December 29, 2005

Hon. Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Partnership Equity for Services

Dear Commissioner Everson:

Enclosed are comments concerning Partnership Equity for Services. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department
Donald L. Korb, Chief Counsel, IRS
Heather C. Maloy, Acting Deputy Chief Counsel (Technical), IRS
William P. O’Shea, Deputy Associate Chief Counsel, (Passthroughs & Special Industries), IRS
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Michael J. Desmond, Tax Legislative Counsel, Treasury Department
Daniel Hogans, Attorney-Advisor, Treasury Department
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Audrey W. Ellis, Attorney, IRS
Stephen B. Tackney, Attorney, IRS
Demetri Yatrakis, Attorney, IRS
COMMENTS CONCERNING PARTNERSHIP EQUITY FOR SERVICES

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Adam M. Cohen of the Section of Taxation’s Partnerships & LLCs Committee. Substantive contributions were made by Sheldon Banoff, Paul Carman, Patrick Crawford, David Culpepper, Chuck Fassler, Jay Ghiya, Robert Keatinge, Bahar Schippel and Thomas Yearout. Other substantive contributions were made by Allan Donn, J. Leigh Griffith, David Kahen, Arnie Kogan, Kurt Lawson, Malinda Susalla, Steve Bachelder, Scott Ludwig, Martin Pollack, Devorah Pomerantz and Sharon Shachar. The comments were reviewed by Thomas R. White of the Section’s Committee on Government Submissions and Fred T. Witt, Jr., Council Director for the Partnerships & LLCs Committee.

Although the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal income tax principles addressed by these comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: December 29, 2005
EXECUTIVE SUMMARY

In Notice 2000-291 (the “Notice”), the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “Treasury”) requested public comment on “the tax consequences to the recipient of the partnership interest as well as to the partnership upon the exercise of a partnership option or conversion of a debt or preferred interest in that partnership.” Comments of individual members of the Section of Taxation’s Partnerships and LLCs, Real Estate and Employee Benefits committees were submitted to the Treasury in response to the Notice dated January 30, 2002.2 REG-103580-023 requested further comments to be submitted to the Treasury, both on the proposed regulations promulgated pursuant to such document (the “NonCompensatory Proposed Regulations”) and on other issues. Comments of individual members of the Section of Taxation’s Partnerships and LLCs, Real Estate and Employee Benefits committees were submitted to the Treasury in response to the NonCompensatory Proposed Regulations dated October 9, 2003.3 By REG 105346-03, the Treasury and the Service promulgated proposed regulations regarding the transfer of interests in partnerships in connection with the performance of services for the transferring partnership (the “Proposed Regulations”). In conjunction with the Proposed Regulations, the Treasury and the Service issued Notice 2005-43,4 which contained a proposed revenue procedure that is proposed to be finalized simultaneously with the Proposed Regulations (the “Proposed Rev Proc” and, collectively with the Proposed Regulations, the “Proposals”). These comments address certain issues raised by the Proposals.

We applaud the Treasury and the Service for the Proposals, which we believe take substantial steps forward in clarifying the issues related to transfers of partnership interests in connection with the performance of services (“Compensatory Interests”). For the significant reasons set out in the Original Comments, we particularly support the position taken in the Proposals regarding the application of section 721 to the grant of Compensatory Interests. However, we recommend, when the Proposed Regulations are promulgated as final regulations (the “Final Regulations”) and the Proposed Rev Proc is issued in final form (the “Final Rev Proc” and, collectively with the Final Regulations, the “Final Authorities”), the Treasury and the Service reconsider several portions of the Proposals to make them more administrable and consistent with other areas of federal tax law. In addition, these comments discuss the application of the Proposals to partnerships in respect of which capital is not a material income producing factor (as described in section 736) (“Service Partnerships”) and point out some of the unique realities of Service Partnerships.

Generally, these comments seek to make the contribution of services by service providers (“SPs”) in exchange for Compensatory Interests consistent with other contributions to partnerships. In this regard, we recommend that the Treasury and the Service reconsider the requirement that the capital account of SPs and the income recognized by SPs on the receipt of a Compensatory Interest must be equal. In the event that they must be equal on receipt, we

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2 56 The Tax Lawyer 203 (Fall 2002) (the “Original Comments”).
3 2003 TNT 213-21 (October 9, 2003) (the “NonCompensatory Interest Comments”).
recommend that a mechanism be available to ensure that, while the requirements of section 83 are met on receipt, the flexibility of subchapter K in allowing partners to obtain the benefit of their bargain be similarly met by adjusting capital accounts to reflect the partners’ economic deal. We also address the interaction of the Proposals with the recently finalized regulations under section 752.

In an effort to ensure consistency with the receipt of other property for services, we recommend that the forfeiture allocations contained in Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(c) (the “Forfeiture Allocations”) be eliminated.\(^5\) Similarly, we recommend that the regulations under section 83 be clarified to provide that a recipient of unvested property for which a section 83(b) election is made only faces disallowance of a deduction as to the income recognized by the SP upon the receipt of the Compensatory Interest (the “Grant Income”), and not any income recognized by the SP after such receipt.

As section 83 can apply to transfers of property to a SP by one party while services are being provided to another party, we make several recommendations to attempt to arrive at consistency where a SP provides services to one partnership and receives a Compensatory Interest in another, related partnership. These recommendations focus on an attempt to find consistency with similar compensatory transfers of property.

In attempting to make the Proposals more administrable, we focused on the election allowed under the Proposed Rev Proc (the “LV Election”). We recommend that the method of, and requirements for, making the LV Election be reconsidered, as well as the consequences of certain events that would terminate the LV Election under the Proposed Rev Proc. We also ask the Treasury and the Service to consider the interaction of the LV Election with disregarded entities.

Finally, in looking at Service Partnerships, our conclusion is primarily that the Final Authorities should reserve the treatment of the Service Partnerships for further study. Service Partnerships have a unique potential for double taxation of the partners, all of whom are SPs and many of whom may be receiving Compensatory Interests annually, monthly, quarterly, etc. To the extent the Final Authorities do address Service Partnerships, we make a few specific recommendations to attempt to eliminate some of the potential traps for the unwary.

**PRINCIPAL RECOMMENDATIONS**

1. We recommend that the Final Authorities provide that either (a) the capital account credit and the section 83 income amounts not be tied together, with the former determined based on the agreed-upon liquidation value and the latter determined based on the fair market value (the “FMV”) of the interest received, or (b) after issuance of Compensatory Interests, partnerships be allowed (but not required) to revalue their assets so that the capital account of SPs after the revaluation will be equal to the economic agreement between the SPs and

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\(^5\) In the event that Forfeiture Allocations are not eliminated, we consider various changes that should be made to the Forfeiture Allocations to make them more fair.
the partnership issuing Compensatory Interests to them, in a method similar to that utilized upon the exercise of an option under the NonCompensatory Proposed Regulations. 6

2. We recommend that Forfeiture Allocations be eliminated from the Final Regulations.

3. We recommend that the second portion of the flush language of section 83(b)(1) is and should continue to be properly read as only precluding a SP from taking a loss with respect to the Grant Income and that Treas. Reg. § 1.83-2(a) be explicitly clarified to reflect this. We further recommend that the Final Regulations make clear that a SP may take a deduction with respect to any basis that the SP may have in the forfeited Compensatory Interest that is not due to Grant Income. Similarly, we recommend that the other partners in the partnership not be required to recognize any income due to any loss claimed by the SP as a result of prior allocations of income and gain.

4. We recommend that, if the Final Regulations contain Forfeiture Allocations, partnerships be allowed, but not be required, to utilize notional tax items to make Forfeiture Allocations. We further recommend that, if the Final Regulations contain Forfeiture Allocations, the language used to describe the Forfeiture Allocations be clarified.

5. We recommend that the Treasury and the Service not include in the Final Regulations the statement in the Proposed Regulations that allocations in respect of an interest that is substantially nonvested cannot have substantial economic effect. Alternatively, we recommend that a method be added to the Final Regulations so that such allocations may be deemed to have substantial economic effect. Additionally, we recommend that, to the extent forfeiture allocations are continued in the Final Regulations, forfeiture allocations are added to the permitted chargebacks under Treas. Reg. § 1.514(c)-2(e).

6. We recommend that a disregarded entity (or the taxpayer deemed to own the assets of the disregarded entity) be allowed to make the LV Election before issuing a Compensatory Interest to a person who will cause the disregarded entity to become a partnership.

7. We recommend that the LV Election be made on a form provided by the Service (or with contents specified in the Final Rev Proc) such that the partner having responsibility for federal income tax reporting by the partnership either (a) certifies that the partnership agreement (or another agreement that binds all partners, the partnership and the SP) contains the election language or (b) certifies that the election itself binds all partners, the partnership and the SP. In the case of an election described in (b) in the preceding sentence, the election would have to be signed by sufficient partners and/or the SP and/or the partnership to allow for such certification, but the election would not be terminated if the partnership could not produce the relevant agreement upon a later examination.

8. We recommend that reporting inconsistent with the LV Election only terminate the LV Election if the partnership is the offending party, meaning that inconsistent reporting by a partner or the SP not cause the LV Election to terminate. If the SP reports inconsistent with the LV Election, however, the Service should be able to enforce the SP’s agreement to

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6 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).
the LV Election, perhaps by requiring agreements akin to those required under section 367(a) and Treas. Reg. § 1.367(a)-8(b).

9. We recommend that the Final Rev Proc make clear that, in a partnership with an LV Election, the failure of an interest to qualify as a “Safe Harbor Partnership Interest” not terminate the LV Election for that partnership, but only causes that interest to fall outside the safe harbor provided by the LV Election (the “LV Safe Harbor”).

10. We recommend that a buy-sell right generally not create a presumption that a Compensatory Interest was transferred in anticipation of a subsequent disposition. It may be appropriate for the Final Rev Proc to adopt a facts and circumstances test with respect to buy-sell provisions. If a Compensatory Interest can fall outside the LV Safe Harbor due to buy-sell provisions, we recommend that the Final Rev Proc provide a list of provisions that do not cause Compensatory Interests to fall outside the LV Safe Harbor.

11. We recommend that the Final Rev Proc provide a presumption that dispositions outside of two years or those made by reason of the death or disability of the holder of the interest were not transferred in anticipation of a subsequent disposition.

12. We recommend that a list of factors and examples be provided in the Final Rev Proc so that taxpayers have guidance regarding what facts and circumstances might rebut the presumptions created regarding whether a Compensatory Interest was transferred in anticipation of a subsequent disposition. We further recommend that a standard similar to that used in the disguised sales rules of Treas. Reg. § 1.707-3 be used to overcome the presumptions.

13. We recommend that the Final Regulations clarify how an option to acquire a partnership interest (whether compensatory or not) will be valued for section 83 and subchapter K purposes while it is outstanding. Specifically, if a partnership has an effective LV Election, we recommend that the Final Regulations specify that the option will be valued (for purposes of sections 752, 704(b) and otherwise) under the methodology of the LV Safe Harbor.

14. We recommend that, for purposes of the making of an election under section 83(b), the “date of transfer” be interpreted in the Final Regulations as the actual date of the transfer. We further recommend the date for valuing the Compensatory Interest for purposes of section 83 be the effective date of the grant.

15. We recommend that the Proposals apply to transfers in which the partnership issuing the Compensatory Interest (the “Issuing Partnership”) holds more than a de minimis interest in the capital or profits of the partnership employing the SP (the “Employer Partnership”) or the Employer Partnership holds more than a de minimis interest in the capital or profits of the Issuing Partnership (“Related Partnership Transfers”).

16. We recommend that the principles of Treas. Reg. §§ 1.83-6(d) and 1.1032-3 be extended to Related Partnership Transfers.
17. We recommend that the Issuing Partnership be permitted to make an LV Election and to adjust the partners’ capital accounts to reflect a revaluation of the Issuing Partnership’s property in connection with a Related Partnership Transfer.

18. We recommend that neither the Issuing Partnership nor the Employer Partnership recognize any gain or loss as a result of a Related Partnership Transfer.

19. We recommend that Treas. Reg. § 1.83-7 be expanded to apply to options to acquire any equity interests of an entity (i.e., partnership interests and stock). We recommend that Prop. Treas. Reg. § 1.761-3 not be expanded to apply to options to acquire Compensatory Interests. We recommend that the Final Authorities either (i) state that, in the case of a compensatory option, the issue of whether an optionee is treated as a partner will be decided under general federal income tax principles, or (ii) adopt rules similar to those set forth in Treas. Reg. § 1.1361-1(l)(4)(iii).

