at the top of their tax forms or any other filed documents. Victims of these three disasters can get free copies of prior tax returns and tax records from the IRS on an expedited basis.

ADDITIONAL TAX RELIEF UNDER KETRA

Congress has provided enhanced tax relief for victims of Hurricane Katrina. While more disaster relief is expected, including a possible expansion of these benefits to victims of Hurricanes Rita and Wilma, to date KETRA provides the following tax relief only for victims and heroes of Hurricane Katrina (unless otherwise noted).

- **Earned Income Tax Credits and Refundable Child Tax Credit** calculations for qualifying low-income victims for tax year 2005 may be based upon 2004 earned income.
- **Preservation of dependency exemptions, filing status, etc.** for taxpayers who may jeopardize tax benefits because of temporary relocations caused by Hurricane Katrina.
- **Additional personal exemptions** for taxpayers who house (rent-free) dislocated persons from Hurricane Katrina for a minimum of 60 days in their principal residences. The additional exemption is $500 per person to a maximum of $2,000 per year for 2005 or 2006. This deduction is not phased-out and is allowed under the AMT.
- **Gross income exclusion** for certain cancellation of nonbusiness indebtedness for discharges made through December 31, 2006.
- **Retirement plan withdrawals, rollovers and loans** will be more favorable. Eligible victims may withdraw a maximum of $100,000 from their IRAs and pensions without paying the 10% early withdrawal penalty and may pay any income tax on the distribution ratably over a 3-year period beginning on the date of the distribution. Income tax is not due if the distribution is repaid to the account within 3 years.

  Any portion of a qualified distribution may, during the period beginning August 25, 2005, and ending February 28, 2006, be recontributed to a plan, annuity, or IRA to which a rollover is permitted and excluded from a taxpayer's gross income.

  Allowable tax-free loan limits are increased through 2006 and loan due dates from August 25, 2005 through December 31, 2006 are extended one year.
- **A new Work Opportunity Tax Credit target group** for Hurricane Katrina employees comprised of individuals who, prior to the hurricane, lived in the area that is now within the disaster zone. Employers hiring Hurricane Katrina employees will qualify for a 40% credit on the first $6,000 of wages paid to the employee in the first year.
- **Employee retention credit** for small employers located in the disaster area. The tax credit equals 40% of the first $6,000 of wages paid to employees between August 28, 2005 and before January 1, 2006. The credit is available to small employers whose businesses are inoperable as a result of damage sustained by Hurricane Katrina. The credit is not affected if the employee reports to work at another location during the period the business is inoperable.
- **Greater access to mortgage revenue bond proceeds** by waiving the first-time homebuyer requirement through 2007 for qualified Hurricane Katrina recovery residences and providing loans up to $150,000 for repairs to damaged homes.
- **Charitable donations will be given tax favored treatment.** Suspension of limits on charitable contributions for individuals and corporations in 2005. Individuals may elect to deduct cash contributions made from August 28, 2005 to December 31, 2005 to qualifying charities in an amount equal to 100% of AGI. This deduction will be an itemized deduction not subject to the overall itemized deduction limit for high-income taxpayers. Corporations may elect to deduct cash contributions for relief efforts related to Hurricane Katrina made during the same period in an amount equal to 100% of their taxable income.

  Donations of educational books to public schools and food inventory will be enhanced to the lesser of (i) basis plus 1/2 of the item's appreciated value or (ii) two times the basis for any business through 2005.

Charitable mileage deductions will be computed using a rate equal to 70% of the business mileage rate in effect on the date of the contribution, provided the taxpayer uses the vehicle in providing donated services solely for the purpose of relief related to Hurricane Katrina. Volunteers may exclude from gross income reimbursements for the costs of using vehicles up to an amount that does not exceed the business standard mileage rate through 2006 (44.5 cents as of January 1).

