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Client Alert

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IRS Issues Proposed Guidance on Compensatory Partnership Interests — New Rules Will Affect Tax Treatment of Carried Interest

Overview of the Proposed Rules

On May 20, 2005, the IRS proposed new rules regarding the tax treatment of partnership interests that are issued in connection with the performance of services. When finalized, these new rules will affect the taxation of investment fund managers who receive "carried interests" in the profits of those investment funds.

The proposed rules, set forth in Notice 2005-43 and proposed regulations, provide a framework for determining the timing and amount of taxable income and deduction resulting from the issuance, vesting and forfeiture of compensatory partnership interests and compensatory options.

The proposed rules differ from existing tax rules applicable to compensatory partnership interests. The framework, however, is consistent with the tax treatment applicable to other compensatory transfers of property, such as restricted stock. The proposed rules address, among other things, the following topics:

- The status of the holder of an unvested partnership interest as a "partner" for tax purposes, and the effects of that status on the other partners of the partnership;

- Whether the issuance, vesting or forfeiture of a compensatory partnership interest results in gain or loss to a partnership or its partners; and

- A "safe harbor" for determining the fair market value of a compensatory partnership interest.

General Tax Treatment of Compensatory Transfers of Property — No Tax Until Property Vests Unless Election Made

In general, when property is transferred in connection with the performance of services, the "bargain element" (that is, the difference between the fair market value of property and the amount paid for such property) is taxable to the service provider in the year of the transfer as compensation income. Any subsequent gain or loss generally will be treated as capital gain or loss.

If, however, the property is subject to a "substantial risk of forfeiture" (*e.g.*, vesting restrictions), then the taxable event is delayed until those restrictions lapse. At that later time, the service provider will have taxable compensation income equal to the difference between the fair market value of the property at that time and the amount paid for it. Any subsequent gain or loss generally will be taxable as capital gain or loss. Thus, if the property appreciates in value between the date of transfer and the date that the restriction lapses, the bargain element (and the amount of compensation income) will be greater than it would have been if the property were vested at the time of grant.

If the service provider makes a "Section 83(b) election" with respect to the unvested property, the timing and amount of taxable income would instead be determined as if the property were vested at the date of transfer. In that case, the compensatory taxable event is determined as of the time of grant, based on the value of the property at that time, and no additional compensation income is triggered upon vesting. Whether it is advisable to make this election depends on many factors, but if there is little or no bargain element associated with the property at the date of transfer, the election is almost always recommended. Unfortunately, taxpayers cannot use the benefit of hindsight in deciding whether to make a Section 83(b) election – to be valid, the election must be made within 30 days after the date property is transferred.

Application to Partnership Interests

IRS guidance on the issuance of compensatory partnership interests has been in a state of flux. Under previously released guidance still in effect, neither the grant nor vesting of certain partnership interests is treated as a taxable event, regardless of whether a Section 83(b) election has been filed. This exception to the general rules applicable to other compensatory transfers of property is limited, however. In particular, the exception does not extend to partnership interests that are disposed of within two years of issuance. Because of the limited scope of this exception, many practitioners advised recipients of compensatory partnership interests to continue to file Section 83(b) elections.

Proposed Guidance — New Rules

Under the proposed rules, compensatory partnership interests would be subject to the same tax rules generally applicable to compensatory issuances of other property. The proposed rules, when finalized, will resolve many unanswered questions.

- *Partner Status* — For tax purposes, a holder of an unvested compensatory partnership interest will not be treated as a "partner" until that interest vests, unless a Section 83(b) election is filed for that interest. Such non-partner treatment can have adverse tax consequences to the service provider and the other partners. For example, if a Section 83(b) election is not filed, any "distributions" made to the holder of the interest would be treated as taxable compensation income to the service provider. In addition, because the holder of the interest would not be treated as a partner, (i) the amount of partnership taxable income otherwise allocable to the holder's unvested partnership interest would be allocated to — and taxed to — *the other partners*, and (ii) distributions made to the holder would be treated as a compensation expense of the partnership for which the other partners will receive a corresponding, but potentially limited, deduction.

- *Liquidation Value Safe Harbor* — Making a Section 83(b) election and determining the income and deduction relating to a compensatory partnership interest requires a determination of the fair market value of that interest. The proposed rules provide a new "liquidation value safe harbor." Under the safe harbor, the "liquidation value" of a partnership interest is the amount of cash that the holder of the partnership interest would receive if, immediately after receipt of the interest, the partnership sold all of its assets (including goodwill, going concern value and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated in accordance with the terms of the partnership agreement. Although this safe harbor is consistent with the valuation method adopted by many taxpayers in the past, certain limitations apply to the use of the safe harbor, and it can only be used if the partnership and all of its partners agree to be bound by the safe harbor valuation and its requirements. It is not clear how the value of an interest should be determined if the safe harbor rules are not satisfied.

- *Tax Consequences of Issuance of Partnership Interest to the Partnership and Partners* — There has been a theoretical concern among tax practitioners that the issuance of a compensatory partnership interest results in a "deemed sale" by the partnership of a portion of the partnership's assets, potentially resulting in taxable income to existing partners. The proposed rules provide that neither the issuance, vesting nor forfeiture of a compensatory partnership interest results in such a deemed sale, and consequently, that no gain or loss is recognized by a partnership and its partners upon such event. If the issuance of the interest results in income to the service provider, the partnership receives a corresponding deduction which must, under the proposed rules, be allocated to partners other than the service provider.

- *Consequences of Forfeiture* — Under the proposed rules, the forfeiture of an unvested partnership interest would require special tax allocations of gains and losses among the partners to reflect the economic arrangement among the partners with respect to such forfeiture. In certain circumstances forfeiture may result in income to a partnership and its partners, depending on whether issuance of the forfeited interest gave rise to a deduction to the partnership and its partners.

Although the proposed rules will not be effective until they are finalized, in light of the approach adopted by the proposed rules, and because of the limitations contained in existing guidance and the potential adverse tax consequences to both the service provider and other partners (as detailed above), we strongly recommend that recipients of unvested carried interests in investment funds file Section 83(b) elections.

Issues Yet to Be Resolved

Certain aspects of the proposed rules remain unclear, particularly with respect to the requirements of the liquidation value safe harbor and the allocation provisions required upon forfeiture. In addition, the new guidance applies only to the issuance of a partnership interest in connection with the performance of services for that partnership, and not, for example to tiered partnership arrangements (*e.g.*, compensatory partnership interests issued in a lower-tier partnership in exchange for services provided to an upper-tier partnership). Furthermore, it has not yet been determined whether new reporting requirements associated with the issuance of compensatory partnership interests will be necessary. The Treasury Department and the IRS have requested comments on these and other points.

Stay Tuned

The new guidance has been issued in proposed form and cannot currently be relied upon by taxpayers. We expect further guidance to be issued before the proposed rules become final and will advise you of any requirements to amend partnership agreements or current practices that the new or any additional guidance provide.

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