20. We recommend that the Final Regulations include examples regarding how the partnership must account for a compensatory option to acquire a partnership interest while it is outstanding and upon its ultimate exercise.

21. We recommend that the exclusion in the current regulations of cash from the definition of “property” for purposes of section 83 be interpreted in such a way so that the grant of an interest in a partnership that only represents a right to immediately distributable cash is similarly excluded.

22. We recommend that the Final Rev Proc specify that the liquidation value of a partnership be based upon a hypothetical sale in which the assets of the partnership are sold for their tax book values. It may be appropriate to limit this recommendation to partnerships in respect of which capital is not a material income producing factor (as described in section 736).

23. We recommend that the application of the Final Authorities to partnerships in respect of which capital is not a material income producing factor (as described in section 736) be reserved until a method of reconciling subchapter K and section 83 that avoids double taxation may be developed. Alternatively, we recommend that the LV Election be allowed for such partnerships and that the liquidation value be determined as of the effective date of the grant rather than the actual grant date.7

24. We recommend that, if a partner is delegated the ability to make elections for federal income tax purposes where the partners will be bound by any such elections, the delegate be able to make the LV Election by itself (without the signature of any other partner). Alternatively, we recommend that delegated authority be respected for partnerships in existence when the Final Authorities become effective.

25. We recommend that the Final Authorities allow taxpayers to apply the Final Authorities to transfers prior to their ultimate effective date.

7 See Principal Recommendation 14.
COMMENTS REQUESTED BUT NOT ADDRESSED

The preamble to the Proposed Regulations requests comments on a number of areas. These comments do not address all of those areas. These comments should not be read as specifically agreeing with the approach taken in the Proposals as to the issues not addressed or as specifically disagreeing. The areas in which the preamble to the Proposed Regulations request comments but which these comments do not address are:

1. Whether the proposed collection of information is necessary for the proper performance of the functions of the Service, including whether the information will have practical utility;

2. The accuracy of the estimated burden associated with the proposed collection of information (see below);

3. How the quality, utility, and clarity of the information to be collected may be enhanced;

4. How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology;

5. Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information;

6. Alternative approaches for resolving the timing inconsistency between section 83 and section 707(c);

7. Whether a requirement that a transfer of a compensatory partnership interest for services, treated as a guaranteed payment, be reported by the partnership on Form 1099-MISC on or before January 31st of the year following the calendar year of the transfer is appropriate and administrable; and

8. Whether continued use of the LV Election should be reported annually on Form 1065 and Schedule K-1, Partner’s Share of Income, Credits, Deduction, etc.

DETAILED COMMENTS

I. Capital Accounts

Under the Proposed Regulations, a SP’s capital account is required to be increased by the amount the SP takes into income under section 83 as a result of receiving the partnership interest (plus any amount paid by the SP for the partnership interest). Under the Proposed Rev Proc, a partnership may make an LV Election. Where a partnership and the SP have made an LV Election, the amount taken into income by the SP and the credit to the SP’s capital account will be based on the liquidation value of the interest received.

Where there is no LV Election, we submit that the requirement to determine the capital account credit for the SP based on the amount recognized as income will in many circumstances distort the economic “deal” between the partnership and the SP.
In the case of a profits-only partnership interest, the economic expectation of the partnership and the SP is that, in the event the partnership were to liquidate immediately after the grant of a partnership interest to the SP, the SP would not receive any liquidating distribution from the partnership. The SP is expected to share only in profits recognized, and appreciation realized, after the date the interest is granted. We recognize that the fair market value of a profits-only interest must be used for purposes of section 83 and that the SP should be required to take that amount into income, but we submit that it is inappropriate to give the SP a positive capital account balance if that value is greater than zero, whether or not an LV Election is made.

The preamble to the Proposed Regulations states:

“The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. * * *, the [Treasury] and the [Service] do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. * * * Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interests and partnership profits interests.”

We concur with the Service and Treasury determination that profits-only partnership interests should be treated as property and that section 83 should apply to both capital and profits-only partnership interests. However, we do believe it would be consistent with the statutory regimes of section 83 and subchapter K to recognize that profits-only partnership interests are unlike any other form of property and that a special capital accounting rule is appropriate for profits-only interests. For these reasons, we respectfully suggest that a SP who receives a profits-only partnership interest should have an initial capital account balance determined based on liquidation value, even in the absence of an LV Election.

In the case of a capital interest, the economic deal between the partnership and the SP frequently determines the capital account credit that the SP should receive and the amount of the liquidating distribution that the SP would receive if the partnership were to liquidate immediately after the grant of the partnership interest. In nearly all situations, the FMV of a partnership interest would be lower than the amount the SP would receive on immediate liquidation, due to factors such as lack of marketability and, in some cases, lack of control over the timing of any future liquidation event. We submit that the agreed-upon right to a liquidating distribution, rather than the FMV of the partnership interest, should control the credit to the SP’s capital account.

Under the capital account maintenance rules of the regulations under section 704(b), when a person contributes cash or property to a partnership, the person receives a credit to his or her capital account based on the FMV of the property contributed, not based on the value of the partnership interest received in exchange for that contribution. In many situations, the FMV of
the partnership interest received for a contribution of cash or property is in fact lower than the FMV of the contribution and thus lower than the credit to the capital account.

We submit that the economic arrangement – namely the agreed-upon amount that would be distributed to the SP if the partnership were to liquidate immediately after the grant of the partnership interest – should control the amount credited to the capital account of the SP.

The following example illustrates the economic distortion inherent in the approach in the Proposed Regulations:

**EXAMPLE 1:** Individuals A and B form a partnership and each contributes $100 cash for a 50% interest in capital and profits. The AB partnership uses the $200 to buy Blackacre (raw land). At a time when the value of Blackacre has increased to $300 (and remains the AB partnership’s sole asset), C is granted a one-third capital and profits interest in the AB partnership in exchange for services performed for the AB partnership. The AB partnership does not make an LV Election. For section 83 purposes, it is assumed that the FMV of the one-third interest granted to C is $70. C reports $70 of compensation income. The nature of C’s services results in an ordinary deduction under section 162 for the same taxable year. The AB partnership and C agree that C is a full one-third partner and that in the event of the liquidation of the AB partnership, even if it occurs immediately after the grant to C, she would receive one-third of the net assets of the AB partnership.

Under the Proposed Regulations, C is entitled to a capital account of only $70, based on the FMV of the partnership interest. In connection with the grant of an interest to C, the capital accounts of A and B are booked up to $300 (i.e., $150 each), and A and B receive an allocation of $70 of deduction (i.e., $35 each).

The capital accounts are as follows:

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<tr>
<td>A</td>
<td>$115</td>
<td>$100 plus $50 less $35</td>
</tr>
<tr>
<td>B</td>
<td>$115</td>
<td>$100 plus $50 less $35</td>
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<tr>
<td>C</td>
<td>$70</td>
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<tr>
<td>Total</td>
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Upon a sale of Blackacre for $300 and liquidation of the AB partnership, C would be entitled to only $70, despite the economic deal that C was to be a full one-third partner. As a result, assuming that the AB partnership complies with the section 704(b) substantial economic effect safe harbor, the Proposed Regulations have distorted the economic arrangement agreed upon by the parties.

We recognize that the economic distortion illustrated in this example could be avoided if the partnership and the SP made an LV Election. However, that election would require C in Example 1 to recognize $100 of income, even though the stipulated FMV of the one-third

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8 Since C’s one-third interest had a FMV of $70, presumably, an interest entitled to less than one-third on liquidation is worth less than $70. This creates a circular problem caused by the linkage of the section 83 amount and the capital account credit.
interest granted to C is only $70. Furthermore, in practice, not all partnerships will be able to make an LV Election.

We submit that the LV Safe Harbor should be retained as an option, but that the Proposed Regulations should be revised to either (a) allow the capital account of the SP to be determined based on the agreed-upon liquidation value of the partnership interest rather than on the FMV of the partnership interest granted or (b) provide a mechanism similar to that provided in the NonCompensatory Proposed Regulations to eliminate the disparity between the SP’s capital account based on the FMV of the partnership interest and a capital account balance based on the parties’ economic deal with respect to liquidating distributions.

Under the first approach, in Example 1, C would receive a credit to her capital account of $100, but would have an outside basis in her partnership interest of only $70 (the amount taken into income upon receipt of the interest). The disparity between the $100 capital account credit and the $70 of income recognized and outside basis would be accounted for and taxed under existing rules of Subchapter K. The parties’ economic deal would not be disrupted and the capital account maintenance rules of section 704(b) would be preserved.

Under the second alternative approach, we recommend that a mechanism for eliminating the disparity based on the approach taken under the NonCompensatory Proposed Regulations would be workable. See Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s). This approach is illustrated by the following example based on Example 1:

EXAMPLE 2: C recognizes $70 of income and receives an initial capital account credit of $70. Upon revaluation of Blackacre from $200 to $300, instead of allocating the full $100 of unrealized appreciation to historic partners A and B, the first $30 of unrealized appreciation would be allocated to C, increasing her capital account to $100, resulting in $30 of reverse section 704(c) gain for C. The remaining $70 of unrealized appreciation would be allocated to A and B.

The resulting capital accounts would be:

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<tr>
<td>A</td>
<td>$100</td>
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<tr>
<td>B</td>
<td>$100</td>
</tr>
<tr>
<td>C</td>
<td>$100</td>
</tr>
<tr>
<td>Total</td>
<td>$300</td>
</tr>
</tbody>
</table>

Upon a sale of Blackacre for $300, each partner would receive $100 of liquidation proceeds. A and B would each be allocated $35 of reverse section 704(c) gain and C would be allocated $30 of reverse section 704(c) gain. (Under the NonCompensatory Proposed Regulations, if there is no unrealized gain at the time the partnership interest is granted, capital of existing partners is reallocated to the new partner and the partnership agreement must require corrective allocations to take into account the reallocations.)
II. Section 83(b) Issues

A. Elimination of Forfeiture Allocations

As a consequence of transfers of Compensatory Interests being subject to section 83, the Proposed Regulations provide that the holder of a Compensatory Interest will not be treated as a partner solely by reason of holding the interest until such interest is substantially vested. The holder will be treated as a partner if she makes an election with respect to such interest under section 83(b).

The preamble to the Proposed Regulations notes that this treatment is similar to the current treatment of a holder of substantially nonvested stock in an S corporation. Treas. Reg. § 1.1361-1(b)(3) provides that S corporation stock issued in connection with the performance of services that is substantially nonvested, and for which no section 83(b) election has been made, is not treated as outstanding stock of the S corporation. It also states that the holder of such stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes a section 83(b) election with respect to such stock.

If a section 83(b) election has been made with respect to an unvested Compensatory Interest, the holder of the unvested interest may be allocated partnership items that may later be forfeited. The Proposed Regulations summarily state that allocations of partnership items while the interest is substantially nonvested cannot have economic effect due to this possibility of forfeiture. Prop. Treas. Reg. § 1.704-1(b)(4)(xii), however, provides that such allocations of partnership items while the interest is substantially nonvested can be deemed to be in accordance with the partners’ interests in the partnership (“PIP”). To obtain this treatment, among other things, the partnership agreement must require that the partnership make Forfeiture Allocations, offsetting the previous allocations to the SP if the interest for which the section 83(b) election was made is later forfeited.

The Service is incorrect, however, in stating that allocations of partnership items to a substantially nonvested interest can never have substantial economic effect. To illustrate, take

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9 The terms “substantially vested” and “substantially nonvested” have the meanings specified in Treas. Reg. § 1.83-3(b), and the use of words such as “vested,” “nonvested” and “unvested” in these comments are shorthand references to the Treas. Reg. § 1.83-3(b) terms.


11 Prop. Treas. Reg. § 1.704-1(b)(4)(xii). There is no apparent rationale why the substantially nonvested nature of one partnership interest should cause the other allocations made by the partnership to cease to have substantial economic effect. The distinction is potentially significant under several provisions of the Code. Therefore, we recommend that the Final Regulations clarify that an outstanding, unvested Compensatory Interest will not cause all allocations by the partnership which are not with respect to such Compensatory Interest to fail to have substantial economic effect.

