## POINTS TO REMEMBER

# Apply the Rule As Written: When Does a Section 83 Transfer of a Beneficial Interest in an Investment Partnership Profits Interest Occur?

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For more than 20 years, the Service has been flummoxed over the appropriate treatment of a transfer of a partnership profits interest in exchange for services, and the question has become a subject for proposed legislation and even a presidential election campaign issue. The Obama administration continues to press for legislative changes. *See* Department of the Treasury, *General Explanation of the Administration's Fiscal Year 2014 Revenue Proposals* 159 (Apr. 2013), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf. But why, when the solution to the riddle lies within the existing language of Regulation section 1.83-3?

In this article, we submit that the Service has stumbled in the application of the central question of *when* the "transfer" occurs, and that a straightforward application of the "transfer" principles set forth in Regulation section 1.83-3(a) would result in the proper tax treatment of the transferee of a profits interest.

## Treasury Regulation Section 1.83-3(a)

Regulation section 1.83-3(a) is a curious provision, which begins with a general rule providing that "a transfer of property occurs when a person acquires a beneficial ownership interest" in the property, but then continues with a series of principles describing circumstances where such a transfer has *not*, at least yet, occurred. The first such principle, in Regulation section 1.83-3(a)(2), is that the grant of an option to purchase property does not constitute a transfer of property. Similarly, Regulation section 1.83-3(a)(4) provides that "[a]n indication that no transfer has occurred is the extent to which the conditions relating to a transfer are similar to an option." Finally, Regulation section 1.83-3(a)(6) provides that "[a]n indication that no transfer has occurred is the extent to which the transferee does not incur the risk of a beneficial owner that the value of the property at the time of transfer will decline substantially."

Regulation section 1.83-3(a)(7) Example (2) illustrates the "similarity to an option" and "risk of loss" principles. In this example, E (presumably, an employee) acquires shares of stock in W (presumably, his employer) in exchange for a nonrecourse note, secured solely by the acquired shares. The face amount of the note equals the fair market value of the acquired stock. No payments, other than interest, are due on the note until a year subsequent to the year of the acquisition. The example finds that because E has no personal liability on the note, and has made no payments toward the face amount, E bears no risk that the stock will decline in value. The example concludes that no "transfer" occurred on the date of the purchase, but that E, instead, was granted on that date an *option* to purchase the shares.

## Applying the Regulation to a Partnership Profits Interest

A typical profits interest in an investment partnership entitles the holder to share in distributions only after the cash investors have received both the return of their initial invested capital and an annual compounded "hurdle" rate of return on the capital invested. Until distributions have been made to investors satisfying both the return of the invested capital and hurdle rate of return, the holder of the profits interest does not share in distributions (a critical element, in our view, of holding "beneficial ownership"). Likewise, the holder of the profits interest, having made no cash investment, bears no risk that the investment property purchased with the invested capital will decline in value before the hurdle rate and original investment have been paid to the cash investors, the other critical determinant as to whether beneficial ownership of the property has been transferred from the investors to the profits interest holder.

Therefore, we submit that the proper application of the transfer definition of Regulation section 1.83-3(a) would result in the transfer of the profits interest to be deemed to occur not when the rights of the profits interest holder are created in the partnership agreement (at the formation of the partnership), but instead at the time when a share of any subsequent distributions would

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become payable to the holder of the profits interest (or, if later, at the time that any applicable risk of forfeiture lapses in accordance with the general rules of section 83). The example below illustrates how the proposed "new reading" of the section 83 definition of "transfer" would work in practice.

Assume investors acquire interests in an investment partnership, paying a total of $20 million, which the partnership invests in two $10 million investments. Under the terms of the partnership agreement, they are entitled to 100% of the distributions until they have received back their initial invested capital. (The annual, compounded hurdle rate of return is treated as 0% in this example for simplicity.) Thereafter, the investors will receive 80% of distributions, while the manager will receive 20% (the 20% profits interest). At the end of year two, the partnership sells one of the two investments for $20 million and distributes the proceeds to the investors, satisfying their right to the return of their original investment. At the time of this sale, the second investment also has a fair market value of $20 million.

Using traditional profits interest analysis, most would conclude that the manager, as the holder of the profits interest, would be allocated $2 million of long-term capital gain from the sale of the first investment (20% of the $10 million of gain), and an additional $2 million long-term capital gain if the second investment were thereafter also sold for $20 million. We think that is wrong: applying the definition of "transfer," as it seems to have been intended to apply, the critical time is upon the sale of the first investment and distribution of the proceeds to the cash investors in full satisfaction of their exclusive distribution rights. At that time, the manager would be deemed to have received a compensatory transfer of a 20% *capital* interest in a partnership holding only the second investment, then having a value of $20 million. The result would be $4 million of ordinary compensation income, realized *at the end of year two*, if the interest is then vested or, if not, a section 83(b) election is then made. (The compensation income could be different if the interest is not then vested and no section 83(b) election is made—in that case, the compensation determination would be made at the time of the subsequent vesting.)

In essence, we are arguing that a "grant of a profits interest," like the non-recourse purchase example, is the economic equivalent of a grant, by the investors, of a right to acquire a percentage interest in the partnership for a strike price of $0, deemed exercisable, and exercised, immediately after the return to the investors of their hurdle return plus their initial investment.

And this seems like the right answer: the compensation element should not be measured prior to the time the manager's beneficial rights as a partner begin, which can occur only after the cash investors' exclusive rights to receive partnership distributions end. Only thereafter will the manager be entitled to a share of partnership distributions and bear a share of the risk of loss in value of partnership property (*e.g.*, if the second investment subsequently declined in value from $20 million to $16 million, the manager's 20% interest would decline in value from $4 million to $3.2 million).

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Some, we suppose, would argue that the proposed interpretation does not go far enough to cure the world of the plague of the profits interest, since it would not deprive the manager of the benefits of long-term capital gain treatment on subsequent appreciation on the second asset. Others, we are equally certain, will cry foul for suggesting a fresh look be taken at what has become established practice. And there is no doubt that fair market valuation of the investments at the time of deemed exercise would be challenging, but no more so than valuation problems encountered on a daily basis by all taxpayers, tax administrators, and tax advisors. But embedding option-equivalent rights in a document entitled "Partnership Agreement," as opposed to one called "Option Agreement," should not change the tax treatment of the arrangement. ■