TAX LAW AND ESTATE PLANNING SERIES
Tax Law and Practice
Course Handbook Series
Number J-912

The Partnership Tax Practice Series:

Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2011

Volume Three

Edited By
Louis S. Freeman

Incorporating the 2011 Update #32731
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EQUITY AND EQUITY-RELATED COMPENSATION: A JAUNT THROUGH SECTIONS 83, 409A, 457A AND PROPOSED SECTION 710

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January 31, 2011

This article appeared in the Tax Club.

INTRODUCTION

A well-beloved client, a private equity fund sponsor, is purchasing a portfolio company as a fund investment and calls with a question. The portfolio company (which may be U.S. or foreign, a corporation or an operating partnership, an operating business or a collection of assets like mortgage loans) is to be run by a management team that will stay on after the purchase. The fund is, of course, focused on the returns that it can achieve after disposing of the portfolio investment either in a strategic sale or in an IPO. The deal professionals would like to incentivize the management team to focus on obtaining cash on cash returns from the investment, so they would like to have an equity pool, a program of some sort in which management could share in the upside gains, although compensation based on other metrics (revenues, EBITDA, profits) may also be desirable. Of course the managers are not supposed to realize on this compensation until the fund gets its return, so their rights to this compensation will if possible have to be deferred for a time. The fund professionals have heard of a number of different sorts of arrangements – restricted stock, partnership interests, options, RSUs or SARs, thin common stock or leveraged co-investments, bonus payments – that might serve this purpose. They have slightly different economics, and a number of commercial, regulatory, accounting and other differences, but for now assume each is workable. Does it matter from a tax perspective how they do this? Upon further questioning, you learn that there are (or are not) likely to be dividends, and there are (or are not) likely to be additional capital calls and follow on investments as the portfolio company makes additional acquisitions of assets. It is not clear exactly who the co-investors will be, so the ownership mix for the investment (U.S. taxable, foreign taxable, U.S. tax-exempt etc.) is somewhat in flux.

The short answer is yes, of course, tax considerations matter. The longer answer (or one longer answer) is this paper. This paper focuses on various tax considerations, as well as occasional commercial observations, relevant to structuring incentive compensation arrangements for the management team of a private equity portfolio company. (There may of course be accounting, securities law, regulatory and other considerations that are also relevant but they are generally beyond the scope of the paper). Certain of the issues discussed are relevant in a public company context as well, but compensation arrangements put in place by private equity or similar owners tend to be more flexible in structure (since they can generally avoid public disclosure, are not subject to the same stock exchange and SEC regulatory regimes, and may be less concerned with immediate accounting considerations) and private equity owners tend to have an intention to exit the investment within a relatively short time frame, so that it may be possible as a commercial matter to get management to delay its compensation until the fund receives its return.

As it happens, although there often are commercial differences in the economics that ought to be taken into account, to a surprising extent the economic benefits and therefore incentives to the managers are similar, and the differing tax results to the sponsor, company or manager are driving factors in choosing an arrangement. Moreover, notwithstanding the ubiquity with which these arrangements are found in business, there are a surprising number of issues on which there is no clear

guidance. A vast amount of learned tax literature has been written over the years regarding various issues relating to employment compensation in the corporate and partnership context, and this paper does not attempt to replicate them or discuss all the issues in depth. Rather, this is intended to serve as a survey identifying relevant tax issues as they come up in comparing the different alternatives. The considerations to be balanced have in some circumstances become more complex since the relatively recent passage of section 409A in 2004 (relating to taxation of nonqualified deferred compensation), the recent passage of section 457A in 2008 (also relating to the taxation of nonqualified deferred compensation), and the potential passage, someday, of section 710 (relating to the taxation of partnership interests held by certain service providers).[1]

Section I of the paper summarizes certain relevant provisions of section 83, section 409A, section 457A, and proposed section 710. Sections II though VIII describe various compensation arrangements and discuss various tax and other considerations applicable to them. Section IX concludes. Attached to the end is a summary chart of relevant considerations.

I. STATUTORY BACKGROUND.

Before discussing the variety of compensation arrangements available to the private equity sponsor, it makes sense to set out in summary form some of the relevant tax provisions that govern the taxation of equity-related compensation in this arena. The intention is not to describe the relevant provisions in all in their gory detail, although in certain areas the details are unavoidable. Often the first gating issue is often determining which set of rules applies.

Section 83

Section 83 provides the tax rules for the delivery of "property" in connection with the provision of services.[2] It is under section 83 that one finds the general rule that an employee that receives property in respect of services is taxed when such property is received, and that an employer is generally entitled to a deduction in the year of payment of such cash or property.[3] The amount taken into account as compensation is taxable to a U.S. taxpayer (who may include a foreign person working

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1 All references to sections are to sections of the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

2 Section 83(a) provides that if "property" is "transferred" to a person (other than the person for whom the services are performed) in connection with the performance of services, the transferee shall include the excess of the fair market value of such property over any amount paid for the property in the gross income of the transferee "at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture." Section 83(a)

3 In certain circumstances compensation expense is capitalized or is otherwise non-deductible, of course, but that relates to a different area of law and is not relevant to the issues discussed here.