12 Prop. Treas. Reg. § 1.704-1(b)(4)(xii) also requires that all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made be recognized under section 704(b) in order for the allocations to be deemed to be in accordance with PIP. Additionally, the Proposed Regulations do not indicate what happens to the capital account of the SP that is left after the forfeiture and the Forfeiture Allocations occur. We recommend that the Final Authorities clarify that, upon a forfeiture of a Compensatory Interest, the capital account (after adjustment for Forfeiture Allocations to the extent that the Forfeiture Allocations are retained in the Final Authorities) of the SP is eliminated.
the example of a SP who receives a profits-only interest in connection with her performance of services for the partnership. The terms of the transfer state that the interest will be issued to the SP for no additional consideration. The SP will be subject to a binding commitment to return the interest to the partnership for no additional payment if she leaves the employment of the partnership for any reason prior to the expiration of a two-year period from the date of such transfer. The terms of the transfer also provide that any items of income or gain allocated to the SP and not previously distributed to her will be promptly distributed to her and will not be subject to forfeiture. All partners of the partnership, including the SP, have an obligation to restore any deficit balance in their capital account. Assuming that the LV Safe Harbor under the Proposed Rev Proc is utilized, all allocations to the SP will have substantial economic effect, despite the possibility that the interest might be forfeited.

Moreover, the Proposed Regulations do not merely suggest the use of Forfeiture Allocations as a potential safe harbor pursuant to which allocations to unvested interests will be deemed to be in accordance with PIP. Prop. Treas. Reg. § 1.706-3(b) explicitly states:

If an election under section 83(b) is made with respect to a partnership interest that is substantially nonvested (within the meaning of §1.83-3(b)), and that interest is later forfeited, the partnership must make forfeiture allocations to reverse prior allocations made with respect to the forfeited interest. (emphasis added)

Thus, the Proposed Regulations do not even allow the parties the option of asserting that particular allocations to an unvested interest are in accordance with PIP. The Service, however, does not claim that such allocations cannot be in accordance with PIP and there is nothing in section 704 or the regulations thereunder that suggests that Forfeiture Allocations are necessary for allocations to be in accordance with PIP. The mandatory Forfeiture Allocations should therefore be eliminated from the Final Regulations.

Additionally, while the preamble to the Proposed Regulations highlights the similarity between the proposed treatment of a SP holding unvested partnership interests and a SP holding unvested stock in an S corporation, the S corporation rules do not require or provide for Forfeiture Allocations upon the forfeiture of unvested stock for which a section 83(b) election was made. There seems to be little, if any, policy reason for treating the forfeiture of a Compensatory Interest differently than the forfeiture of nonvested S corporation stock, particularly when the nature of a Forfeiture Allocation merely exaggerates the difference between stock issued by S corporations and Compensatory Interests issued by partnerships.

As an alternative to Forfeiture Allocations, the Service should instead simply provide that allocations of income and loss with respect to unvested partnership interests shall be deemed to be in accordance with PIP.13 Such treatment would be similar to the permitted allocations of income and loss to unvested S corporation stock for which a section 83(b) election has been made, and would reduce any unnecessary disparity between the tax treatment of allocations to unvested S corporation stock and allocations to unvested partnership interests.

13 Additionally, if the allocations to the unvested partnership interest have substantial economic effect, the allocations should be treated as complying with the safe harbor provided in Treas. Reg. § 1.704-1(b)(2)(iv).
B. Section 83(b)(1) Prohibition on Deductions in Respect of Forfeitures is Properly Limited to Grant Income

In the preamble to the Proposed Regulations, the Treasury and the Service also requested comments as to whether section 83(b)(1) should be read to allow a forfeiting SP to claim a loss with respect to partnership income that was previously allocated to the SP and not offset by Forfeiture Allocations of loss and deduction. They further asked whether it would be appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of loss claimed by the SP. Section 83(b)(1) specifically states that, if a property for which a section 83(b) election was made is subsequently forfeited, “no deduction shall be allowed in respect of such forfeiture.”

We believe that the correct interpretation of this language in section 83(b)(1) is that the prohibition on deductions is limited to those deductions that would specifically reverse Grant Income. Under our interpretation, there is a distinction between deductions that arise upon the forfeiture of the interest – which include deductions that are due to previous allocations of income to the unvested partnership interest – and deductions that are in respect of such forfeiture – which are deductions that arise solely due to the previous income inclusion pursuant to the section 83(b) election and the subsequent forfeiture, but do not include deductions that are due to any post-receipt allocation of partnership tax items. We do not see any policy considerations that justify the punitive approach of not allowing a forfeiting SP to claim a loss with respect to post-receipt allocations of partnership income. Furthermore, a different interpretation would merely create a trap for the unwary, as well-advised taxpayers arguably can avoid an unfavorable result by having the partnership distribute all of its earnings, and then require the partners to recontribute such amounts to the partnership.14

To this end, we also suggest that Treas. Reg. § 1.83-2(a) be explicitly clarified to reflect this interpretation. If and when unvested property for which a section 83(b) election has been made is forfeited, the forfeiture should be treated as a sale or exchange upon which the SP realizes a loss equal to the excess of (1) the sum of (A) the amount paid (if any) for such property and (B) any allocations of income and gain in excess of loss with respect to such property for which corresponding distributions were not made, over (2) the amount realized (if any) upon such forfeiture.

Furthermore, we do not believe it appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of loss claimed by the SP. The other partners will eventually recognize income with respect to the amounts that were previously allocated to the SP. The other partners were not allocated such amounts and, therefore, did not obtain a corresponding increase in their bases in their partnership interests, but presumably will ultimately realize the economic benefit of such items. This approach would replicate the current treatment of the other shareholders of an S corporation upon the forfeiture of unvested stock. Therefore, we recommend that the other partners in the partnership should not be required to recognize any income due to any loss claimed by a SP as a result of prior allocations of income and gain.

14 Such recontribution would be treated as an additional amount paid with respect to the partnership interest and the SP would be able to deduct such amount upon forfeiture. See Treas. Reg. § 1.83-2(a). This, of course, assumes that the form of this transaction would be respected.
C. Notional Tax Items Upon Shortage of Actual Tax Items

The Treasury and the Service also requested comments regarding whether the Final Regulations should require or allow partnerships to create notional tax items to make Forfeiture Allocations where the partnership does not have enough actual tax items in the taxable year of forfeiture to make such allocations. If Forfeiture Allocations are not eliminated from the Final Regulations, at a minimum, the Forfeiture Allocations should be modified to allow partnerships to create notional tax items to make such allocations in situations where the partnership does not have enough actual tax items to make all required Forfeiture Allocations.

The Proposed Regulations provide for Forfeiture Allocations to be made out of the partnership’s items for the entire taxable year, ostensibly to increase the likelihood that sufficient items of income, gain, loss or deductions will be available for the partnership to make its Forfeiture Allocations.\(^{15}\) In certain circumstances, however, the partnership will not have sufficient partnership tax items in the taxable year of forfeiture to fully offset prior allocations to the SP. As discussed below, in the event that there is a shortage of actual partnership items for the taxable year of forfeiture such that the partnership cannot fully offset prior allocations, the Proposals provide for significantly different results depending on whether there are insufficient items of income and gain to fully offset prior allocations of losses and deductions, or whether there are insufficient items of losses and deductions to fully offset prior allocations of income and gain. This seems to create a distinction without being based on a meaningful difference.

In determining the gross income of the partnership in the taxable year of the forfeiture, Treas. Reg. § 1.83-6(c) provides that the partnership will generally have gross income in the taxable year of the forfeiture equal to the amount of the previously allowed deduction to the service recipient partnership upon the transfer of the interest as a result of the making of the section 83(b) election.\(^ {16}\) Thus, to the extent that losses and deductions were previously allocated to the SP, the partnership will generally have gross income pursuant to Treas. Reg. § 1.83-6(c) to utilize for Forfeiture Allocations.

In the event that, despite the gross income generally created as a result of Treas. Reg. § 1.83-6(c), the partnership still does not have enough income and gain to fully offset prior allocations of losses and deductions to the forfeiting SP and an LV Election was made, section 4.04 of the Proposed Rev Proc requires that the SP include an amount equal to the income and gain that was not allocated to the SP due to any shortage of actual partnership items as ordinary income in the taxable year of the forfeiture.

On the other hand, in the event that the partnership does not have enough losses and deductions to fully offset prior allocations of income and gain to the forfeiting SP, there is no equivalent of section 4.04 of the Proposed Rev Proc that authorizes an ordinary loss in the taxable year of the forfeiture in an amount equal to the losses and deductions that were not allocated to the SP due to any shortage of actual partnership items in such tax year. Additionally, section 4.04 of the Proposed Rev Proc is inapplicable if no LV Election was made.

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\(^{15}\) Prop. Treas. Reg. §§ 1.706-3(b), 1.704-1(b)(4)(xii)(f).

\(^{16}\) See Treas. Reg. § 1.83-6(c).
Thus, the Proposals require inclusion of ordinary income to the extent a partnership has a shortage of actual items of income and gain for the taxable year of the forfeiture where an LV Election was made, but fail to provide the benefit of a similar provision in the case of a partnership with insufficient actual items of losses and deductions in the taxable year of forfeiture where an LV Election was made or insufficient actual items of income and gain in the absence of an LV Election. There seems to be no policy reason behind such anomalous treatment. Taxpayers will be disadvantaged in the aggregate by this asymmetrical regime. Allowing notional tax items in the event of a shortage in actual tax items will eliminate any such disparity of treatment. We therefore recommend that, if Forfeiture Allocations are not eliminated, the Final Regulations should authorize such notional tax items for cases where there are insufficient actual tax items to fully offset prior allocations.

In cases where the partnership does not have enough income and gain to fully offset prior allocations of losses and deductions, section 4.04 of the Proposed Rev Proc also disadvantages the SP by treating amounts included in income pursuant to section 4.04 as ordinary income. Unlike section 4.04, Forfeiture Allocations are to consist of a pro rata portion of each item of gross income and gain. Thus, while Forfeiture Allocations pursuant to the Proposed Regulations are likely to result in some mix of ordinary income and capital gains, income included pursuant to section 4.04 will always be includable as ordinary income, which generally is taxed at a higher rate. There does not appear to be any policy reason behind requiring ordinary income treatment for income included pursuant to section 4.04 of the Proposed Rev Proc. We believe that the actual tax items of the partnership for the taxable year of forfeiture will generally provide a sensible estimate of the character of tax items previously allocated to the SP. We therefore recommend that the Final Regulations provide that notional tax items be deemed to exist in the same pro rata portion as the character of each actual tax item of the partnership for the taxable year of the forfeiture.17 Such characterization of the notional tax items is better aligned with the Service’s overall goal to offset prior allocations, instead of the proposed ordinary income inclusion pursuant to section 4.04 of the Proposed Rev Proc.

Finally, allowing for notional tax items would also alleviate the issue regarding losses claimed by a SP with respect to partnership income that was previously allocated to the SP, which was discussed above. Notional tax items will allow a partnership to fully offset any prior allocations of income and gain, and the SP will not need to seek any deduction with respect to such allocations.

D. Implications Under Sections 168(h) and 514(c)(9)(E)

Both section 168(h) (dealing with the definition of tax-exempt use property for the purposes of the alternative depreciation system) and section 514(c)(9)(E) (dealing with qualified allocations for the purposes of determining unrelated debt-financed income of exempt organizations) provide exceptions to the generally detrimental tax treatment of those sections if the allocations of a partnership meet certain requirements. Section 168(h) requires all allocations to be straight-up (i.e., strictly in proportion to percentage interests) and have

17 Alternatively, notional items could have the same character and source as the items being offset by the Forfeiture Allocations. In this context, we also recommend that the partnership be allowed to attempt, if possible, to match character and source of prior allocations when making Forfeiture Allocations.
substantial economic effect. Section 514(c)(9)(E) requires that income allocations to an exempt partner (i) cannot, subject to certain exceptions, be in percentages greater than the smallest percentage of loss allocated to the partner in any year and (ii) have substantial economic effect or be deemed to be in accordance with the partners’ interests in the partnership.