TREASURY ISSUES MUCH-ANTICIPATED **PROPOSED PARTNERSHIP EQUITY COMPENSATION** REGULATIONS

by Matthew Belcher and Glenn Mincey, New York, NY

On May 20, 2005, the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") issued much-anticipated proposed regulations (the "Proposed Regulations") addressing the U.S. federal income tax treatment of certain transfers of partnership equity (including options to acquire partnership equity) in connection with the performance of services ("compensatory partnership interests"). The Proposed Regulations

are generally taxpayer friendly and appear to contain few surprises. The Treasury and the IRS also issued Notice 2005-43, 2005-24 I.R.B. 1, (the "Notice") containing a proposed revenue procedure that provides additional guidance for partnerships that transfer compensatory partnership equity. The Notice provides that the proposed revenue procedure will be finalized once the Proposed Regulations are finalized. The Notice also provides that Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, will be obsoleted when the proposed revenue procedure becomes final. What follows is a brief summary of the more significant issues addressed by the Proposed Regulations:

All Partnership Interests Are Property for Purposes of Section 83. Section 83(a) provides rules regarding the taxation of property transferred in connection with the performance of services. For example, section 83(a) provides that income inclusion occurs in the first year in which the property received is vested, *i.e.*, when the property is transferable or is not subject to a substantial risk of forfeiture. Although some practitioners have argued that partners and partnerships are simply outside the scope of section 83, the Proposed Regulations specifically provide that a partnership interest—whether a capital interest or a profits interest—will be treated as property within the meaning of section 83, and the transfer of a compensatory partnership interest will be subject to section 83. Accordingly, the excess of the fair market value of the partnership interest received by the service provider over the amount, if any, paid by the service provider will generally be includible in income during the taxable year of the service provider in which the partnership interest is substantially vested (within the meaning of section 83(a) and Treas. Reg. § 1.83-3(b)). Further, the service provider will be treated as a partner at that time.

The timing of the deduction for the partnership will also be governed by section 83. Thus, the deduction will be recognized in the taxable year of the partnership that ends within or with the taxable year of the service provider in which compensation under section 83 will be included in the service provider's income, unless the interest is vested upon receipt, in which case the partnership claims the deduction in accordance with its normal method of accounting. As a general matter, partners are free to allocate items of loss and deduction as they see fit, subject to the requirements of section 704(b). Nevertheless, section 706(d)(1) generally provides that, if there is a change in any partner's interest in a partnership during a taxable year, each partner's distributive share of the partnership's income, gain, loss, deduction, and credit must be determined in a manner that takes into account the varying interests of the partners. According to the Preamble to the Proposed Regulations, the government believes that section 706(d)(1) "adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners." Preamble at 29,677.

Liquidation Value Approach Still Available. Consistent with Rev. Proc. 93-27 and Rev. Proc. 2001-43, a safe harbor election (the "Safe Harbor") will be available to permit partnerships to value compensatory partnership interests using the liquidation value approach. As a result, the receipt of a profits interest will not result in income to the recipient if the Safe Harbor election is made. Accordingly, the full fair market value of the partnership interest received by the service provider will generally be includible in income during the taxable year in which the partnership interest is no longer subject to a substantial risk of forfeiture or becomes transferable. Nevertheless, consistent with Rev. Proc. 93-27 and Rev. Proc. 2001-43, a safe harbor election can be made by the partnership to value compensatory partnership interests using the liquidation value approach. As a result, the flexibility previously afforded under the revenue procedures is preserved. Consistent with section 83 principles, the Proposed Regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. The Proposed Regulations provide that a service provider who receives a partnership interest in connection with the performance of services and makes a section 83(b) election will be treated as a partner.

