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Newly Proposed Tax Rules on Compensatory Partnership Interests

On May 20, 2005, the IRS issued proposed rules relating to the tax treatment of the receipt of partnership equity (including profits interests and compensatory options) in connection with the performance of services. The proposed rules, which are set forth in proposed regulations and in a proposed Revenue Procedure, will not be effective until they are published in final form. If the proposed regulations are adopted in their current form, they will have a significant impact on the "carried interest" arrangements common in most private equity funds, hedge funds, and real estate funds, and other compensatory arrangements common in venture capital. This is the first time the IRS has specifically addressed the tax consequences of compensatory partnership interests in such a comprehensive manner.

The proposed rules treat compensatory partnership interests as property for Section 83 purposes. Therefore, under the proposed rules, a service provider will have compensation income at the time a compensatory partnership interest is received equal to the fair market value of the interest less any amount paid for the interest—even if the interest represents only a "pure profits interest". A service provider who receives a substantially nonvested compensatory partnership interest will not be taxed (and will not be treated as a partner) until the interest becomes substantially vested, unless a Section 83(b) election is made. The Section 83(b) election should preserve the character of the "carried interest" profits that are allocable to an electing service provider's partnership equity interest. The amount the service provider must include in income in connection with the Section 83(b) election is also generally equal to the fair market value of the interest, less any amount paid for the interest.

Recognizing that fair market value is often difficult to determine, the proposed rules provide for a "Safe Harbor Election" that may be made by the partnership and its partners to value the partnership interests at "liquidation value." If the service provider would not receive any distribution if the partnership assets were sold at fair market value and the partnership were liquidated immediately after the grant of the interest, the Safe Harbor Election should ensure that the issuance of the partnership equity interest will not result in any income recognition to the recipient. To be eligible to make a Safe Harbor Election, however, the partnership agreement (or separate document executed by each partner) must contain specific language authorizing the making of such election and the partners must all agree to comply with certain Safe Harbor requirements. The Safe Harbor Election requirements set forth in the proposed rules are not easy to meet, as some of them are unfavorable, and they are administratively burdensome especially for partnerships that are already in existence. It is unclear how the proposed rules would apply to partnership equity arrangements that exist today and many of those arrangements may not satisfy the Safe Harbor Election requirements. If a partnership does not qualify for or does not make the Safe Harbor Election, it will potentially be required to value partnership equity interests each time an interest is granted or vests.

In addition, if a service provider makes a Section 83(b) election and later forfeits the partnership interest, under the proposed rules, certain forfeiture allocations are required to be made in order to offset prior distributions and allocations of partnership items. It is unclear how these rules will ultimately apply and what will be required where a partnership does not have enough actual tax items to make such allocations.

The proposed rules also provide that the transferring partnership will not recognize gain or loss as a result of the transfer of an equity interest to a service provider. If a new partner recognizes income upon the receipt of a compensatory partnership interest, the partnership will have a corresponding compensation deduction in the same year. The proposed rules expressly provide, however, that the deduction cannot be allocated to the service provider.

Note that these proposed rules expressly do not apply to transactions involving the transfer of an interest in a partnership in exchange for services rendered to another, related partnership--a common practice in the investment funds industry. For example, the proposed rules do not deal with a situation in which services are rendered to the management company of an investment fund but a profits interest is issued by a different affiliated partnership that is the general partner of the investment fund; such arrangements are common. The IRS has asked for comments on the income tax consequences of compensatory transactions involving tiered and related partnership arrangements, which indicates that the IRS intends to deal with such structures in the future or expand the scope of the proposed rules.

It is not clear whether and how investment fund managers and others should change their practices with respect to the grant of partnership equity interests to service providers during the interim period until the time the proposed rules are made final. Because the proposed rules would, as written today, apply to post-effective date grants of interests by existing partnerships, in order to prepare for future compliance with the final version of the proposed rules investment fund managers may want to consider including a provision in new partnership agreements calling for all partners or members to consent to and to provide any required information in connection with any tax elections, forfeiture allocations, or other matters that are necessary or desirable under the final rules. Investment fund managers should consult with their tax advisors in connection with the future issuance of compensatory partnership equity interests.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul, Weiss Tax Department, including Richard J. Bronstein (212-373-3744), Peter J. Rothenberg (212-373-3154), Jeffrey B. Samuels (212-373-3112), David R. Sicular (212-373-3082), or Stephanie R. McCavitt (212-373-3558).