The Proposed Regulations explicitly provide that the allocations to a partner in respect of an interest that is substantially nonvested cannot have substantial economic effect. If this conclusion is interpreted to mean that none of the allocations to any partners have substantial economic effect during the period that an interest in the partnership is substantially nonvested, allocations to exempt partners would fail to meet the requirements of sections 168(h) and 514(c)(9)(E)(i)(II). In addition, the Proposed Regulations propose the adoption of forfeiture allocations to cause the allocations of the partnership to be deemed to be in accordance with the partners’ interests in the partnership. Forfeiture allocations would cause the allocations of the partnership to also fail the requirement that the allocations be straight-up for a partnership which has an exempt partner. While Treas. Reg. § 1.514(c)-2(e) allows for certain chargebacks without violating the disproportionate prohibition, the Proposed Regulations do not add forfeiture allocations to the permitted list of chargebacks. Unless forfeiture allocations are added to the permitted chargebacks under Treas. Reg. § 1.514(c)-2(e), an exempt organization could have unrelated business taxable income from a partnership in the year of a forfeiture allocation even if the partnership otherwise complies with the rules of section 514(c)(9)(E). There appears to be no policy reason for subjecting partnerships that have an exempt partner to additional tax burdens merely because nonvested partnership interests were issued to SPs, and such results are unduly harsh and likely were never contemplated prior to the issuance of the Proposed Regulations as being of concern.

We recommend that the Treasury not include in the Final Regulations the statement in the Proposed Regulations that allocations in respect of an interest that is substantially nonvested cannot have substantial economic effect. Alternatively, we recommend that a method be added to the Final Regulations so that such allocations may be deemed to have substantial economic effect. Additionally, we recommend that, to the extent forfeiture allocations are continued in the Final Regulations, forfeiture allocations be added to the permitted chargebacks under Treas. Reg. § 1.514(c)-2(e).

E. Suggested Change in Wording of Forfeiture Allocation Provisions

Finally, if Forfeiture Allocations are not eliminated from the Final Regulations, and if the provisions are not modified to allow partnerships to create notional tax items to make Forfeiture Allocations where the partnership does not have enough actual tax items to make such allocations, the provisions should be nevertheless be rewritten to clarify how the mechanism operates. Our proposal for the revised provision follows below:

18 Treas. Reg. § 1.168(h)-1T A-22. Violation of section 168(h) can also have unexpected and adverse consequences under section 470.
19 Treas. Reg. § 1.514(c)-2(b)(1).
(c) Forfeiture allocations. Forfeiture allocations are allocations to the service provider (consisting of a pro rata portion of each item) of gross income and gain (if the formula below is a positive amount) or gross deduction and loss (if the formula below is a negative amount) (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to –

(1) The excess (not less than zero) of –

(i) the amount of distributions (including deemed distributions under section 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under section 731); over

(ii) the amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under section 752(a)) to the partnership with respect to the forfeited partnership interest; minus

(2) The cumulative net income allocated to the partner with respect to the forfeited partnership interest; plus

(3) The cumulative net loss allocated to the partner with respect to the forfeited partnership interest.

(d) Exception. Paragraph (b)(4)(xii)(b) of this section shall not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a section 83(b) election if, at the time of the section 83(b) election, there is a plan that the interest will be forfeited. In such a case, the partners’ distributive shares of partnership items shall be determined in accordance with the partners’ interests in the partnership under paragraph (b)(3) of this section. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

(e) Cross references. Forfeiture allocations may be made out of the partnership’s items for the entire taxable year of the forfeiture. See §1.706-3(b) and paragraph (b)(5) Example 29 of this section.

F. Section 83(b) Elections when Compensatory Interest Granted Retroactively

The preamble states that the Proposed Regulations seek to coordinate the principles of subchapter K with the principles of section 83. Section 761 allows the partnership agreement to
include amendments made through the date for filing the partnership’s tax return (within the confines of other provisions of subchapter K, such as section 706(d)). Section 83(b), however, requires a decision (and a consequent election) to be made not later than 30 days after the date of transfer. If a SP is granted a compensatory interest in a partnership retroactively and in compliance with sections 761 and 706(d), the SP should be able to make the election allowed by section 83(b). To that end, we recommend that the SP should be allowed to make that election not later than 30 days after the date of the actual grant of the compensatory interest, regardless of a retroactive effective date. However, the date for valuing the interest granted for purposes of section 83 should remain the retroactive effective date of the grant.

III. LV Election

The Proposed Rev Proc creates a safe harbor, intended to both simplify the application of section 83 to partnership interests transferred in connection with the performance of services and coordinate the principles of section 83 with the principles of partnership taxation.21 The safe harbor is available to any “Safe Harbor Partnership Interest” that is transferred while an LV Election is in effect, provided that the rules of the Proposed Rev Proc are applied.22 The following discussion addresses recommendations with regard to each component of the requirements to obtain the safe harbor.

A. Disregarded Entities Issuing Compensatory Interests

The preamble to the Proposed Regulations states:

“"The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in [a disregarded entity] that becomes a partnership ... as a result of the transfer or substantial vesting of the interest. See McDougal v. Commissioner, 62 T.C. 720 (1974) ....""

While we agree that this is the appropriate approach, a question arises regarding the timing of making an LV Election in this situation. Section 3.03 of the Proposed Rev Proc provides that the LV Election must be made by a partnership after certain conditions are satisfied. Specifically, the LV Election must be attached to the tax return of the partnership that includes the effective date of the LV Election. In certain circumstances, it may be important for the owner of an entity that is disregarded as separate from its owner to make an LV Election prior to becoming a partnership for federal tax purposes. There does not appear to be a valid policy reason why such an entity could not make an LV Election prior to becoming a partnership for federal tax purposes. Thus, we recommend that LV Elections be permitted to be made by such entities, by allowing the owner to attach the LV Election to its tax return for the tax return that includes the effective date of the LV Election.

B. Mechanics for Making the LV Election

21 Proposed Rev Proc § 1.
22 Proposed Rev Proc § 3.01.
Section 3.06 of the Proposed Rev Proc requires partnerships to retain a copy of the LV Election submitted to the Service and, if applicable, the original of the document from each partner agreeing to the LV Election. That section further provides that inability to produce a record of either document will cause the LV Election to be treated as not made “generally resulting in termination of the [LV] Election ....”

This provision is unnecessarily burdensome and confusing. First, if the LV Election is submitted to the Service, it is unclear why the partnership should have the burden of producing that document, as such document can presumably be obtained from the service center with which the tax return was filed. Second, in today’s world of electronic communications, what constitutes an “original” may vary from state to state. Third, the requirement that an “original” be produced is unnecessarily cumbersome, if a copy would be sufficient for all other purposes. Additionally, it is unclear if the inability to produce the record would cause the LV Election to be terminated as of that date (i.e., ineffective for transfers of interests after such date or, at least, until a new LV Election could be made) or is treated as if it was never made (i.e., all transfers of interest purportedly within the LV Safe Harbor are treated as not within the LV Safe Harbor).

To clarify this provision, we recommend that the Service promulgate a form, which could look quite similar to the Form 2553, on which the LV Election could be made. The form should have two alternatives. The partner having responsibility for federal income tax reporting by the partnership (the “Reporting Partner”) would certify that the election is properly made in either alternative.

Under the first alternative, the Reporting Partner could select a box indicating that the partnership agreement (or another agreement, as applicable) contains the election language. If this alternative is selected, the partnership would have the burden of producing a copy of the applicable agreement showing the requisite signatures to prove that the LV Election was, in fact, made.

Under the second alternative, the Reporting Partner could select a box indicating that the persons executing the form constitute all of the required parties to the LV Election. The form would have a section for execution, in which the required parties to the LV Election would be agreeing to the election language. The election language should be printed directly on the form. If this alternative is selected, the partnership would only have the burden of showing that the correct parties executed the form and the LV Election should not be terminated merely because the form cannot be produced without resort to the Service’s service center.

C. Reporting Inconsistent with LV Election

Section 3.04 of the Proposed Rev Proc provides that “[a] Safe Harbor Election also terminates automatically in the event that the partnership, a partner, or service provider reports income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the requirements of this revenue procedure....” Thus, the Proposed Rev Proc attempts to prevent taxpayers from reporting inconsistently in a manner which maximizes individual taxpayer deduction and minimizes individual taxpayer income to the overall detriment of the fisc.

It would be acceptable to have the form set forth in the Final Rev Proc. See, e.g., Treas. Reg. § 1.1445-2(b)(2)(iv).
EXAMPLE 3: The DE partnership issues an interest to F, a SP with respect to the DE partnership. The partnership interest issued to F is entitled to an initial capital account balance equal to $100. The FMV of such interest is $50 and liquidation value of such interest is $100. The DE partnership has an otherwise valid LV Election in effect. The DE partnership thus reports a $100 deduction in the year of the issuance of the interest. F, however, reports income of only $50 in violation of the LV Safe Harbor.

Section 3.04 of the Proposed Rev Proc currently provides that the DE partnership’s LV Election is globally revoked upon such inconsistent reporting by F. Presumably, global revocation is intended to discourage inconsistent reporting as described in Example 3. However, it is unlikely that requiring global revocation of the LV Election upon such inconsistent reporting will have the desired effect of preventing such inconsistent reporting. On the contrary, global revocation likely will merely increase the ability of an interested party (F in Example 3) to “hold up” the other interested parties by threatening to report inconsistently. It would also likely substantially increase monitoring and related transaction costs that are already substantial due to the requirement that the partnership agreement contractually bind all relevant taxpayers to the detailed requirements of the LV Safe Harbor. Thus, global revocation would not likely decrease the probability of inconsistent reporting as a practical matter and, rather, would impose substantial transactional costs.

Accordingly, if the Treasury and the Service wish to prevent inconsistent reporting that would be detrimental to the fisc as described in Example 3, a better and more direct approach would require recognition agreements between the Service and each of the affected taxpayers. The agreement would require such taxpayers to report – and pay taxes – consistently with the LV Election. Such recognition agreements, of course, have precedent.

On the other hand, the Service has a variety of ways of ensuring that other partners report consistently with their Schedule K-1s. For example, the Service has a program to match Schedule K-1’s to individual returns that should flag inconsistencies. Section 6222 requires consistent reporting for TEFRA partnerships. Therefore, we recommend that inconsistent reporting by partners other than the SP not cause termination of the LV Election, so long as the partnership is reporting consistently with the election.

D. Qualification of Compensatory Interest

Section 3.02 of the Proposed Rev Proc excludes certain partnership interests from the application of the LV Safe Harbor. Any partnership interest may qualify for the LV Election (a “Safe Harbor Partnership Interest”) unless it is (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 section 7704(b).

25 The agreement could be part of the form suggested under “Mechanics for Making the LV Election” above.
26 See, e.g., Treas. Reg. § 1.367(a)-8(b).
Section 3.02 of the Proposed Rev Proc sets forth certain presumptions regarding whether a transfer of a Compensatory Interest to a SP is deemed made in anticipation of a subsequent disposition. A partnership interest is presumed to have been transferred in anticipation of a subsequent disposition under one of two circumstances. First, the presumption exists if the partnership interest is sold or disposed of within two years of the date of its receipt, other than by reason of the death or disability of the holder of the interest. Second, if the partnership interest is subject, at any time within two years of the date of receipt, to a right to buy or sell, regardless of when the right is exercisable (other than a buy/sell right that is exercisable only upon the death or disability of the holder), the presumption will exist. In either circumstance, the presumption that the Compensatory Interest is not a Safe Harbor Partnership Interest can only be overcome if it is established by clear and convincing evidence that the Compensatory Interest was not transferred in anticipation of a subsequent disposition.

Section 3.04 of the Proposed Rev Proc states that an LV Election terminates automatically on the date that a partnership fails to satisfy certain conditions and requirements described in the Proposed Rev Proc, including the requirements of section 3.02 of the Proposed Rev Proc. Because the requirements of a Safe Harbor Partnership Interest are included in section 3.02 of the Proposed Rev Proc, it is not clear whether a transfer of a Compensatory Interest by a SP that causes it to be disqualified as a Safe Harbor Partnership Interest would cause a termination of the LV Election. We recommend that the Final Rev Proc clarify that the failure of a Compensatory Interest to qualify as a Safe Harbor Partnership Interest does not terminate an existing LV Election for the partnership, but only disqualifies that interest as a Safe Harbor Partnership Interest.

In addition, although the presumptions set forth in the Proposed Rev Proc are helpful in determining whether a Compensatory Interest is a Safe Harbor Partnership Interest, it is not clear what factors may be used to overcome them. For example, the Proposed Rev Proc does not make clear under what circumstances, if any, a Compensatory Interest transferred within two years of its grant still may be treated as a Safe Harbor Partnership Interest. We therefore recommend that the Final Rev Proc provide a list of factors and examples to illustrate the circumstances under which the taxpayer-adverse presumptions set forth in the Proposed Rev Proc may be overcome.

