News Analysis: NYSBA Considers Partnership Questions

by Lee Sheppard

Two Treasury officials responded to complaints about proposed compensatory partnership interests regulations at the New York State Bar Association annual meeting on January 24.

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Some readers may wonder why partnership specialists are so whiny. It is because they are used to doing anything they want -- and we do mean anything -- and because it works. So at the New York State Bar Association annual meeting on January 24, they whined about proposed regulations that this correspondent has characterized as giveaways. Eric Solomon, Treasury's deputy assistant secretary for tax policy, and Matthew Lay, an attorney-adviser in Treasury's office of tax legislative counsel, were on hand to respond to complaints.

Last spring the government released proposed compensatory partnership interests regulations that would allow the parties to *elect to value partnership profits interests or options at zero.* If a newly created profits partner makes a section 83(b) election with his partnership, he can value his compensatory interest at zero. The section 83(b) election for zero valuation is contained in prop. reg. section 1.83-3(l). It would be implemented by a proposed revenue procedure described in Notice 2005-43, 2005-24 IRB 1221, *Doc 2005-11236* [**PDF**] or *2005 TNT 98-37*. (For the proposed regulations, see *Doc 2005-11235* [**PDF**] or *2005 TNT 98- 31.)*

So what's not to like? Partnership practitioners don't want to have to have clients make section 83(b) elections, and don't want to have to get all the partners together to get them to be bound by a section 83(b) election. The NYSBA Tax Section suggested that the zero value election -- called "liquidation value" -- be the general rule. (For the NYSBA report, see *Doc 2005-22612* [**PDF**] or *2005 TNT 214- 19.)*

Solomon and Lay gently suggested that section 83 trumps subchapter K in the apparent conflict between the two, because the transaction is a compensatory award of property. As such, section 83 requires inclusion of the fair market value of the compensatory property award in income when any restrictions come off, or earlier if the recipient has made a section 83(b) election. Solomon was of the view that if section 83 requires inclusion of fair market value, zero value cannot be the general rule; it would have to remain as an election.

What's the big deal about making a section 83(b) election? Lay explained that the mechanics of the election flow from section 83 itself. Solomon acknowledged that there are problems with the election mechanism generally. Practitioners seemed to be asking for a default election. It is within the government's power to provide for a negative election -- that is, the recipient would be deemed to have made the election unless he or she affirmatively opted out. Reg. section 1.401(k)-1(a)(3)(ii) provides a negative election for employees to participate in a section 401(k) cash or deferred plan. (See also Rev. Rul. 2000-8, 2000-1 C.B. 617, *Doc 2000-2856* or *2000 TNT 19-5.)*

Solomon asked what partnerships are doing when they make compensatory awards of equity. The answer he got raised another question lost in the dustup about taxation at the time of the award -- capital gain conversion of compensation income.

David H. Schnabel, Debevoise and Plimpton LLP, New York, said that everyone uses an award of a profits interest as compensation unless they don't want the service provider to be considered a partner. The point is that a profits interest provides the service provider with capital gain rather than ordinary income upon his or her exit from the partnership. Capital interests, which would give a service provider a share of partnership assets, are not typically used as compensation. Options on partnership equity interests are used by investors who want to mimic ownership while deferring income. (For the proposed regulations (REG-103580-02), see *Doc 2003-2099* [**PDF**] or *2003 TNT 17-66*.)

The proposed regulations on disguised sales of partnership interests could catch hedge funds whose partners are constantly entering and exiting, because one new investor's contribution of cash could literally be used to redeem another investor's exit. This is because hedge funds have set times of year for entry and exit, so there are many simultaneous transactions. (For the proposed regulations, see *Doc 2004-22588* [**PDF**] or *2004 TNT 228-3*. For the NYSBA report, see *Doc 2005-8507* [**PDF**] or *2005 TNT 78-42*.)

Lay speculated that hedge fund practices might not result in disguised sales under the proposed regulations because the exiting partners would not know the entering partner. He hoped the final version of the regulations would say that this lack of familiarity would be a "no sale" factor. If entry and exit are not simultaneous, Lay mused, then one would have to look at whether the deal was wired. Solomon said that the disguised sale regulations are a straightforward application of the step transaction doctrine, but that the proposed regulations' "but for" test was intended to be narrower than the end result test of the step transaction doctrine.

A partnership can fall into the sale-in, lease-out rules of section 470 if there is a tax-exempt partner and allocations of deductions are not proportionate. Solomon assured his audience that the Treasury was working with Congress to narrow the application of section 470 to avoid pulling in legitimate deals with exempt partners where real sharing is going on. (See Notice 2006-2, *Doc 2005-25450* [**PDF**] or *2005 TNT 242-11*, and Notice 2005-29, *Doc 2005-4961* [**PDF**] or *2005 TNT 47-6*. For the NYSBA report, see *Doc 2005-15279* [**PDF**] or *2005 TNT 137-24*.)

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