The deduction also can relate back to a prior year, if the compensation is paid within two and a half months of the end of the taxable year. *See* section 404(a)(6).

in the United States, and includes a U.S. person working anywhere in the world), at ordinary income rates, and generally is subject to employee withholding and employment taxes.[4] The more interesting questions covered by section 83, the answers to which sometimes vary from what a non-practitioner would expect, relate to the question of what is "property" for this purpose, when is it treated as paid (or "transferred"), what the relevant amount of compensation is and, in some situations, which entity is entitled to a deduction.[5]

Property, for purposes of section 83, includes cash, or stock, or sometimes (though rarely) more tangible forms of property such as timber, cows or gold.[6] Notwithstanding the fact that people rely every day on the legal obligations of business entities (to pay rent, to perform a service, to pay an amount in the future), and there is in a real world sense value to be found in such obligations, an "unsecured promise" by an employer to pay an amount in the future is not treated as "property".[7] This is true whether the employer obligates itself to pay cash, or obligates itself to distribute stock in the future (when subject to vesting, a restricted stock unit or "RSU"), obligates itself to pay an amount measured by the increase in the value of stock (a stock appreciation right or "SAR"), or obligates itself to pay a bonus based on some other performance metric. As a result, under section 83 the mere fact that a service provider

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4 There is no employee withholding tax with respect to payments made to persons treated as partners. They are generally subject to pay tax on net earnings from self employment, with an exception for the distributive share of income derived by a limited partner. *See* section 1402(a)(13).

5 For a general discussion of the key terms of art employed in section 83, *see* John L. Utz, *Restricted Property – Section 83*, BNA PORTFOLIO 384 (2001). *See also* Matthew A. Rosen, *The Many Continuing Uncertainties of Section 83*, TAX FORUM No. 541 (April 3, 2000), William R. Welke & Olga Loy, *Compensating the Service Partner with Partnership Equity: Code Sec. 83 and Other Issues*, 79 TAXES 94 (2001) (discussing the transfers of capital and profits interests to service partners), G. Edgar Adkins & Jeffrey A. Martin, *Restricted Stock: The Tax Impact on Employers and Employees,* 107 J. TAX'N 4 (2007) (discussing the use of restricted stock in compensation arrangements)

6 Treasury regulation section 1.83-3(e) provides that property includes real and personal property "other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account."

7 If the promise is "secured" – for example by placing the relevant compensation amounts in a trust out of the reach of the employer's creditors – then it is treated as paid currently. An obligation to pay compensation, where the amounts are placed into a "rabbi trust" subject to claims of creditors, is not treated as secured for this purpose. *See* Ltr. Rul. 8113107, (December 31,1980) (where assets of trust are accessible by creditors as if they were the general assets of the trust contributors, such amounts will not be included in the income of the beneficiary in the year of contribution to the trust but rather in the year in which they are "actually received or otherwise available" for purposes of section 451); *see also* Ltr. Rul. 9332038 (May 18, 1993) (where employer contributes amounts to nonqualified employee benefit plan but amounts contributed are fully accessible by the employer's creditors in the event of bankruptcy, neither the creation of the plan nor the contribution of assets to the plan results in taxable income to employees under section 83). *But see* 409A(b)(1) (offshore trusts may give rise to an inclusion under section 409A).

has become legally entitled to receive compensation in the future does not mean that the service provider is taxed currently. Arrangements to provide compensation in the future – and thereby defer the imposition of tax until receipt – are generally referred to as "nonqualified deferred compensation."[8] (As contrasted to "qualified" plans such as pensions).

For purposes of section 83, options are not treated as "property" when granted unless they have a "readily ascertainable value" (a defined term with a very narrow scope).[9] As a result, under section 83, taxation attributable to options is generally delayed until the option has been exercised or disposed of, and at that time section 83 applies to it. At the time of exercise the spread value of the option (the excess of the value of underlying stock over the exercise price) is treated as ordinary compensation income.

Special rules are applicable to property that is subject to a "substantial risk of forfeiture" (in common parlance, vesting).[10] For purposes of section 83 a "substantial risk of forfeiture" exists if a person's "rights to full enjoyment" of property transferred in connection with the performance of services is "conditioned upon the future performance of substantial services by any individual."[11] This includes as well

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8 There are a variety of "qualified" plans (pension plans), and other statutory arrangements (*e.g.*, ESOPs, ISOs) that are not discussed here. Section 409A(d)(1) defines "nonqualified deferred compensation plan" as any plan other than a "qualified employer plan" and "any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan." The term qualified employer plan includes qualified retirement plans (as defined in sections 401(a) and 403(a)), tax-sheltered annuities and custodial accounts (as defined in section 403(b)), simplified employee pensions (as defined in section 408(k)), SIMPLE retirement accounts (as defined in section 408(p)), and "eligible" deferred compensation plans of government and tax-exempt employers (as defined in section 457(b)).

9 *See* Treasury regulation section 1.83-7(b)(2), (3). For an option not actively traded on an established market, it will not be treated as having a "readily ascertainable value" unless the fair market value can otherwise be established with reasonable accuracy. This requires that the option is transferable by the employee, that option is immediately exercisable in full by the transferee (which would never be the case if the option is unvested), that the option or underlying property is not subject to any restriction or condition that would affect value, and that the fair market value of the "option privilege" be readily ascertainable (which itself looks to whether the value of the underlying property can be ascertained, the probability of the ascertainable value increasing or decreasing and the length of the option term). These requirements have been stringently applied. *See, e.g., Cramer* v. *Comm'r*., 64 F.3d 1406 (9th Cir. 1995) (the 9th Circuit held that options that vested over a five year period and that could not be exercised unless the original recipient remained in the employment of the grantor were thus subject to a substantial risk of forfeiture, were not freely transferable and "so clearly failed" the conditions of having a fair market value in accordance with the treasury regulations).

10 *See*, *generally*, David. E. Kahen, *Substantial Risk of Forfeiture and Section 457A: What are the Issues? Where are we Headed?*, TAX CLUB (March 2009).