Another concern is that the Proposed Rev Proc only sets forth taxpayer-adverse presumptions. We believe that it would be helpful to include taxpayer-friendly presumptions in the Rev Proc. For example, dispositions outside of two years, or those made by reason of the death or disability of the holder of the interest should receive a favorable presumption. If this recommendation is followed, we would also recommend a list of factors and examples which could be used to illustrate the circumstances which may overcome such taxpayer-friendly presumptions.

A buy/sell right generally should not create a presumption that a partnership interest was transferred in anticipation of a subsequent disposition, thus disqualifying the partnership interest as a Safe Harbor Partnership Interest. This is because buy/sell provisions in partnership agreements are a common means of addressing valid business issues, such as providing an exit strategy for partners or preventing sales of partnership interests to competitors. Therefore, we believe that the mere right to buy or sell a Compensatory Interest should not cause the
partnership interest to be disqualified as a Safe Harbor Partnership Interest. Otherwise, many Compensatory Interests commonly issued that are subject to legitimate transfer provisions will not qualify as Safe Harbor Partnership Interests. However, we believe that it would be appropriate for the Final Rev Proc to adopt a facts and circumstances test with respect to buy/sell provisions. This test should take into account not merely the existence of a buy/sell provision, but also its terms – such as the price at which the interest would be bought or sold – and the events triggering the provision – including death, disability, separation from service, divorce, disagreement as to management, etc. Additionally, if the buy/sell provision passes this facts and circumstances test (and does not, therefore, by its existence, disqualify the Compensatory Interest as a Safe Harbor Partnership Interest), then any actual transfers made pursuant to the exercise of such a buy/sell provision should also not cause the Compensatory Interest to be disqualified.

Finally, the presumptions set forth in the Proposed Rev Proc may be overcome only by “clear and convincing” evidence. For the sake of consistency in subchapter K, we recommend a similar standard as under the disguised sales rules of Treas. Reg. § 1.707-3 be used to overcome the presumptions. Specifically, Treas. Reg. §§ 1.707-3(c) and (d) provide for certain presumptions which may be overcome if the facts and circumstances “clearly establish” a different result.

IV. Interaction between section 752 Regulations and Compensatory Interests

The NonCompensatory Proposed Regulations contain special rules regarding the revaluations of partnership property while non-compensatory partnership options are outstanding. While a non-compensatory option is outstanding, the NonCompensatory Proposed Regulations provide that any revaluations of partnership property must take into account the value of any non-compensatory options outstanding.

In the NonCompensatory Proposed Regulations, the Treasury and the Service avoided or minimized the economic distortion that otherwise would have been created in the capital accounts while the option was outstanding by subtracting the option price and liquidation value of the option from the value of the assets allocated in any adjustment to the capital accounts while the option was outstanding. The approach of the NonCompensatory Proposed Regulations provided a solution to the economic problem that the capital accounts somehow need to be adjusted to reflect the economic agreement of the parties. The Proposed Regulations do not contain a mechanic to obtain this result.

Instead, the Treasury indicates in the preamble to the Proposed Regulations that, under recent modifications to Treas. Reg. § 1.704-1(b)(2)(iv), the obligation to issue a partnership interest in satisfaction of an option agreement is a liability that is taken into account in determining the FMV of partnership assets as a result of a revaluation. In the discussion, the Treasury and the Service refer to regulations promulgated under section 752, relating to the assumption of certain obligations by partnerships from partners.

The regulations under section 752 dealing with the treatment of non-debt liabilities of a partnership do not directly make any change to Treas. Reg. § 1.704-1(b)(2)(iv)(f) or (h), which deal with the valuation of property for the purpose of book revaluations. However, Treas. Reg. § 1.752-7(c)(1)(ii) provides that if there is a change in the value of a liability governed by Treas. Reg. § 1.752-7 (a “§1.752-7 Liability”) for the purposes of Treas. Reg. § 1.704-1(b)(2)(iv)(f), the amount of the decrease or increase constitutes an item of income or loss for the purposes of section 704(b) and Treas. Reg. § 1.704-1(b). For such purposes, a §1.752-7 Liability is an obligation, including contingent obligations and options, to the extent such obligation does not (i) create or increase the basis of any asset; (ii) give rise to an immediate deduction; or (iii) give rise to an expense (that is neither deductible nor capitalizable). An obligation to issue a Compensatory Interest pursuant to a compensatory option may satisfy this definition because the tax consequences are generally deferred until the option is exercised.

The amount of a §1.752-7 Liability is the amount of cash that a willing assignor would pay to a willing assignee to assume the §1.752-7 Liability in an arm’s length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contact, and those contracts are contributed to the partnership in connection with the partnership’s assumption of the contractual obligation, then the amount of the §1.752-7 Liability is the amount of cash, if any, that a willing assignor would pay to a willing assignee to assume the entire contract.

It is unclear how the Treas. Reg. § 1.752-7 valuation rules are intended to apply in the context of partnership options issued in exchange for service. The value generated for a §1.752-7 Liability in respect of a compensatory option may or may not equal the liquidation value attributable to the interest. Although not stated expressly in Notice 2005-43, presumably the Treasury intended for an electing partnership to use the liquidation value for all purposes – otherwise, an electing partnership could use liquidation value for purposes of section 83 and the value calculated under Treas. Reg. § 1.752-7 for other purposes.

On a theoretical level, assuming all parties priced the services and the equity on a FMV basis, at the outset of the contract, the net value of the entire contract should equal zero – in other words, the value of the services contributed to the partnership should equal the total value of consideration to be paid to the SP, including the partnership equity to be issued. However, as time passes, an increased likelihood of exercise, plus the increased present value of the future payment because of a shortened time span, might cause the value of the §1.752-7 Liability to approach the value of the partnership interest that would be received on exercise. The following example represents a modification of example 22 in Prop. Treas. Reg. § 1.704-1(b)(5) to use the concepts under Treas. Reg. § 1.752-7:

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29 Treas. Reg. § 1.752-7(b)(3).
30 It is not clear that an option to acquire a partnership interest should be treated as an obligation or liability for purposes of section 752 and the regulations thereunder.
31 Treas. Reg. § 1.752-7(b)(3)(ii).
32 Id.
33 Notice 2005-43 on its face only deals with a deemed value for the purposes of section 83. However, Prop. Treas. Reg. § 1.83-3(l) is not so limited.
EXAMPLE 4:  

(i) In Year 1, G and H each contribute cash of $10,000 to the GH partnership, a newly formed entity classified as a partnership for federal tax purposes, in exchange for 100 units in the GH partnership. Under the partnership agreement, each unit is entitled to participate equally in the profits and losses of the GH partnership. The GH partnership uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, the GH partnership issues an option to J. The option allows J to buy 100 units in the GH partnership for an exercise price of $15,000 in Year 2. J pays nothing to the GH partnership for the issuance of the option because the option is issued in connection with services performed and to be performed by J for the GH partnership. Assume that all material allocations and capital account adjustments under the partnership agreement not pertaining to compensatory options are recognized under section 704(b). Also assume that J’s option is a compensatory option and that J is not treated as a partner with respect to the option. Also assume that the value of J’s services maintains the value of the assets of the GH partnership, but does not add any net value (after the consideration of the compensation expense).

(ii) Prior to the exercise of J’s option, K contributes $16,666 to the GH partnership for 100 units in the GH partnership. At the time of K’s contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the liquidation value of J’s option is $1,666. Under Treas. Reg. § 1.752-7, the amount of the GH partnership’s §1.752-7 Liability in respect of J’s option is determined by reference to the amount the GH partnership would have to pay a willing assignee to assume the GH partnership’s entire contract with J, including J’s agreement to perform future services. If the value of J’s services to be performed are at least equal to $1,666, the §1.752-7 Liability of the GH partnership in respect of J’s option will be $0. For the purposes of this example, it will be assumed that, at the time of K’s admission, the §1.752-7 Liability in respect of J’s option is $1,000, which means that the value of the remaining services to be performed by J is $666.

(iii) Upon K’s admission to the GH partnership, the capital accounts of G and H (which were $10,000 each prior to K’s admission) are, in accordance with Treas. Reg. §§ 1.704-1(b)(2)(iv)(f) and (g) (the “Revaluation Rules”), adjusted upward to reflect their shares of the unrealized appreciation in the GH partnership’s assets. Under the Revaluation Rules, those adjustments must be based on the FMV of the GH partnership’s property on the date of the adjustment. The FMV of the GH partnership’s property ($35,000) must be reduced by the §1.752-7 liability related to the option ($1,000). Therefore, the revaluation adjustments must be based on a value of $34,000. Accordingly, G and H’s capital accounts must be increased to $17,000. The $19,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between G and H in accordance with section 704(c) principles.

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34 \$30,000 + $5,000 + $16,666 + $15,000 = $66,666. $66,666 / 4 = $16,666. $16,666 - $15,000 = $1,666.
35 Taking section 7701(g) into account.
36 Immediately prior to the entry of K into the LLC. See, Treas. Reg. § 1.704-1(b)(5), Ex. 14.
37 Treas. Reg. § 1.752-7(c)(2).
<table>
<thead>
<tr>
<th>ASSETS</th>
<th>BASIS</th>
<th>VALUE</th>
<th>OPTION ADJUSTMENT</th>
<th>704(c) BOOK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>$10,000</td>
<td>$30,000</td>
<td>($1,000)</td>
<td>$29,000</td>
</tr>
<tr>
<td>Property B</td>
<td>$10,000</td>
<td>$ 5,000</td>
<td>0</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>$20,000</td>
<td>$35,000</td>
<td>($1,000)</td>
<td>$34,000</td>
</tr>
<tr>
<td>Cash contributed by K</td>
<td>$16,666</td>
<td>$16,666</td>
<td>0</td>
<td>$16,666</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$36,666</td>
<td>$51,666</td>
<td>($1,000)</td>
<td>$50,666</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND CAPITAL</th>
<th>TAX</th>
<th>BOOK VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td>$10,000</td>
<td>$17,000</td>
</tr>
<tr>
<td>H</td>
<td>$10,000</td>
<td>$17,000</td>
</tr>
<tr>
<td>K</td>
<td>$16,666</td>
<td>$16,666</td>
</tr>
<tr>
<td>Option</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$36,666</td>
<td>$50,666</td>
</tr>
</tbody>
</table>

It is clear that the use of the §1.752-7 Liability amount in determining the capital account revaluation has overstated the capital accounts of G and H by the value of the services of J that are yet to be performed, assuming such services are not adding value to the GH partnership (as opposed to maintaining its value). The pricing of K’s interest in the GH partnership indicates that G, H and K believed that the value of 100 units in the GH partnership was $16,666. It is true that the distortion should correct itself upon exercise of J’s option if the LV Election has been made, but the distortion may affect the validity of allocations and, in some circumstances, the amount of distributions until such exercise.38

To avoid a potential avenue of manipulation and a trap for the unwary, we recommend that, if a partnership makes an LV Election under the Proposed Rev Proc, the liquidation value also be used for determining capital account adjustments under the Revaluation Rules. Similarly, the Treasury and the Service should consider whether, in the absence of an LV Election, a consistent valuation methodology should apply, such as that described in the NonCompensatory Proposed Regulations.

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38 The distortion should also correct itself in the absence of an LV Election, but will be replaced by the distortion discussed under “Capital Accounts” above.
V. Compensatory Interests Transferred to Persons Providing Services to Related Partnerships

The preamble to the Proposed Regulations provides that the Proposed Rev Proc and certain parts of the Proposed Regulations only apply to a transfer of an interest in a partnership in connection with the performance of services for that partnership. The Treasury and the Service requested comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to an upper-tier partnership.

We believe the Proposals should be extended to transfers of Compensatory Interests by one partnership (the “Issuing Partnership”) to persons providing services to a second partnership (the “Employer Partnership”) where the Issuing Partnership and the Employer Partnership are related. In extending the Proposals to such transactions, we recommend the following: (i) the Proposals should apply to transfers in which the Issuing Partnership holds more than a de minimis interest in the capital or profits of the Employer Partnership or the Employer Partnership holds more than a de minimis interest in the capital or profits of the Issuing Partnership (“Related Partnership Transfers”); (ii) the principles of Treas. Reg. §§ 1.83-6(d) and 1.1032-3 should be extended to Related Partnership Transfers; (iii) the Issuing Partnership should be permitted to make an LV Election and to adjust the partners’ capital accounts to reflect a revaluation of the Issuing Partnership’s property in connection with a Related Partnership Transfer; and (iv) neither the Issuing Partnership nor the Employer Partnership should recognize any gain or loss as a result of a Related Partnership Transfer.

