THE PARTNER'S PERSPECTIVE by ***Charles R. Levun, Esq.***

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Issues to Consider Regarding Code Sec. 83(b) Elections

To make or not to make a Code Sec. 83(b) election—that is the question. In May, 2005, Treasury issued proposed regulations and Notice 2005-43, 2005-24 IRB 1221 (which describes the contents of a revenue procedure that will be issued when the proposed regulations are finalized) that provide a new regime for the taxation of compensatory partnership interests. What the guidance proposes to do is to eliminate the present landscape of authority that is in the form of revenue procedures (Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191), which currently sets forth the position the IRS will take with respect to certain enumerated transactions, and to make all compensatory partnership interests, whether capital interests or profits interests, subject to Code Sec. 83. (The proposed guidance is discussed in detail in the Partner's Perspectives at ¶9697 and ¶9703.) There remain several difficult questions to resolve under the proposed guidance, and it is unclear when the new regime will be finalized. Until then, the revenue procedures still rule the day for the taxation of compensatory profits interests.

A question that constantly arises under the present regime is whether a Code Sec. 83(b) election should be made when a restricted profits interest is provided to the partnership service provider. Why the confusion? This month's Partner's Perspective will analyze the question and provide its recommended answer.

Where We Are Today

Code Sec. 83 sets forth the tax consequences of the transfer of property to one person from another in connection with the performance of services. In general, under Code Sec. 83(a), the receipt of such property is taxed as ordinary income at the earlier to occur of when the property is transferable or is not subject to a substantial risk of forfeiture, to the extent of the excess of the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount paid for the property. However, pursuant to Code Sec. 83(b), a taxpayer may accelerate the time of taxation of "restricted" property to the date of its receipt by filing an election to do so no later than 30 days after the receipt of the property. Until such time as the recipient of the property becomes subject to tax, the transferor is considered to be the owner of the property. Reg. §1.83-1(a)(1). At such time as the recipient is subject to tax, the transferor generally is entitled to a corresponding deduction (subject to potential capitalization in certain circumstances). If the property is subsequently forfeited, Code Sec. 83(b)(1) provides that "no deduction shall be allowed [to the recipient] in respect of such forfeiture."

There had been much confusion as to the application of Code Sec. 83 to partnerships, particularly in the case of a partnership profits interest—a topic that has been subject to substantial rhetoric over the years and beyond the scope of this column. However, the IRS had largely put many of the issues to bed by the issuance of Rev. Procs. 93-27 and 2001-43. Very generally, Rev. Proc. 93-27 provides that the IRS will take the position that the receipt of a profits interest is non-taxable and there is no partnership deduction in connection with the issuance. There are three exceptions to non-taxability:

1. If the profits interest relates 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;

2. If within two years of receipt, the partner disposes of the profits interest; or

3. If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code Sec. 7704(b).

Rev. Proc. 2001-43 embellishes on Rev. Proc. 93-27 by providing that even if the profits interest is subject to a substantial risk of forfeiture, the principles contained in Rev. Proc. 93-27 continue to apply, so long as the partnership and the service provider treat the service provider as the owner of the partnership interest from the date the profits interest is acquired (and no deduction is taken for the fair market value of the interest). In this regard, Rev. Proc. 2001-43 provides that a Code Sec. 83(b) election need not be made for such a restricted profits interest. While these revenue procedures do not address the tax consequences of the transfer of a capital interest, there is little disagreement that the provisions of Code Sec. 83 apply to such an interest.

Rev. Proc. 93-27 distinguishes between a capital interest and a profits interest by using a liquidation approach to value, not by determining whether a partnership interest has any fair market value. In many instances, the right to a "free ride" by sharing in income and/or growth in the value of a business without making any payment has value. Nevertheless, the IRS took a pragmatic approach and determined that a more administratively convenient approach would be to tax a service recipient only if the recipient would share in the proceeds of liquidation if all partnership assets were sold at fair market value at the time the partnership interest was received. However, note that fair market value generally is not liquidation value and liquidation value is not a valuation standard used in the Code.