11 Section 83(c)(1). Section 83(c) was added to the Code in 1969. The explanation for the provision did not provide significant detail regarding the determination of whether a substantial risk of forfeiture existed other than noting that "The question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances." Staff of the J. Comm. on Internal Revenue Taxation, General Explanation of the Tax Reform Act of 1969 (the 1969 Bluebook), at 111.

conditions relating to "refraining from performance" of substantial services or the "occurrence of a condition related to a purpose of the transfer" where the possibility of such condition being enforced is substantial.[12] It is not clear from the regulations – and the case law is inconsistent on the point – as to whether the "substantiality" test looks to the likelihood of forfeiture, or the likelihood that the forfeiture condition would be enforced should it apply.[13]

Whether services are substantial depends on the "regularity of the performance of services and the time spent in performing such services."[14] Generally, conditions that are not directly linked to services performed (or not performed) for the employer do not result in substantial risk of forfeiture, even if such conditions are imposed concurrently with the transfer of property to the employee (*e.g.*, where the employee loses the property if the employee is discharged for cause or for committing a crime the property is not subject to a substantial risk of forfeiture, but where retention is linked to the financial success of the employer the property is subject to a substantial risk of forfeiture).[15] Special consideration is given to non-compete arrangements and retirement-related provisions[16] and also to circumstances in which property is

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12 Treasury regulation section 1.83-3(c)(1). It is not clear from the regulations whether the likelihood that the condition related to the purpose of the transfer will be met is relevant to the determination of whether the risk of forfeiture is substantial, and case law on this point has not been consistent.

13 Compare, *e.g.*, *Burnetta v. Comm'r*, 68 T.C. 387 (1977) (in evaluating whether a condition that required an employee to return property to an employer if the employee was discharged for theft of company property, the Tax Court noted that although under pre-1969 law "the mere possibility that benefits could be lost through the commission of criminal acts or misconduct constituted a contingent that resulted in the employee's rights being forfeitable, under section 83, "the inquiry becomes not whether there is *any* contingency that would cause the amounts to be forfeited, but rather whether such contingency is substantial") and *Robinson v. Comm'r*, 805 F.2d 38 (1st Cir. 1986) ("Whether a condition creates a substantial risk of forfeiture is not a function of time, nor, as the Commissioner urges in this appeal, is it a function of the likelihood of triggering the event that will require the forfeiture to take place. To the extent that the substantiality of the risk depends on probability, the probability should be measured by the likelihood of the forfeiture taking place once the triggering event occurs.").

14 Treasury regulation section 1.83-3(c)(2).

15 *Id.* Note, however, that vesting conditions not solely linked to continued employment are used– *e.g.*, vesting conditions linked to performance metrics. *See* Adkins and Martin, *supra* note 5 (noting that vesting conditions linked to employer's financial performance can be considered a substantial risk of forfeiture for purposes of section 83 because they are a "condition related to the purpose of the transfer.").

16 *Id.* Non-compete clauses are presumed to not result in a substantial risk of forfeiture unless "the particular facts and circumstances indicate to the contrary". Factors to be considered involve a general inquiry into the marketability of the employee – age, health, and the relative skill of the employee. *See* Treasury regulation section 1.83-3(d) ex. 4 (where a corporation transfers shares to its employee, subject to the condition that the shares can be retained only if the employee does not compete with the corporation for a five year period in the geographic region in which the employee previously performed services for the corporation, the shares are subject to a substantial risk of forfeiture because "in order to earn a salary comparable to his current compensation, while preventing the risk of forfeiture from arising", the employee would have to

transferred to an employee of a corporation who owns a significant amount of voting power of the corporation.[17]

Property is not subject to a substantial risk of forfeiture if the employer is required to pay the fair market value of the property to the employee on the return of such property.[18] Note, however, that even if property is not described as being subject to "forfeiture" or "vesting," if the employer has the right to acquire the property for less than fair market value (*e.g.*, a call right to acquire the property at the lesser of its cost or fair market value) then it may be treated as subject to a substantial risk of forfeiture.[19] In addition, a "nonlapse restriction", standing by itself, is not considered to be a substantial risk of forfeiture.[20]

In general, to the extent property is subject to a substantial risk of forfeiture within the meaning of section 83, the service provider is not taxed on receipt of the property, and generally is not treated as owning it for tax purposes, unless and until the property vests (*i.e.*, there is no longer a substantial risk of forfeiture), and at that point is taxed on its full value. Note that this is true even if the service provider has paid *full* value for the property at the time of initial acquisition, if the property is nonetheless subject to a substantial risk of forfeiture.[21]

An election described in section 83(b) (an "83(b) election") can be made to take into income the value of property at the time of grant, *disregarding* any discount to value attributable to the lapse restrictions.[22] If this election is made, then any

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"expend a substantial amount of time and effort". The example also notes that the employee has no intention of retiring at the time the shares were granted).

17 Treasury regulation section 1.83-3(c)(3).

18 Treasury regulation section 1.83-3(c)(1).

19 Rev. Rul. 2007-49, 2007-31 IRB 237 (in determining whether there has been a "transfer" of substantially nonvested stock subject to section 83 under a variety of circumstances, the IRS treats stock which the employee must sell back to the employer at the lesser of the fair market value of the stock at the time of issuance and the fair market value when the stock is sold back, as subject to a substantial risk of forfeiture). *See also* Ltr. Rul. 9046030 (August 20, 1990) (stock issued to employees, subject to the condition that issuer allowed to repurchase stock at some percentage of book value if employee terminates employment with specified period of time, is subject to a substantial risk of forfeiture. "Conversely, when, as in this case, the agreement provides that, upon termination of employment, the employee will receive substantially less than the fair market value of the stock, and when that amount bears no relation to the stock's fair market value, the employee's rights to "full enjoyment of such property" are conditioned upon the future performance of substantial services, and thus are subject to a substantial risk of forfeiture.").

20 Treasury regulation section 1.83-3(c)(1) (last sentence).

21 *See* Treasury regulation section 1.83-2(a); *Alves* v. *Comm'r*, 734 F.2d 478 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982).