There are a number of circumstances in which a partnership may transfer a Compensatory Interest to an employee of a related partnership. For example, an upper-tier partnership may have responsibilities as general partner of a lower-tier partnership that has a key employee. Although the key employee works for the lower-tier partnership, the upper-tier partnership could issue a Compensatory Interest to the key employee because it believes the employee’s services enhance the value of its interest in the lower-tier partnership. In another case, the key employee may be employed by an upper-tier partnership that is general partner of a lower-tier partnership. Although the key employee works for the upper-tier partnership, the lower-tier partnership could issue a Compensatory Interest to the key employee because it believes the employee’s services are particularly valuable to the lower-tier partnership’s business. In still another situation, key employees of one partnership may form a second partnership. Instead of issuing Compensatory Interests directly to the employees, the first partnership could issue Compensatory Interests to the second partnership and, in turn, the second partnership could issue Compensatory Interests in that partnership to the employees.

The current regulations contain rules that deal with situations in which a shareholder transfers property to an employee of a corporation or a corporation transfers property to an employee of another corporation or partnership. We believe the principles of those regulations should be extended to Related Partnership Transfers.

Treas. Reg. § 1.83-6(d) contains rules that govern transfers of property by a shareholder of a corporation to an employee of that corporation. Under those rules, if the shareholder transfers property to an employee (or an independent contractor) of the corporation, in
consideration of services performed for the corporation, the transaction is treated as a contribution of the property to the corporation by the shareholder and, immediately thereafter, a transfer of the property by the corporation to the employee (or independent contractor). In the case of such a transfer, any money or property paid to the shareholder is treated as paid to the corporation and transferred immediately thereafter by the corporation to the shareholder as a distribution. If the transferred property is subsequently forfeited to the shareholder, the rules that require a corporation to recognize income with respect to any deduction previously claimed by the corporation (or increase in basis or reduction in gross income) and which determine the basis of the forfeited property apply both with respect to the shareholder and with respect to the corporation. In addition, in the year of forfeiture, the corporation realizes a loss (or a gain) that offsets any gain (or loss) realized in connection with the original transfer of the property.

Treas. Reg. § 1.1032-3 contains rules that apply to a corporation’s transfer of its stock (the issuing corporation) to any person in consideration of services performed for another corporation or partnership (the acquiring entity). In such a situation, the transaction is treated as if the acquiring entity purchased the issuing corporation’s stock for FMV with cash contributed to the acquiring entity by the issuing corporation. The amount of cash deemed contributed by the issuing corporation to the acquiring entity is equal to the difference between the FMV of the issuing corporation’s stock and the amount of money or the FMV of property that the issuing corporation actually receives as payment for its stock. Immediately following the acquiring entity’s deemed purchase of the issuing corporation’s stock, the acquiring entity is treated as transferring the issuing corporation’s stock to the person performing services for the acquiring entity. No gain or loss is recognized on the disposition of the issuing corporation’s stock by the acquiring entity.

The examples to Treas. Reg. § 1.1032-3 illustrate how that provision applies in practice. Assume that X corporation owns all of the outstanding stock of Y corporation and B, an individual, is an employee of Y. Pursuant to an agreement between X and Y to compensate B for services provided to Y, X transfers to B 10 shares of X stock with a FMV of $100. Under Treas. Reg. § 1.1032-3, X is treated as contributing $100 of cash to Y and, immediately thereafter, Y is treated as transferring the X stock from X with the $100 of cash deemed to have been contributed to Y by X. Y is then treated as transferring the X stock to B. No gain or loss is recognized on the deemed disposition of the X stock by Y.39

The Service has also applied Treas. Reg. §§ 1.83-6(d) and 1.1032-3 in various rulings. For example, in Revenue Ruling 80-196, A and B each owned 15,000 shares of the outstanding common stock of X corporation.40 A and B each transferred 100 shares of X stock to each of three employees in consideration of past services. The X stock transferred to the employees was fully transferable and not subject to any restrictions. The Service concluded that A and B should be treated as contributing the transferred stock to X and, thereafter, X is treated as transferring the stock to the three employees. A and B did not recognize gain or loss in the transaction and X was entitled to a deduction equal to the amounts included in income by the employees.41

39 Treas. Reg. § 1.1032-3(e), Example 4.
41 See also Priv. Ltr. Rul. 200118046 (Feb. 5, 2001).
Revenue Ruling 2003-98 considered a case in which an employee of M corporation was granted a non-statutory option to acquire stock in M. Corporation N subsequently acquired all of the outstanding stock in M. In one situation, on the acquisition date employee exchanged the M option for an option to acquire stock in N and, subsequently, employee exercised the N option. The Service ruled that, applying Treas. Reg. § 1.83-6, because M was the service recipient, only M was permitted to deduct the compensation includible in employee’s gross income as a result of the exercise of the N option. Although N actually transferred its stock directly to employee, such transfer was treated as a cash capital contribution by N to M and M was treated as purchasing the stock from N and as transferring the N stock to the employee. Because the compensation received by the employee upon the exercise of the N option was substantially vested N shares, to the extent that the compensation was deductible, only M was entitled to the deduction.

We believe Treas. Reg. § 1.83-6(d) should be extended to partnerships and the regulations under section 721 should be amended to incorporate the principles of Treas. Reg. § 1.1032-3. Neither the Issuing Partnership nor the Employer Partnership should recognize any gain or loss as a result of a Related Partnership Transfer. The Issuing Partnership should be permitted to make an LV Election and to adjust the partners’ capital accounts to reflect a revaluation of the Issuing Partnership’s property in connection with a Related Partnership Transfer. If an LV Election is not made, the principles of Treas. Reg. §§ 1.83-6(d) and 1.1032-3 should be based upon the FMV of the transferred partnership interest and the mechanism applied to eliminate any disparity between the employee’s tax capital account (based on the FMV of the partnership interest) and book capital account (based on the parties’ economic deal) should be applied to the Issuing Partnership.

**Example 5 (Grant of an Upper-Tier Capital Interest to a Lower-Tier Employee).** LT (an entity classified as a partnership for federal income tax purposes) is in the real estate development business. LT’s assets have a book value of $50 and a FMV of $100. The profits and capital interests in LT are owned 60% by UT (an entity classified as a partnership for federal income tax purposes) and 40% by N (an individual). UT’s assets consist of its 60% interest in LT and Blackacre. UT’s interest in LT has a book value of $30 (i.e., $50 x 60%) and a FMV of $60 (i.e., $100 x 60%). Blackacre, UT’s other asset, has a book value of $20 and a FMV of $40. Each of L and M (both individuals) owns a 50% interest in the profits and capital of UT. UT has a valid LV Election in effect.

SP (an individual) is a key employee of LT. In exchange for past services provided by SP to LT, UT grants SP a 10% interest in the profits and capital of UT. The interest issued to SP is not subject to restrictions on transfer or a risk of forfeiture on the date of grant. Compensation paid to SP is currently deductible in the year of grant.

Because UT has a valid LV Election in effect, a 10% interest in the profits and capital of UT is valued at $10 (i.e., 10% x [$60 (FMV of UT’s interest in LT) + $40 (FMV of Blackacre)]). UT is treated as contributing $10 of cash to LT. UT then adjusts

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43 See Treas. Reg. §§ 1.83-6(d)(1), 1.1032-3(b)(1) and 1.1032-3(e), Example 8.
45 See “Capital Accounts” section of these comments.
L’s and M’s capital accounts to reflect a revaluation of UT’s assets and, thereafter, LT is treated as purchasing a 10% interest in the profits and capital of UT with the cash contributed to LT by UT. LT is then treated as transferring the 10% interest in the profits and capital of UT to SP. SP recognizes $10 of compensation income and LT is entitled to a $10 deduction which is allocated 60% to UT and 40% to N. The resulting capital accounts in UT would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>L</th>
<th>M</th>
<th>LT / SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Capital Accounts</td>
<td>$25</td>
<td>$25</td>
<td>--</td>
</tr>
<tr>
<td>Revaluation of UT’s Assets</td>
<td>$25</td>
<td>$25</td>
<td>--</td>
</tr>
<tr>
<td>Deemed Purchase by LT</td>
<td>--</td>
<td>--</td>
<td>$10</td>
</tr>
<tr>
<td>UT’s Share of Deduction</td>
<td>$(3)</td>
<td>$(3)</td>
<td>--</td>
</tr>
<tr>
<td></td>
<td>$47</td>
<td>$47</td>
<td>$10</td>
</tr>
</tbody>
</table>

**Example 6** (*Grant of an Upper-Tier Profits Interest to a Lower-Tier Employee*).
The facts are the same as Example 5, except that UT grants SP a 10% interest in the future profits of UT.

Because UT has a valid LV Election in effect, a 10% interest in the future profits of UT is valued at $0. UT is not treated as contributing cash to LT. UT adjusts L’s and M’s capital accounts to reflect a revaluation of UT’s assets and, thereafter, LT is treated as acquiring a 10% profits interest in UT for no cash. LT is then treated as transferring the 10% profits interest in UT to SP. SP recognizes no compensation income and LT is not entitled to a deduction. The resulting capital accounts in UT would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>L</th>
<th>M</th>
<th>LT / SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Capital Accounts</td>
<td>$25</td>
<td>$25</td>
<td>--</td>
</tr>
<tr>
<td>Revaluation of UT’s Assets</td>
<td>$25</td>
<td>$25</td>
<td>--</td>
</tr>
<tr>
<td>Deemed Acquisition by LT</td>
<td>--</td>
<td>--</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$50</td>
<td>$50</td>
<td>$0</td>
</tr>
</tbody>
</table>

**Example 7** (*Grant of a Lower-Tier Capital Interest to an Upper-Tier Employee*).
The facts are the same as Example 5, except that SP is a key employee of UT. LT (not UT) has a valid LV Election in effect. Although SP is an employee of UT, SP performs services for UT that benefit all of LT’s partners. In exchange for past services provided by SP to UT, LT grants S a 10% interest in the profits and capital of LT. The interest issued to SP is not subject to restrictions on transfer or a risk of forfeiture on the date of grant. Compensation paid to SP is currently deductible in the year of grant.

Because LT has a valid LV Election in effect, a 10% interest in the profits and capital of LT is valued at $10 (i.e., 10% x $100 [FMV of LT’s Assets]). LT is treated as distributing $10 of cash to UT. LT then adjusts UT’s and N’s capital accounts to reflect a revaluation of LT’s assets and, thereafter, UT is treated as purchasing a 10% interest in the profits and capital of LT with the cash distributed to UT by LT. UT is then treated as transferring the 10% interest in the profits and capital of LT to SP. SP recognizes $10
of compensation income and UT is entitled to a $10 deduction which is allocated 50% to L and 50% to M. The resulting capital accounts in LT would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>UT</th>
<th>N</th>
<th>SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Capital Accounts</td>
<td>$30</td>
<td>$20</td>
<td>--</td>
</tr>
<tr>
<td>Deemed Distribution to UT</td>
<td>($10)</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Revaluation of LT’s Assets</td>
<td>$30</td>
<td>$20</td>
<td>--</td>
</tr>
<tr>
<td>Deemed Purchase by UT</td>
<td>$10</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Transfer From UT to SP</td>
<td>($10)</td>
<td>--</td>
<td>$10</td>
</tr>
<tr>
<td></td>
<td>$50</td>
<td>$40</td>
<td>$10</td>
</tr>
</tbody>
</table>

**Example 8 (Grant of a Lower-Tier Profits Interest to an Upper-Tier Employee).**

The facts are the same as Example 7, except that LT grants SP a 10% interest in the future profits of LT.