Section 83(b) Elections Required for Unvested Interests. Section 83(b) allows a service provider to elect to treat restricted property as if it were substantially vested on transfer and include in income the amount, if any, that would be included in income if the property were in fact substantially vested on transfer. The service provider does not subsequently include additional compensation income when the property in fact becomes substantially vested. If the property is later forfeited, however, the service provider is not entitled to claim a loss in respect of such forfeiture. I.R.C. § 83(b)(1). Under the Proposed Regulations, however, a service provider who receives a restricted (i.e., unvested) partnership interest in connection with the performance of services would need to make a section 83(b) election to be treated as a partner prior to vesting. The timing for making a section 83(b) election is limited. Such election must be made within 30 days of transfer. The specific requirements for making such an election are contained under Treas. Reg. § 1.83-2. If a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, the holder of the partnership interest would not be treated as a partner until the interest becomes substantially vested. Under current

administrative guidance, the recipient of an unvested profits interest does not need to make a section 83(b) election so long as the profits interest falls within the parameters of Rev. Proc. 2001-43. For profits interests that are currently covered by Rev. Proc. 2001-43, requiring a section 83(b) election imposes new administrative burdens without changing the tax result.

No Gain or Loss Recognized by Partnership on Issuance of Interest. While some tax practitioners believed that the issuance of a partnership interest in exchange for services could cause the issuing partnership to recognize gain or loss, the Proposed Regulations provide that a partnership will recognize neither gain nor loss on the issuance or vesting of a partnership interest (whether a profits interest or a capital interest) issued in connection with the performance of services for the issuing partnership. The Preamble to the Proposed Regulations states:

> [T]he Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 – to defer recognition of gain and loss when persons join together to conduct a business – than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Preamble to Proposed Regulations, 70 Fed. Reg. 29,675 (May 24, 2005).

Special "Forfeiture Allocations" Required. Allocations are supposed to affect the amount that a partner would receive on the liquidation of his or her partnership interest. Practitioners have long been concerned that, in situations in which a partner's interest is unvested, the IRS might argue that an allocation of income to that partner does not satisfy the section 704(b) regulations because, if the service provider were to forfeit her interest, she would receive nothing. Notwithstanding this uncertainty, most practitioners have concluded that the potential for forfeiture should be ignored, provided that the service provider makes an election under section 83(b) or was not required to make such an election (by virtue of Rev. Proc. 2001-43). The Preamble explains that allocations of partnership items to the holder of an unvested interest cannot have economic effect because there is a possibility that the partnership might not liquidate in accordance with positive capital account balances, as is required by the safe harbor regulations under section 704(b). For this reason, the Proposed Regulations provide that such allocations "cannot have economic effect." Nevertheless, the Proposed Regulations would permit such allocations to be made by adopting a special rule that would treat such allocations as being in accordance with the partners' interests in the partnership. To satisfy this rule, where a service provider makes a section 83(b) election with respect to a substantially unvested partnership interest and later forfeits that interest, the partnership would be required to make reversing allocations of income or loss (so-called "forfeiture allocations") to the service provider.

Regulations Effective When Finalized. The Proposed Regulations will apply to issuances of compensatory partnership interests and options that occur on or after the date final regulations are published in the Federal Register.

NEXT STEPS

Even though the Proposed Regulations will apply prospectively from the date such regulations are finalized, partnership agreements should include, or should be amended to include, a provision that would permit the partnership to make an election to use the liquidation value approach in valuing compensatory partnership interests. Such provisions would enable taxpayers to receive the same tax treatment that is currently afforded service providers under Rev. Proc. 93-27 and Rev. Proc. 2001-43.

The Proposed Regulation and the proposed revenue procedure confirm that partnerships issuing compensatory equity will not recognize gain. Nevertheless, because the Proposed Regulations and the proposed revenue procedure will change the way that taxpayers and practitioners have approached the issuance of partnership equity, they pose traps for the unwary. Practitioners should pay close attention to further developments in this area. ■

A quick way to view ABA Section of Taxation Committee Meeting Materials...

Comm-Online

Comm-Online.
www.abanet.org/tax/commonline

Section of Taxation Committee Meeting Materials and more, powered by

LexisNexis Online Services

LexisNexis™