22 A "lapse" restriction is any restriction *other* than a "nonlapse" restriction and includes (but is not limited to) a restriction that constitutes a substantial risk of forfeiture. A nonlapse restriction is a permanent limitation on the transferability of property which will require the transferee to sell or offer to sell the property at a formula price (other than at its fair market value), which will

subsequent vesting is disregarded. The benefit of making a section 83(b) election is that once the compensation has been taken into income, the holder is treated as if he or she owned the property outright, so subsequent dispositions may be treated as giving rise to long-term capital gains.[23] The detriment to making the section 83(b) election is that if the property is forfeited no deduction or other loss is available with respect to the forfeiture notwithstanding the previously paid tax (except to the extent of the amount the holder paid for the asset, if anything, less amounts received upon forfeiture).[24]

Section 409A

Section 409A is a provision that imposes strict limitations on the time and form of payments under a nonqualified deferred compensation arrangement. While it is a bit of a fool's errand to describe section 409A briefly (exceeded only by the foolishness of trying to describe it at length), an understanding of the basic limitations imposed by section 409A is essential in devising a compensation arrangement where payments are to be deferred, and so a brief description seems unavoidable.[25] Section 409A requires all nonqualified deferred compensation to which it applies to be paid out under a fixed schedule or only on the occurrence of certain specified permissible distribution events. Once the payment schedule has been set, the payments generally cannot be accelerated or further deferred. Although "stock rights" (options and SARs) generally do, by their nature, provide for electivity as to the timing of receipt of compensation, they qualify under section 409A (*i.e.*, are not treated as deferrals of compensation) so long as they meet certain specified requirements. In the event that a plan of nonqualified deferred compensation does not qualify under section 409A, either under its legal provisions or in operation (*e.g.*, because it permits, directly or indirectly, improper electivity as to the timing of compensation), the deferred compensation becomes taxable at the time there is no longer a substantial risk of forfeiture (as defined for section 409A purposes), plus interest on deferred amounts at an underpayment rate

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continue to apply against the transferee or any subsequent holder. *See* Treasury regulation section 1.83-3(i) (defining lapse restriction), -3(h) (defining nonlapse restriction).

23 The character of the income is determined by the character of the underlying property. So, for example, if a partnership interest is sold, gains generally will be taxed as capital gains (*see* section 741), but all or a portion of the gain may be characterized as ordinary income to the extent the gain is attributable to "hot assets" owned by the partnership (*see* section 751).

24 Treasury regulation section 1.83-2(a). *See* Adkins, *supra* note 5 (noting that the disadvantages of making a section 83(b) election include accelerating the payment of taxes and bearing the risk of a over-taxation (where the value of the stock declines or the stock is forfeited)).

25 For other discussions, *see, e.g.,* William A. Drennan, *Enron-Inspired Nonqualified Deferred Compensation Rules: "If you don't know where you are going, you might not get there"*, 73 TENN. L. REV. 415 2005 (discussing the environment that inspired section 409A, the types of arrangements to which the law was intended to apply, the basic provisions of the law and various shortcomings thereof). *See also* Janet B. Korins, *Recent Developments in Partnership Compensation: The Interplay Between Section 409A and Subchapter K*, TAX CLUB (Sept. 14, 2005) (addressing the application of section 409A in the partnership context).

plus 1%, plus an additional 20% tax.[26] This tax result is adverse enough that it is not too far off the mark to state simply that section 409A "prohibits" plans of nonqualified deferred compensation that do not satisfy its requirements.[27]

In choosing among compensation arrangements the most important question is often whether section 409A applies at all. If it does not, then of course the details relating to the documentation and implementation of the compensation plan are irrelevant. That is often a much happier state of affairs than having section 409A apply.[28] As a rough and ready guide to whether section 409A applies, the following is a first cut at the analysis (and then of course check the regulations carefully):

> (1) Section 409A does not apply to arrangements covered by section 83. (There is no nonqualified deferred compensation because there is no deferral; section 83 requires recognition no later than the time that there is no longer a substantial risk of forfeiture.) So if property is delivered, whether subject to a substantial risk of forfeiture or not, section 409A generally does not apply.[29] This applies to corporate stock and (under current law)[30] to interests in partnerships (capital or profits interests), and will often be the best method to

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26 In addition, "plans" of deferred compensation may be aggregated, with the result that improper documentation or operation of one compensation arrangement may "blow up" treatment of other arrangements within the same category. *See* Treasury regulation section 1.409A-1(c)(2).

27 Amounts includible in the gross income of an employee under section 409A are subject to withholding under section 3401(a) and are treated as "supplemental wages" under 3402(a). Notice 2008-115 provides guidance on certain mechanical aspects of Section 409A and provides that "an employer must treat amounts includible in gross income under § 409A as wages for income tax withholding purposes." Notice 2008-115 2008-52 IRB 1367 (December 10, 2008). The amount that must be included in an employee's gross income for any given year (if a nonqualified deferred compensation plan fails to meet the requirements of section 409A) is all compensation deferred under the year for the current year and all prior years "to the extent not subject to a substantial risk of forfeiture and not previously included in gross income." Comments submitted by the ABA Section of Taxation highlight certain of the short-comings associated with Notice 2008-115, including failures with respect to withholding guidance. *See* Stuart M. Lewis, *Comments on Notice 2008-115 Reporting and Wage Withholding Requirements with Respect*, Doc 2010-8683, 2010 TNT 75-17.

28 Where section 409A does apply my first inclination is to think "well, great, now I have to go get a lawyer." My second inclination is to open the regulations and spend some time studying them. My third inclination is to go get a lawyer.

29 Treasury regulation section 1.409A-1(b)(4)(i)(B). Details matter, of course. For example, it is possible that an arrangement to deliver property that generally would be taxed under section 83 may trigger the application of section 409A, if the arrangement effectively permits a deferral of a prior arrangement (*e.g.*, a prior entitlement to deferred compensation is waived or forfeited and the new arrangement effects a "substitution" for the prior entitlement). Treasury regulation section 1.409A-3(f).