Because LT has a valid LV Election in effect, a 10% interest in the future profits of LT is valued at $0. LT is not treated as distributing cash to UT. LT adjusts UT’s and N’s capital accounts to reflect a revaluation of LT’s assets and, thereafter, LT is treated as transferring a 10% profits interest to UT for no cash. UT is then treated as transferring the 10% profits interest in LT to SP. SP recognizes no compensation income and UT is not entitled to a deduction. The resulting capital accounts in LT would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>UT</th>
<th>N</th>
<th>SP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Capital Accounts</td>
<td>$30</td>
<td>$20</td>
<td>--</td>
</tr>
<tr>
<td>Revaluation of LT’s Assets</td>
<td>$30</td>
<td>$20</td>
<td>--</td>
</tr>
<tr>
<td>Deemed Transfer to UT/SP</td>
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<td>--</td>
<td>$0</td>
</tr>
<tr>
<td></td>
<td>$60</td>
<td>$40</td>
<td>$0</td>
</tr>
</tbody>
</table>


We concur with the position of the Proposed Regulations that Prop. Treas. Reg. § 1.761-3 (the “Anti-abuse Rule”) should not be expanded to apply to options to acquire Compensatory Interests, but we believe it would be helpful if the treatment of options to acquire partnership interests were amplified. For this reason, we recommend that Treas. Reg. § 1.83-7 be expanded to apply to options to acquire any equity interests of an entity (i.e., partnership interests and stock).

We believe that the Anti-abuse Rule should not apply to options to acquire Compensatory Interests. Without taking a position on the advisability of this rule in noncompensatory options, we think that applying the Anti-abuse Rule would not work well with respect to options to acquire Compensatory Interests. It is unlikely that the test “as of the date that the option is issued, transferred, or modified, there would be a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities,” would work well in the case of a Compensatory Interest. In most cases, since the SP
would have income and the partnership would have a deduction in the same amount, unless the existing partners and the SP are in significantly different tax brackets, this test is unlikely to be met. Another problem with using the Anti-abuse Rule for compensatory options is that SPs who are managers of limited liability companies may be recipients of such options. A manager will have many of the attributes of a partner such as the ability to control or restrict the activities of the partnership. Thus, when a compensatory option is granted to a manager of a limited liability company, the second prong of the test in Prop. Treas. Reg. § 1.761-3(c) will easily be triggered. Such a test may be appropriate in the case of a noncompensatory option, in which the option is being granted in connection with something other than management services and possession of management powers might appear abusive. In the case of a compensatory option, on the other hand, such management powers would be common and should not be a badge of abuse.

The most likely circumstance in which this test would apply – where the services would be required to be capitalized so that the SP would have income on the receipt of the Compensatory Interest while the other partners would not obtain a corresponding deduction – is not an abusive situation. Thus, the Anti-abuse Rule would not appear to be warranted in the compensatory context.

There are, however, situations in which, even though the test set forth in the Anti-abuse Rule would not be met, it would be appropriate to treat the SP holding an option to acquire a partnership interest as a partner, rather than a mere optionee (such as where the option is so deep in the money (e.g., a penny exercise price for a partnership interest worth $20)). Particularly in light of the detailed rules set forth in the Anti-abuse Rule, we believe it would be appropriate either (i) for the Final Regulations to state that, in the case of a compensatory option, the issue of whether an optionee is treated as a partner will be decided under general federal income tax principles, or (ii) for the Final Regulations to adopt rules similar to those set forth in Treas. Reg. § 1.1361-1(l)(4)(iii).

If rules similar to those set forth in Treas. Reg. § 1.1361-1(l)(4)(iii) are adopted, a SP holding a compensatory partnership option would not be treated as a partner unless, taking into account all of the facts and circumstances, the option (i) is substantially certain to be exercised and (ii) has a strike price substantially below the fair market value of the underlying Compensatory Interest on the date that the option is issued, transferred or “materially modified.” A rule analogous to Treas. Reg. § 1.1361-1(l)(4)(iii)(A) would provide that an option would not be treated as having a strike price substantially below such fair market value if, pursuant to the terms of the instrument, the strike price at the time of its exercise could not be substantially below the fair market value of the underlying Compensatory Interest. In addition, under a safe harbor similar to Treas. Reg. § 1.1361-1(l)(4)(iii)(C), the option would not have a strike price substantially below the fair market value of the underlying Compensatory Interest if the strike price is at least 90% of the fair market value of the Compensatory Interest on the date the option is issued, transferred or materially modified.

Among the other benefits of using rules similar to those in Treas. Reg. § 1.1361-1(l)(4)(iii) for compensatory options is that, under that regulation, the determination of the value of the option is made only at the time of a “material modification” of the option, rather than upon all “modifications,” as is the case under the Anti-abuse Rule. We believe that, in light of
the uncertainty accompanying when a partnership option is modified, including potentially inadvertent modifications caused by amendments to the partnership agreement, and the significant tax stakes for the partnership and the SP, it is preferable to use the concept of “material modification” as the occasion for redetermination.

Presumably, if the optionee were deemed a partner, rather than an optionee, the optionee would be treated in a manner consistent with a person holding a Compensatory Interest.

In addition, we believe that it would be helpful if the Final Regulations provided additional guidance with respect to options to acquire Compensatory Interests. We believe that the Final Regulations should make clear that Treas. Reg. § 1.83-7 applies to compensatory options and should provide examples of the treatment of the grant, exercise and lapse of such an option. We anticipate that an option to acquire a Compensatory Interest would ordinarily not be treated as property because it would lack a readily ascertainable FMV within the meaning of Treas. Reg. § 1.83-7. In such case, the SP would recognize compensation income at the time of the exercise of the option in an amount equal to the excess of the FMV of the partnership interest received over the option exercise price.

We also believe that clarification of how the LV Election rules would apply in the case of a compensatory option would be helpful. For instance, if the option has a readily ascertainable market value at grant, but the option relates to a profits interest, would the amount included in income be the FMV of the option or the liquidation value? Presumably, it would be the former, even if the partnership had an LV Election in effect. If a partnership has an LV Election in effect at the time of the exercise of the compensatory option that did not have a readily ascertainable FMV at the time of grant, we assume that the SP would recognize compensation income at the time of the exercise of the option in an amount equal to the excess of the liquidation value of the partnership interest (versus its FMV) received over the option exercise price.

In the unusual situation where the compensatory option does have a readily ascertainable FMV, the SP should have compensatory income equal to the FMV of the option on the date it is granted and the SP would have a basis in the option equal to the FMV of the option. The partnership would be entitled to an equivalent deduction.

VII. The Difficulty of Applying the Proposed Regulations to Inherently Variable Interests in Service Partnerships

A. Interests in Partnership Profits

As discussed elsewhere in these comments, the Proposed Regulations would, in general, cause the recognition of Grant Income in connection with an interest in the profits of a partnership in an amount equal to the FMV of the interest at the time of the grant. The Proposed Regulations also contemplate conditional relief from such recognition if the granting partnership and its partners make the LV Election.

Neither the general rule under the Proposed Regulations nor the proposed LV Election adequately address the potential for double taxation of grants of inherently variable interests in Service Partnerships.
In Service Partnerships, interests in the profits ("Profits Percentages") of the partnership are generally awarded based upon the contributions of the individual partners to the partnership in terms of billings collected, hours billed, and services performed for the partnership and anticipated to be performed for the partnership. Such awards are generally made in the beginning of the calendar year following the year, in reference to which the billings and hours are calculated, after the numbers for the referenced year have been finalized. Such awards come in three primary variations: purely retroactive awards (relating to the year in reference to which the billings and hours are calculated), mostly prospective awards (based upon the prior year, but relating to the calendar year in which the award is made), and a combination of retroactive and prospective awards (based upon the prior year, but purporting to apply also to the current and potentially future years).

1) Purely Retroactive Grants

In firms that give only retroactive awards, a treatment of such awards as property under section 83 would almost necessarily result in double taxation of the income that is allocable to the partner relating to the percentage awarded. At the time the award is made, the collection of the prior year’s receivables has been made and the cash not previously distributed is sitting in the partnership. The FMV and the liquidation value of the interest would likely be at least equal to the cash that would be immediately distributable in respect of the interest (plus any offsets against advances made during the year). Under subchapter K, the individual receiving a retroactive grant will also be taxable on his or her allocable share of partnership income for the year in respect of which the award is made.

**EXAMPLE 9:** The OPQ partnership is a Service Partnership. The OPQ partnership annually makes retroactive awards of profit percentages in respect of the prior calendar year on March 15 of the following year. In 2005, the OPQ partnership has $1,000 of income. On March 15, 2006, the OPQ partnership determines that partner O (an existing partner) should be awarded 25 percent of the income in respect of 2005 (without being required to make any additional capital contribution). If $250 becomes immediately distributable to O, the FMV and liquidation value of the interest presumably would be at least $250, taxable in 2006, when the grant is made to O. Under subchapter K, the OPQ partnership would allocate $250 to O, taxable in 2005. Under section 705, O’s basis is increased by the allocation of $250 of income and decreased by the distribution of cash, returning O’s basis to zero. Under the Proposed Regulations, on March 15, 2006, O’s basis would again be increased to $250 by Treas. Reg. § 1.61-2(d)(2). In other words, applying the Proposed Regulations to purely retroactive grants by Service Partnerships results in O receiving $500 of taxable income, $250 of cash and a non-economic net basis of $250.

Although gross income includes income, gains and compensation from any source whatsoever, the accession to wealth that O experiences is only $250. Although Congress could increase the rate of taxation on O so that O’s tax is doubled, there is no indication that Congress intended the same accession to wealth to be included in O’s gross income twice.

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46 Section 61.
EXAMPLE 10: In 2006, the OPQ partnership again has $1,000 of income. On March 15, 2007, the OPQ partnership determines that partner O should be awarded 20 percent of the income in respect of 2006.

It seems unlikely that the Treasury would agree that O has had a partial disposition of O’s partnership interest allowing O to recognize a loss based on a portion of O’s $250 noneconomic basis. The more significant question, however, is whether the Proposed Regulations would be applied again to double the inclusion in O’s gross income. On March 15, 2007, O was awarded a right to 20 percent of the OPQ partnership income, which, combined with the right to immediately distributable cash, would have a FMV and liquidation value of $200.\(^{47}\) Subchapter K would require the inclusion of $200 in O’s gross income for 2006, but would the Proposed Regulations require a second inclusion of $200 in respect of the award of the interest in 2007?

One might respond that O has had no grant of an additional interest in the partnership in Example 10, since O’s overall interest in the partnership was less in 2006 than in 2005. However, in a Service Partnership that makes purely retroactive grants, O could have been allocated 15%, 10%, 5% or potentially even 0% depending upon O’s contribution to the firm (in terms of services) during the relevant period. Thus, if the Proposed Regulations were applied literally without modification to the OPQ partnership, each year, all of the partners would receive grants of interests to participate in the profits of the partnership, which would total 100%, resulting in double taxation of 100% of the net income of the OPQ partnership each year and creating an additional noneconomic basis equal to the amount included in income.

Even if one were to look only at the incremental change in each partner’s interest, the result is equally absurd. Each year, partners holding 50% of the interests in the partnership would have their interests increased, potentially creating an income recognition event under the Proposed Regulations, while partners holding the other 50% would have their interests decreased.\(^{48}\) As discussed above, the change in Profits Percentages would occur each year, but by definition the combined Profits Percentages of the partners would remain at 100%.

One way to reconcile the economic reality with the Proposed Regulations would be to interpret the exclusion in the current regulations of cash from the definition of “property” for the purposes of section 83 in such a way so that the grant of an interest in a partnership that only represents a right to immediately distributable cash is similarly excluded.\(^{49}\) Such an interpretation would effectively exclude purely retroactive grants from the application of section 83, leaving the recipient taxable only under subchapter K.

\(^{47}\) In this and the following examples, no FMV has been attributed to goodwill. See, Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).

\(^{48}\) This was apparently the fact pattern in PLR 9821051 (May 22, 1998), in which the Service concluded that neither the partnership nor the partners had a recognition event on the change in allocations.

\(^{49}\) Treas. Reg. § 1.83-3(e).
2) Mostly Prospective Awards

The second common method in which profits are divided in Service Partnerships is awards based upon the prior year’s contributions to the firm, but intended to be applied to the year in which the award is made.

**EXAMPLE 11:** The RST partnership is a Service Partnership that has $1,000 of net income in each of 2005 and 2006. On March 15, 2006, the RST partnership determines that R should, based upon R’s contributions to the firm (in terms of services) in 2005, be entitled to 25% of the net income of the partnership in 2006. Because the award is made on March 15, two and a half months of income would have already been realized by the RST partnership, some of which is likely to have been distributed to R in the form of advances. The award would also represent a right to participate in 25% of the net income of the RST partnership for the full 2006 year. Thus, the interest is likely to have a positive FMV and a positive liquidation value (so long as less than all of the net income has been distributed). However, unlike Examples 9 and 10, there is likely to be a significant difference between the FMV and liquidation value. An LV Election is likely to result in a value equal to 25% of the income earned by the RST partnership in the first two and a half months of the year (to the extent undistributed). A FMV determination might also include some value attributable to the right to participate in income for the balance of the year.

