that relate to (1) the initial deferral election, (2) the timing of payments, (3) acceleration of payments, and (4) later deferral elections on compensation plans or other arrangements that provide for deferred compensation. Such plans must satisfy these requirements in order to avoid potentially significant penalties, including additional tax and interest. (This includes a 20 percent penalty and interest at a rate one percentage point higher than the interest rate on tax underpayments.)

Under an exception to section 409A, that section does not apply to nonstatutory stock options not providing for the deferral of compensation. Treas. Reg. §1.409A-1(b)(5). Nonstatutory stock options generally do not provide for the deferral of compensation if the exercise price of such options is never less than the fair market value of the underlying stock on the date of grant and there is no other deferral of compensation.

#### **Treatment Like Stock**

Notice 2005-1, 2005-1 C.B. 274, and the preamble to the proposed regulations under section 409A, Reg. 158080-04 (Oct. 4, 2005), provide that partnership interests and partnership options granted in connection with performance of services are

governed under the same principles that govern the issuance of stock. Until further guidance is issued, this rule continues to apply. See section III.G of the preamble to the final section 409A regulations, T.D. 9321 (April 17, 2007). Accordingly, compensatory partnership options may be exempted from section 409A if they are issued with an exercise price equal to full fair market value of the underlying partnership interest on the date of grant without an additional deferral. The availability of this exemption depends on determining the fair market value of the issuing partnership's assets.

The treasury regulations under section 409A provide guidance on how to determine "fair market value" for purposes of this exemption. This determination is often difficult for partnerships because they do not have a public market with significant trading among independent parties. Rather, the fair market value of a partnership is usually determined relying on a more vague standard, which is a "reasonable application of a reasonable valuation method." Although section 409A provides safe harbor valuation methods, these methods may be too costly for the partnership (e.g., an independent appraisal) or do not apply. The section 409A valuation methods are beyond the scope of this article but, when issuing compensatory partnership options, it is important for practitioners to review the section

409A valuation methods with their clients in an effort to fall within an exemption from section 409A. Otherwise, the partnership issuing the options must comply with the requirements imposed by section 409A.

**X. CONCLUSION** • Compensatory partnership options and contingent partnership interests may often be a desirable form of compensation to issue to service providers. However, the tax consequences of such equity are uncertain. Because of ambiguous case law, poorly drafted statutes, and the lack of IRS guidance, practitioners are often on their own to determine the tax consequences of compensatory partnership options and contingent partnership interests. The Proposed Authorities are offered as a guide to determining these tax consequences; however, they fall short. Although this article discusses the current and proposed tax consequences of compensatory partnership options and other contingent partnership interests, the purpose of this article is to use that discussion to highlight certain issues that should be considered in this area. The Final Authorities, it is hoped, will address many (if not all) of these issues but, if they do not, you may need to review this list before advising your clients to issue compensatory partnership options and other contingent partnership interests.

### **PRACTICE CHECKLIST FOR Tax Consequences Of The Issuance Of Options To Acquire Partnership Interests For Service--The Compensatory Quagmire**

What are the tax issues surrounding compensatory partnership options?

- Why issue them in the first place?
- Does section 83 apply, or subchapter K—or both?
- Timing of income inclusion and partnership deduction.
- How to value compensatory partnership options?
- When is the service provider treated as a partner of the partnership?
- Effect of exercise of the partnership option on capital accounts and partnership allocations.
- Forfeitures of compensatory partnership options.
- How are the interests characterized, and what are the tax effects?