30 The Treasury regulations reserve on this point and Notice 2005-1 explains that although section 409A may apply, until such time as the service issues additional guidance, "for purposes of § 409A taxpayers may treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock." Treasury regulation section 1.409A-1(b)(7); Notice 2005-1 2005-1 CB 274, Q&A 7 (December 20, 2004).

ensure that section 409A is inapplicable, so long as delivery of property is consistent with other relevant considerations.

There is *not*, however, a carve-out for guaranteed payments for services made to partners by partnerships, so if a partnership interest is granted then the terms relating to partnership distributions must be understood to determine whether there is a risk that the distributions might be treated as guaranteed payments for services.

(2) Section 409A does not apply to service providers that are on the accrual method of tax accounting. (The concept is to limit the ability to defer compensation. An accrual method service provider will accrue compensation into income, generally under the all events test, even if actual payment has been deferred, so 409A was apparently not viewed as being necessary). This will exclude many but not all entity service providers (*e.g.*, management companies), and provides an easy due diligence check to exclude the possibility that section 409A might apply. It will generally not be relevant to individuals.

Section 409A also has an exclusion for independent contractors, which excludes persons providing asset management services and will generally not be relevant for portfolio company management.

(3) Section 409A applies only to *deferred* compensation. For this purpose compensation is not deferred if it must be, and with very limited exceptions is, paid out within two and a half months after the end of the taxable year of the service provider in which there is no longer a substantial risk of forfeiture.[31] This is referred to as the "short term deferral" exception.

The section 409A definition of "substantial risk of forfeiture" draws on similar concepts employed in section 83, but is not identical in all respects.[32] The regulations under section 409A provide that compensation is subject to a "substantial risk of forfeiture if the entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial."[33] The section 409A regulations are explicit regarding the necessary link between the condition and the service provider's provision of services to the employer ("a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals") and also provide

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31 Treasury regulation section 1.409A-1(b)(4).

32 One commentator notes that "The section 409A definition of [substantial risk of forfeiture] is a much more stringent version of the definition of [substantial risk of forfeiture] under section 83." *See* Louis D. Richey, *Multiple Definitions and Use of Substantial Risk of Forfeiture Create Confusion After §409A, but Notice 2007-62 Approach for Tax-Exempts Is Not the Answer*, 36 TM COMPENSATION PLANNING JOURNAL 01 (January 2008).

33 Treasury regulation section 1.409A-1(d)(1).

that a stock right is not subject to substantial risk of forfeiture on the first date the holder may exercise such right and receive cash or property that is substantially vested.[34] The determination of whether any given event (*e.g.*, an IPO, or an IPO at a particular value) is a good performance-related condition may depend on the facts and circumstances – what is the event and is it related to the services performed by the individual? Unlike under section 83, a condition relating to the service provider refraining from services does not render compensation subject to a substantial risk of forfeiture under section 409A.[35]

Since performance-related conditions (related to the purpose of the compensation) can qualify as a substantial risk of forfeiture for purposes of section 409A, it will sometimes be the case that an equity-related payment will be treated as a short-term deferral, so long as there are no features for additional deferral after the amounts have been earned.

(4) Although options and SARs (stock rights) do provide for elective deferral of gains, they are exempt so long as they meet certain detailed specified requirements:

> (i) The exercise price may never be less than the fair market value of the underlying stock (disregarding lapse restrictions) on the date the option or SAR is granted (*i.e.*, the option or SAR may not be "in the money" by *any* amount).[36] If under the terms of an option or SAR the exercise price is or could become less than the fair market value of the stock on the date of grant, the option will be treated as providing for deferral of compensation.[37] As a result, care must be taken to the terms of any adjustment mechanism to ensure that it cannot reduce the exercise price below the value threshold at grant.[38]
>
> For this purpose there are rules for the determination of fair market value in the context of stock not traded on an established security market; in general there is a requirement that there is a reasonable application of a reasonable valuation method. The regulations prescribe

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34 Treasury regulation section 1.409A-1(d)(2).

35 Treasury regulation section 1.409A-1(d)(1).

36 Treasury regulation section 1.409A-1(b)(5)(i)(A)(1).

37 Treasury regulation section 1.409A-1(b)(5)(i)(C).

38 The most obvious sort of adjustment that would be problematic would be an entitlement to have the option exercise price reduced to match subsequent drops in the value of the issuer's stock. A less obvious adjustment that might be problematic would be a reduction in exercise price to compensate employees to the extent the Black-Scholes value of their options drop, because of a reduction in their term, limitations on exercise or a reduction in the leverage of the issuer and therefore volatility in value of the issuer's stock.

certain methodologies that are presumed to be reasonable.[39] The attitude of the IRS appears to be to judge the methodology used rather than on whether the valuation determination in fact is correct.[40]

(ii) The number of shares subject to or referenced by the option or SAR must be fixed on the original date of grant.[41] There are additional rules, noted below, allowing adjustments to the options or SARs to take into account corporate transactions such as stock splits or stock dividends.

(iii) The transfer or taxation of the option is subject to section 83.

(iv) The option or SAR must not include any deferral feature other than deferral of recognition until the later of exercise, disposition or substantial vesting of the underlying stock (*i.e.*, an option *can* be exercised into stock subject to a substantial risk of forfeiture).[42] Any right that would permit an additional deferral, other than the right to receive cash or stock upon exercise, is not allowed.[43]

(v) A right to directly or indirectly share in dividends, if the right is contingent on exercise of the stock right, is impermissible and would generally cause the stock right to fail section 409A. This could include a

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39 Treasury regulation section 1.409A-1(b)(5)(iv)(B). The safe harbors are an appraisal that meets the requirements of section 401(a)(28) (generally, by an independent appraiser) done no more than twelve months prior to the relevant date, with certain exceptions a formula valuation that would be treated as fair market value within the meaning of Treasury regulation section 1.83-5 (often not applicable to stock settled options or SARs), or a valuation of illiquid stock of a start-up corporation made reasonably and in good faith and evidenced by a written report.