When finalized, the new guidance would make Rev. Procs. 93-27 and 2001-43 obsolete, and Code Sec. 83 would apply equally to both profits and capital interests (using the liquidation approach to value, if elected and if eligible). Accordingly, if any type of partnership interest is transferred in connection with the performance of services, the service provider is not subject to tax until the interest is transferable or no longer subject to a substantial risk of forfeiture, unless a Code Sec. 83(b) election is made. This means that Code Sec. 83(b) elections will be required for restricted profits interests. However, as stated above, until the guidance is finalized, Rev. Proc. 2001-43 provides that such an election is not required. So, should tax professionals accept the IRS invitation not to file a Code Sec. 83(b) election for a restricted profits interest or should an election be made?

Why to File the Code Sec. 83(b) Election

At the outset, it is worthwhile noting that some tax professionals take the view that if the IRS says a Code Sec. 83(b) election is not necessary for a restricted profits interest, then why file one—it only raises an unnecessary risk of audit. This author has for years been surveying attendees at the Annual Partnership, LLC & S Corporation Tax Planning Forums and "Back to Basics" Seminars and there has yet to be a single attendee who has been involved in a Code Sec. 83(b) audit. Speculation is that Code Sec. 83(b) elections are being filed in the warehouse next to the box from the Raiders of the Lost Ark. Therefore, audit risk probably is not a significant reason not to file a Code Sec. 83(b) election. But, is an election worth the bother and the professional fees (albeit, generally minimal)?

This author believes the answer is yes for two reasons. The first reason relates to a valuation risk. The predicate for non-taxability is that the taxpayer has received a profits interest. If the taxpayer has received a restricted capital interest and a Code Sec. 83(b) election is not made, the taxpayer is not a partner and the interest becomes taxable at its then fair market value at such time as the risk of forfeiture lapses. Therefore, it becomes critical that under the liquidation approach to value the taxpayer receiving the partnership interest would not receive anything, if the partnership liquidated as of the date of receipt of the interest.

Let's consider the following example. Margaret and Sean are equal owners of an LLC, and decide to admit their right-hand man, Alex, in exchange for a restricted 10% profits interest. An appraiser values the assets of the LLC at $1,000,000, and, based on this appraisal, the capital accounts of Margaret and Sean are adjusted accordingly. The LLC's operating agreement also provides that operating cash flow is to be distributed 45% to each of Margaret and Sean and 10% to Alex, and that on a sale or refinancing of the LLC, Margaret and Sean are to receive the first $1,000,000 of proceeds and any remaining proceeds are to be distributed 45% to each of Margaret and Sean and 10% to Alex—a classic form (but not the only form) of a profits interest. Five years later, the LLC is sold for $5,000,000 (at a time when the LLC assets have no basis), with Margaret and Sean receiving $4,600,000 ($1,000,000 liquidation preference plus 90% of the $4,000,000 excess) and Alex receiving $400,000.

For some reason, assume the IRS audits the sale transaction and, as part of the audit, asserts that the LLC had a value of $1,100,000 at the time Alex received his membership interest. If this assertion is correct, that would mean that Alex received a capital interest having a value (without applying valuation discounts) of $10,000 (i.e., 10% of the $100,000 excess of the value of the LLC over Margaret and Sean's liquidation preference). However, Alex never made a Code Sec. 83(b) election, meaning that there is a risk that Alex's $400,000 share of the gain on sale would be taxable as ordinary income, rather than capital gain. This potentially would be the result, because by not making a Code Sec. 83(b) election within 30 days of receipt of the interest, Alex would not be considered to be a partner and his allocation of gain would be considered compensation rather than an allocation of partnership gain. Of course, Margaret and Sean would have a corresponding deduction, but that doesn't do Alex any good, unless they decided to magnanimously pay Alex a bonus equal to their unexpected tax benefits (which would have the effect of making Alex, Margaret and Sean "flat" from a tax and economic perspective, if everyone is in the same income tax bracket).