Both the FMV and the liquidation value of the interest awarded to R have very similar double taxation problems to those discussed in Examples 9 and 10. If, for example, the liquidation value of the interest awarded to R is $40 and the FMV of the interest is $45 on March 15, under the Proposed Regulations, either $40 or $45 would be included in R’s income under section 83, but R would also be required to include $250 in income under subchapter K, which in part would be based upon the same net profits upon which the values were determined under section 83.

The mostly prospective grant illustrates another aspect of the reality of Service Partnerships that is not present in the purely retroactive grant. If the RST partnership determines on March 15, 2006, that R should be entitled to 25% of the net profits of the partnership for 2006, but R in fact leaves the partnership on March 30, it is extremely unlikely that R will be entitled to participate in any of the profits of the partnership beyond March 30. Depending upon the partnership agreement, R may or may not be entitled to R’s capital account on leaving the partnership. If R is entitled to R’s capital account on leaving the partnership, under the Proposed Rev Proc, and arguably under the current regulations, R’s interest was vested. However, at least for the purposes of determining the FMV, the disappearance of R’s continuing right to participate in the profits of the partnership if R leaves the RST partnership would be a non-lapse restriction that must be taken into consideration under section 83. Moreover, even if not subject to a substantial risk of forfeiture by the terms of the grant, he or she may be subject to a nonlapse restriction of expulsion or suspension without pay if he or she does not continue to adequately perform services, which makes the determination of the FMV of the profits interest even murkier.

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51 Id.
If R is not entitled to R’s capital account on leaving the partnership, R’s interest may not be vested, but this raises the conundrum of how the Proposed Regulations can be applied to a partnership in which none of the partners have vested interests (assuming no section 83(b) elections have been made).

One could argue that, if the interests in the partnership are not vested at the time of grant, they become vested incrementally each day as the partner becomes entitled to participate in another day’s income of the partnership. Such an approach is not only administratively unmanageable by effectively requiring daily calculations of allocable income, but it would also convert a mostly prospective grant into a purely retroactive grant discussed above, creating double taxation on the entire income of the partnership for each year.

As with the purely retroactive grants, it seems unlikely that Congress intended that partners in Service Partnerships be subject to a system imposing double taxation on the same income earned. Unlike purely retroactive grants, the double taxation of mostly prospective grants cannot be solved by interpreting “property” to exclude a right to immediately distributable cash. As to the year of the grant, the issues of double taxation would be significantly reduced in regard to mostly prospective interests if the Proposed Regulations were modified to allow Service Partnerships to determine the liquidation value as of the effective date of the grant rather than the date of the award. In Example 11, on March 15, R is awarded a 25 percent Profits Percentage effective as of January 1, 2006. If the liquidation value were determined as of January 1, rather than March 15, the income of the partnership for 2006 would not yet be included in the liquidation value. But such an approach merely shifts the issue in regard to double taxation since, on January 1, 2006, it is likely that the income from 2005 has been fully realized, but not yet distributed. Thus, a liquidation value determined on January 1, 2006 would likely subject the income from 2005 to double taxation.

Also, as with the purely retroactive grants, it has been assumed that mostly prospective grants are made annually by the partnership with the Profits Percentage granted in one year creating no right in the partner to expect the same Profits Percentage in the following year. Thus, applied literally, the Proposed Regulations would appear to subject the full FMV or liquidation value of the Profits Percentage awarded annually to double taxation without regard to whether the Profits Percentage of the partner as compared to the previous year went up or in fact went down. As stated above, it seems unlikely that such a result is consistent with the intent of Congress in enacting subchapter K and section 83.

Unfortunately, there appears to be no readily apparent way of reconciling the approach of the Proposed Regulations with subchapter K in regard to mostly prospective interests. Thus, we respectfully suggest that the application of the Proposed Regulations to mostly prospective interests in Service Partnerships be reserved until a method of reconciling the two provisions of the Code that avoids double taxation may be developed. Alternatively, we suggest that the LV

\[52\] Depending upon the terms of the partnership agreement, the newly granted interest may have no rights in the already realized income for the prior year, in which case this particular issue may be eliminated if the liquidation value election were made effective as of January 1.
Election be allowed for Service Partnerships and that the liquidation value be determined as of the effective date of the grant rather than the actual grant date.  

3) Purportedly Continuing Profits Percentages

To complicate matters further, it is not uncommon for Service Partnerships to make grants of Profits Percentages that, on their face, purport to be continuing indefinitely into the future. The grant may state that the percentage indicated is granted until such time in the future as it is changed by the managing partner or the management committee, or the grant may simply say that the partner is granted an x% Profits Percentage. Such grants often have at least a small retroactive aspect to them (retroactive to the beginning of the year, the quarter or the month), in which case they would include the same problems as the mostly prospective interests discussed above. But, because they appear on their face to be a perpetual grant, they may appear at first blush to be more similar to a stock grant than the two types of Profits Percentages discussed above that effectively disappear at the end of every year.

The simplest example would be the grant of a purportedly continuing Profits Percentage to a new income or non-equity partner (i.e., a partner that only shares in the income of the partnership) of a Service Partnership. Depending upon the size of the partnership, a new income partner might be granted a 0.01%, a 1%, a 5%, etc., Profits Percentage. As indicated, such grant may appear to be an outright grant of a fixed percentage for an indefinite period. However, the realities of a Service Partnership described above are likely to qualify the substance of such appearance.

In spite of the language of the grant, the reality of the relationships within Service Partnerships is that, at least annually, the relative percentages of the partners will be reviewed. If a new income partner does not perform as expected, he or she may receive the purportedly granted percentage for a year, but he or she will have the percentage reduced for subsequent years, have his or her legal status changed or be terminated. Although the initial grant of a Profits Percentage to an income partner may purport to be of indefinite duration, the actual duration of the interest is unlikely to be for more than a year, which would make the interest of the income partner more like the mostly prospective grants discussed above rather than the grant of stock.

Because purported continuing grants of Percentages Interests are economically substantially similar to the mostly prospective grants discussed above (with the same potential for double taxation), we respectfully suggest that the approach adopted for mostly prospective grants apply to most purportedly continuing interests in Service Partnerships.

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53 This latter approach comports with our recommendation regarding section 83(b) elections on retroactive grants on page 16.
54 Purportedly continuing grants of Profits Percentages to capital partners are not very different from the grant of a purportedly continuing interest to a new income partner. A Profits Percentage may have some degree of greater stability when granted to a capital partner or may not. Some partnerships review the Profits Percentages of capital partners every five years, some every year and some every quarter. But, whether the Profits Percentages are changed every quarter or every five years, the Profits Percentages granted to capital partners do not represent a permanent right to any income of the relevant partnership. At best, such rights represent a right to come to the table, the next time the relative percentages of the partners are discussed.
55 See discussion on page 34.
B. Interests in Partnership Capital

Although one might be inclined to initially believe that the application of section 83 to capital interests in Service Partnerships would be simpler than the application of section 83 to Profits Percentages, in a Service Partnership, a so-called capital interest may, in fact, primarily represent (other than an obligation to contribute capital to the firm) a larger percentage of profits. The difficulty of applying the Proposed Regulations to a capital partner in a Service Partnership may be illustrated by the treatment of a lateral capital partner who joins an existing Service Partnership.

**EXAMPLE 12:** The UVW partnership is an existing Service Partnership on the cash basis method of tax accounting. X is an experienced SP in the same line of business as the UVW partnership. The UVW partnership convinces X to join the partnership as a capital partner. X is required to contribute $200 to the partnership in order join the partnership as a capital partner. X is awarded a 5 percent interest in the UVW partnership in exchange for X’s contribution of $200 and X’s agreement to provide services to the UVW partnership. The UVW partnership agreement provides that if X leaves the partnership, X will be entitled to a return of X’s $200 but nothing more. On the date that X joins the firm, assume the FMV of a 5 percent interest (if treated as a continuing right) is worth $500. On the date that X joins the firm, the liquidation value of a 5 percent interest (including work in progress and accounts receivable) would be $600. X would have no ability under the partnership agreement or state law to force a liquidation of the partnership, and no liquidation is intended or contemplated.

Under Treas. Reg. § 1.83-5(a), the limitation on what X would receive when X left the firm to $200 would be a nonlapse restriction and should be taken into account in determining the FMV of X’s interest. Taking such a limitation into account, assume the FMV of X’s interest in the partnership would be worth $250.

This points to an issue under the Proposed Regulations in regard to a tension between capital partners and income partners. The Proposed Regulations only reflect the economic intent of the parties in regard to grants of Profits Percentages if the LV Election is made as of the effective date of the grant. However, using the numbers in Example 12, X (and every other capital partner in UVW) has no reason to consent to an LV Election, which is going to cause X to recognize an additional $350 ($600 - $250). Such a result, if the partnership is aware of it, would effectively eliminate the availability of the LV Election for Service Partnerships. Such a result, if the partnership is not aware of it, becomes a significant trap for the unwary.

In the context of determining PIP, the Treasury has indicated that one appropriate method is for the interests to be determined based upon a hypothetical sale of the assets of the partnership in exchange for their tax book values followed by a liquidation of the partnership.\(^{56}\) In a Service Partnership, such an approach would eliminate the distortion in the liquidation value caused by the acceleration of work in progress and accounts receivable. Removing such distortion is likely to also reduce, if not eliminate, the disincentive of capital partners in Service Partnerships to consent to the LV Election.

\(^{56}\) Treas. Reg. § 1.704-1(b)(3)(iii).
Capital interests, to the extent that they carry with them a Profits Percentage, are also likely to have the same issues in regard to double taxation that a mostly prospective interest or a purportedly continuing interest, discussed above, would have.

We, therefore, respectfully suggest that the liquidation value of Service Partnerships be based upon a hypothetical sale in which the assets of the partnership are sold for their tax book values, or alternatively, application of the Proposed Regulations to Service Partnerships be reserved until a method may be developed that reflects the economic reality of the interests granted to both capital partners and income partners.

The above discussion illustrates only a few of the issues resulting from the application of the Proposals to Service Partnerships which have inherently variable interests. Our overall comment is, therefore, that the application of the Proposed Regulations be reserved and not be applied to Service Partnership until a method of eliminating the double taxation risk is developed.

VIII. Transition Rules

The Proposed Regulations indicate that they will be applicable to transfers of property on or after the date that Final Regulations are published in the Federal Register. The Proposed Rev Proc indicates that it will be finalized and made effective in conjunction with the finalization of the Proposed Regulations. While the Proposals are outstanding, many taxpayers will seek to implement provisions in their partnership agreements that either incorporate the requirements of the Proposals or that allow for one or more partner or manager to modify the partnership agreement to incorporate the requirements of the Final Authorities without the approval of any other partner. To provide certainty for these taxpayers and a consistent approach to issuances of compensatory equity in the same partnership, we recommend that the Final Authorities allow taxpayers to apply the Final Authorities to transfers prior to their ultimate effective date.

Additionally, to the extent that the LV Election will continue to require the consent of all partners, we recommend that the Final Rev Proc respect LV Elections made pursuant to provisions of a partnership agreement that were in place before the finalization of the Proposals and that permit one or more partner or manager to amend the partnership agreement to incorporate the requirements of the Final Authorities. If the Final Rev Proc requires an agreement that binds all partners, it would be acceptable to require that LV Elections will only be respected if the aforementioned provisions and the amendments made pursuant thereto are binding on all partners.

CONCLUSION

The Proposals represent substantial steps forward in clarifying the issues related to transfers of Compensatory Interests. A great many issues have been resolved by the Proposals. However, the Proposals also raise significant issues.

As shown through these comments, we believe that a variety of improvements can be made to the Proposals. If our recommendations are followed, the Final Authorities will be more administrable and more consistent with other areas of tax law. The LV Election will be more
practical and the Final Authorities will be more consistent with capital accounting in non-compensatory arrangements and with other compensatory transfers of property.

While we understand that the hearing on the Proposals was cancelled, we would be pleased to discuss these comments with representatives of the Treasury and the Service in a formal or informal setting.