40 There is a question as to whether a failure to utilize any real method at all to determine value (*e.g.*, the board simply decides in its judgment that fair market value is no more than X so the exercise price can be X) is a problem if, in fact, the stock rights are not in the money at grant. This is, perhaps, most likely at a time when a transaction occurs that is treated as a modification of the stock rights and therefore a re-issuance. *See* Treasury regulation section 1.409A-1(b)(5)(v)(A) (modification of a stock right treated as a new grant). Although section 409A does in some respects focus on having compensation arrangements that are properly documented even in the absence of any actual electivity in practice, in the author's view this should not be an issue since the operative rule (that the stock right is not in the money at grant) was not violated. That does not detract from the general point that it would be highly advisable to try to fall within one of the valuation safe harbors, or at least to have a "reasonable method" that is applied reasonably, with the determinations recorded contemporaneously.

41 Treasury regulation section 1.409A-1(b)(5)(i)(A)(1).

42 Treasury regulation section 1.409A-1(b)(5)(i)(A)(3).

43 This might include, for example, receipt upon exercise of the option of an unsecured note or other unsecured promise to pay. See for example the JCT Report on Enron, discussing the "deferral of stock option gains program." Joint Comm. on Tax'n., 108th Cong., Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (February 2003).

payment of dividend amounts in cash on exercise or an offset against the exercise price.

A right to share in dividends that is not contingent on exercise may itself constitute deferred compensation, assuming there is a legal right to receive the dividend amounts, but would not necessarily cause the related stock option or SAR to fail to qualify.[44]

(vi) An option or SAR will be treated as providing for deferral of compensation if it relates to stock other than "service recipient stock."[45] Service recipient stock is a class of stock that is "common" stock within the meaning of section 305 (*i.e.*, which participates in corporate growth to a significant extent),[46] and that does not have any preference in distributions by the issuer (other than on distributions of stock or on liquidation). As a result, although "preferred" stock (with a preference on liquidation or on distributions) may be treated as "common" stock for purposes of section 305 generally, any preference with respect to dividends or other cash distributions would cause it not to qualify as common stock for purposes of section 409A. The underlying stock also may not be subject to certain mandatory repurchase rights, or put or call rights, if the put/call is a non-lapse restriction and is based on an equity value that is not fair market value.

Service recipient stock must be issued by an "eligible issuer." This is a corporation (or other entity) that is a service recipient, or any parent corporation in a chain of controlling entities (generally, 50% owners, although for legitimate business criteria the ownership percentage can be as low as 20%).[47] Except where a service provider provides services directly to a corporation, an eligible issuer does not include an investment entity the primary purpose of which is to hold minority ownership interests in entities other than the service recipient.[48] Anti-abuse rules also apply to disallow structures or transactions undertaken with a purpose of providing deferred compensation not subject to section 409A.[49] A stock right will not fail the underlying

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44 Treasury regulation section 1.409A-1(b)(5)(i)(E); *see also* Treasury regulation section 1.409A-3(d) (dividend equivalent amounts are equivalent to an right to earnings; payment may be exempt under the short term deferral rule or treated as paid on a fixed payment date).

45 Treasury regulation section 1.409A-1(b)(5)(i)(A)(3).

46 Treasury regulation section 1.409A-1(b)(5)(iii); 1.305-5(a).

47 Treasury regulation section 1.409A-1(b)(5)(iii)(E)(1) (cross-referencing Treasury regulation section 1.414(c)-2(b)(2)(i) and reducing the relevant percentage from "at least 80 percent" to "at least 50 percent" or in appropriate circumstances "at least 20 percent"). For corporations the relevant percentages look to voting power or value, and for partnerships look to profits interests or capital interests.

48 Treasury regulation section 1.409A-1(b)(5)(iii)(E)(2).

49 Treasury regulation section 1.409A-1(b)(5)(iii)(E)(3).

"service recipient stock" test where the stock right is obtained in substitution of an existing, qualifying stock right in a "corporate transaction" (*e.g.*, a spin-off transaction). For example, if an employee owns an option issued on parent stock, and parent distributes stock of controlled in a spin-off (which could be tax-free under section 355 or could be a taxable dividend), it does not violate the section 409A rules for the employee to have his option split between options on parent and options on controlled even if the employee is working for only one of them.

(vii) With certain exceptions, if the stock right is considered to be "modified" then that is considered to be a new grant that needs to meet the above requirements. A modification for these purposes includes any change in the terms of the stock right or any other agreement governing the stock right that may directly or indirectly reduce the exercise price,[50] any change that adds discretion to add benefits that would be a modification or extension,[51] or changes the terms of the underlying stock in a manner that adds value (except to the extent the terms of the relevant stock right are adjusted to take into account such a corporate transaction).[52] Many other changes, including shortening the term of the stock right, modifying vesting conditions, increasing the exercise price, or allowing net share settlement, are not treated as modifications for this purpose.

A substitution or assumption of the stock right by reason of a "corporate transaction" is not treated as a modification if the adjustment meets the principles under Treasury regulation section 1.424-1.[53] These generally require that the amount of aggregate spread be maintained and that the ratio of the exercise price to the fair market value of stock not be increased.[54] These rules may impede commercial flexibility in crafting the terms of an option pool, and will be particularly problematic if it is expected that a portfolio investment may pay out extraordinary dividends (*e.g.*, proceeds from refinancing or sales of individual units) or have additional capital put in over time (*e.g.*, a business plan to roll up additional assets into the original portfolio investment).

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50 Treasury regulation section 1.409A-1(b)(5)(v)(B).