Alex does have a potential defense to any such IRS assertion. Reg. §1.704-1(b)(2)(iv)(*f*) permits (but does not require) a partnership to revalue its assets at a time when a more than *de minimis* partnership interest is provided to a service provider. If revaluation occurs, Reg. §1.704-1(b)(2)(iv)(*h*) provides that for purposes of determining whether the capital account maintenance rules of the Code Sec. 704(b) regulations have been satisfied, the amount to which assets are revalued will be presumed to be correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations and (2) the partners have sufficiently adverse interests.

Alex could assert that these revaluation concepts should apply to the determination of whether he received a profits interest or a capital interest. However, this approach is only an assertion, and has several potential flaws. First, the language of the revaluation regulation only refers to the capital account maintenance rules under Code Sec. 704b) and makes no reference to Code Sec. 83 determinations. Second, a determination has to be made that the partners have sufficiently adverse interests for the presumption to apply (although the partners, if not related to each other, generally should be considered adverse). Third, the rule is only a presumption, not an iron-clad rule. Fourth, in some circumstances (although not under this example), a profits interest can be issued by providing for a priority allocation of profits on liquidation, rather than by revaluing capital accounts; if such were the case, the valuation presumption would not be applicable.

Alex might also assert that he received two interests—(1) a \$10,000 capital interest and (2) a profits interest—and that on sale he should be subject to tax on the \$10,000 capital interest and should be treated as a partner from the get-go on the profits interest. The problem with this argument is that there does not appear to be any authority for this type of bifurcation. (In fact, of potential relevance is that the Code Sec. 704(b) regulations generally provide that a taxpayer holding two partnership interests in a partnership is considered to have one partnership interest for allocation purposes.) Moreover, even if bifurcation were permitted, why would all the value increase be ascribed only to the profits interest portion of Alex's LLC interest?

While there certainly are arguments to combat the valuation risks, why take the risk of not making the Code Sec. 83(b) election? The only apparent risk to a Code Sec. 83(b) election would be an IRS assertion, in the unlikely event of an audit of the election, that the liquidation approach to value cannot be used in valuing the restricted partnership interest or that the valuation was wrong. In light of Treasury's proposed regulation that would apply the liquidation approach to value to Code Sec. 83(b) elections (if elected and eligible), the first of these risks would seem to be minimal. And the valuation risk can be managed by making a diligent and, where the dollars so warrant, professional analysis of the LLC's value.

In addition to attempting to eliminate any valuation risk, another reason to make a Code Sec. 83(b) election is to eliminate a potential problem if the LLC is sold within two years of the transfer to the service provider of the LLC interest. Recall that Rev. Proc. is conditioned on no disposition of the partnership interest within two years of receipt of the interest. Assume, for example, that the LLC is the above example sells its assets and liquidates within two years of Alex receiving his restricted membership interest. Because of this disposition, Alex does not fall within the protection of Rev. Proc. 93-27, which means that because a Code Sec. 83(b) election was not made at the time of receipt of the interest, Alex may not be considered a partner and his allocable share of the gain from sale would be taxed as compensation.

In such a circumstance, one wonders whether the IRS would be receptive to an argument that because Alex did not control the disposition of his membership interest, he should still receive Rev. Proc. 93-27 protection. In this regard, the new proposed guidance slightly alters the two-year rule by providing that the liquidation approach to value is not available if a partnership interest is provided to a service provider in anticipation of a subsequent disposition, and that a subsequent disposition is presumed to violate this two-year rule if the disposition occurs within two years of receipt. However, the presumption can be rebutted. This new proposed guidance suggests that the IRS might not apply the "two-year rule" to an unanticipated disposition; however, there is nothing in Rev. Proc. 93-27 that provides any rebuttable presumption. Consequently, discretion suggests that a Code Sec. 83(b) election be made because one cannot predict the future.

The bottom line—because of the valuation risk and the two-year disposition risk, the benefits of a Code Sec. 83(b) election in connection with the receipt of a restricted profits interest would appear to greatly outweigh any detriments. And in any event, tax professionals might as well start getting into the habit of recommending Code Sec. 83(b) elections to their clients in profits interests transactions for when there no longer will be a choice.