51 Treasury regulation section 1.409A-1(b)(5)(v)(F).

52 Treasury regulation section 1.409A-1(b)(5)(v)(G). Query whether this would include a sponsor that makes an additional capital contribution (thereby increasing the value of the issuing corporation) without taking back shares with an equal fair market value.

53 Treasury regulation section 1.409A-1(b)(5)(v)(D). A "corporate transaction" is defined under Treasury regulation section 1.424-1(a)(3) as a merger, consolidation, acquisition of property or stock, separation, reorganization, liquidation, stock split or pro rata stock dividend, or an extraordinary dividend.

54 Treasury regulation section 1.409A-1(b)(5)(v)(D).

Example:

Assume employees hold options on 10 shares with an exercise price of 8 and a fair market value of 10. There is 20 of aggregate spread value inherent in the options. If the company pays out an extraordinary dividend of 4 per share, the value per share will decrease to 6. The options can be adjusted by reducing their exercise price by 4, so that the options would have an exercise price of 4 on shares worth 6 each. This retains the aggregate spread (20) and the ratio of the exercise price to fair market value has gone down from 8/10 to 4/6.

Example:

Assume instead that the options have an exercise price of 2. There is 80 of aggregate spread. When the extraordinary dividend is paid, the existing options cannot simply be adjusted by reducing their strike price (from 2 to negative 2). Instead, new options would need to be issued to cover the spread. There are a number of different solutions, but one would be options on 20 shares with a strike price of 2 (on shares worth 6), so to retain the aggregate spread.[55] The option-holders now have a greater percentage of the upside in the company, so this may skew the commercial intentions relating to the size of the equity pool.

Example:

Now assume that instead of an extraordinary dividend, there is a contribution to capital of 5. Shares that were worth 10 are now worth 15. The invested capital may be in exchange for shares that dilute the underlying option shares, which would reduce the size of the equity pool by percentage. This reduction in equity pool percentage is unavoidable. It is not possible to simply increase the exercise price (from 8 to 13) to reflect the higher value; although the aggregate spread would be maintained, the ratio of exercise price to fair market value would go up (from 8/10 to 13/15). The aggregate spread and ratio could be maintained only by reducing the number of option shares; to maintain the ratio the exercise price could not be below 12 (80% of 15), and so to maintain the spread of 20, there can be no more than 6.67 option shares (down from 10).

(vii) An extension of the term of the stock right is treated as adding a deferral feature that makes it subject to section 409A, although

[55] Market practice is that the exercise price of the options should not be less than 25% of the fair market value of the underlying shares.

an extension is allowed until the earlier of the latest under which the stock right would have expired under its terms or the tenth anniversary of the date of grant. An extension at the time the stock right is out of the money is treated as a modification rather than an extension.[56]

Section 457A

Section 457A is another provision that limits nonqualified deferred compensation, since section 409A was apparently insufficient for the purpose. Although commonly considered to have been passed in an effort to crack down on deferred compensation arrangements entered into by offshore hedge fund management companies,[57] in fact it has a much broader application. Where section 409A delineates strict rules on how nonqualified deferred compensation will be "allowed" (which is to say, arrangements entered into without penal rates of tax), section 457A effectively prohibits any plan of nonqualified deferred compensation payable by a "nonqualified entity." The policy intention of section 457A is to limit the payment of nonqualified deferred compensation by entities that are fundamentally indifferent as to when, if ever, they get a tax deduction for the compensation expense. (It is worth noting up front that the rules are often arbitrary in application, so using the policy as a shorthand for whether section 457A applies is an invitation to trouble.)

If section 457A is violated (*i.e.*, a nonqualified entity enters into a plan providing for nonqualified deferred compensation) then the deferred compensation is taxed currently or, to the extent not "determinable" in amount, is taxed at the time it is determinable, plus an interest charge at the underpayment rate plus 1%, plus an additional 20% income tax.[58] Many equity-related compensation arrangements should give rise to deferred compensation that is determinable in amount (based on the value of the reference equity at the end of the year), although determinability will of course depend on the nature of the arrangements.[59]

If the relevant service recipient is a nonqualified entity, then the only commercial route to follow is to try to ensure that the arrangement entered into is not a "plan" of nonqualified deferred compensation. Section 457A generally utilizes the

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56 Treasury regulation section 1.409A-1(b)(5)(v).

57 Many hedge fund management companies are owned solely by individuals and therefore are eligible to use cash method tax accounting. So long as their deferred compensation arrangements qualified under section 409A (*e.g.*, deferred performance fee amounts were payable only on fixed dates and were not eligible for acceleration or further deferral except as permitted under the section 409A rules), the management companies were able to defer tax on considerable amounts of compensation income, often notionally re-invested in their funds.

58 The statute also contains a very narrow "investment asset" exception to the definition of "substantial risk of forfeiture" that may make (if and when regulations are issued) section 457A inapplicable in some odd circumstances, but at this point it is not effective and may never be usable in practice. *See* section 457A(d)(1)(B).

59 Notice 2009-8, Q&A 19 covers determinability. Although the value of RSUs and SARs should be treated as determinable (based on equity values as of the end of the year), it would be helpful if guidance clarified the point.

definitions of "plan" of nonqualified deferred compensation described under section 409A, with a few differences:

(1) Section 457A, like section 409A, has a short-term deferral exclusion. It is, however, different in a few respects. It applies if payments are made within twelve months (not two and half months) after the end of the service recipient's (not recipient or provider's) taxable year in which there is no longer a substantial risk of forfeiture.

More importantly, the relevant definition of "substantial risk of forfeiture" differs. While section 409A does not treat compensation payable within the short term deferral period after the satisfaction of a relevant performance condition (*e.g.*, stock price, achievement of regulatory approval, etc.) as "deferred," section 457A does not take into account any condition other than the requirement that substantial services are to be performed. As a result, if a service provider is subject to a performance-related condition but is no longer subject to a service condition, the compensation arrangement has "vested" for section 457A purposes and the short term deferral period is measured from the year in which there is no longer a substantial risk of forfeiture attributable to (the failure to perform) services. Current law does not even appear to provide an exception for vesting attributable to death or disability, although there is always hope that subsequent guidance may do so. Since equity-related plans often have performance-related conditions (*e.g.*, the achievement of a certain IRR for the fund), there may be many plans that are not subject to section 409A due to the short term deferral exception, but would be subject to section 457A.

Example:

An employee is granted cash-settled RSUs by his employer, a nonqualified foreign corporation. The RSUs have three year time vesting and have a performance condition that they vest only if the employer meets certain earnings targets within seven years. Although the employee has a legal right to the RSUs, and the payment date is indeterminate, he is subject to a substantial risk of forfeiture within the meaning of section 409A since he loses the RSUs if the earnings targets are not met within seven years. Assuming the employee is paid within two and half months after the end of the taxable year in which the target is hit, there is no violation of section 409A because the payment is within the short term deferral period. However, because the RSUs are a plan of nonqualified deferred compensation, and have no *service*-related substantial risk of forfeiture for purposes of section 457A after year 3, they are subject to section 457A.

(2) Unlike section 409A, section 457A does *not* exclude accrual method service providers.[60]

(3) Section 457A, like section 409A, should not apply to property delivered pursuant to section 83.[61] As with section 409A, partnership interests (capital and profits) are currently excluded, while guaranteed payments are not. While guaranteed payments – to the extent tied to participation in equity, hitting revenue targets, other business related conditions – will (depending on the facts) often be viewed as having a performance related condition and therefore be exempt under section 409A under the short term deferral exception, that will often not apply to exempt such guaranteed payment from section 457A.

(4) Section 457A does not apply to options that qualify for the exemption under section 409A. For seemingly arbitrary reasons, however (*i.e.*, the statute says so), SARs that are excluded from section 409A are generally not excluded from section 457A.[62] Notice 2009-8 provides an exception for SARs that must, in all circumstances, be stock-settled (*i.e.*, SARs without appreciable differences from a stock-settled option), although the Notice still somewhat arbitrarily restricts this exception to a SAR relating to a corporate entity rather than a partnership.

The gating issue in determining whether section 457A applies, or may apply, to a compensation arrangement is whether the service recipient is or might (prior to there being no substantial risk of forfeiture) become a nonqualified entity.[63] If the service recipient is a domestic corporation then there is no issue. If the service recipient is a partnership, or is a foreign corporation, then the determination swiftly becomes much more difficult.

A foreign corporation is *not* a nonqualified entity if substantially all of its income (*i.e.*, 80% of its gross income) is effectively connected with the conduct of a United States trade or business ("ECI"), or if it is "subject to a comprehensive foreign income tax." A foreign corporation is subject to a comprehensive foreign income tax

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60 Notice 2009-8 Q&A 5 provides for an independent contractor exception similar to that applicable for section 409A.

61 There is some lack of clarity as to whether a right to receive property in the future that is non-vested at the time would be excluded under section 457A, although the better answer is that it should be. *See* New York State Bar Association Tax Section, *Report on Rules Governing Nonqualified Deferred Compensation Under Section 457A,* 2009 TNT 191-15 (October 5, 2009) ("NYSBA Report") at p.26 (discussion of "Transfers of Property Subject to Section 83 Should be Excluded").

62 Since prior to the passage of section 457A there was little appreciable difference in taxation between an option and a SAR, there is little guidance on point that distinguishes them.

63 Notice 2009-8 actually uses the term "plan sponsor" rather than "service recipient." Notice 2009-8 refers to the entity that "if the entity paid the amount deferred in cash to the service provider in the relevant taxable year, would be entitled to a compensation deduction under U.S. federal income tax principles." The application of this principle is discussed further below. In general this paper uses the term "service recipient" for consistency among statutory regimes.

only if the corporation (1) is an eligible resident of a treaty country;[64] (2) not taxed under any regime or arrangement that is materially more favorable than the corporate income tax generally imposed by such treaty country; (3) in each relevant year, no more than 20% of its gross income is "excluded" nonresidence source income (with certain exceptions for income taxed in the U.S. as ECI or excluded dividends from subsidiaries that are themselves not nonqualified entities). Section 457A also does not apply, even if a foreign corporation is a nonqualified entity, to the extent the compensation would have been deductible against ECI of the corporation had it been paid in cash on the date there is no substantial risk of forfeiture.[65]

There are a myriad of ways in which the rules for the determination of nonqualified entity status are unclear legally, or are likely to be unclear factually.[66] In many cases foreign corporations owned by a private equity fund will be nonqualified entities, or there will be some degree of risk that they would be so treated. Merely being organized outside of a tax haven or paying a normal rate of corporate tax will not necessarily suffice to avoid being a nonqualified entity.

For example, focusing first on the requirement that the foreign corporation must be an eligible resident of a treaty jurisdiction, there are any number of jurisdictions (and not necessarily low tax jurisdictions) which come up in ordinary commercial life that are not treaty jurisdictions (*e.g.*, Hong Kong, Brazil, Argentina, Singapore, the UAE, Cyprus, Mauritius). Even if the corporation is organized in a treaty jurisdiction (the one element of the test that is easy to determine), there may well be questions as to whether it is an eligible resident under the treaty. The limitation on benefits provision in treaties generally looks to the ownership of the relevant corporation, and particularly in cases where the private equity fund has partners who are mainly non-U.S., that ownership test will not be met. Even where the ownership test is met, a base erosion test also often must be met, requiring knowledge of the deductible payments by the entity (*e.g.*, interest expense) and the recipients of those payments. The relevant recipients of deductible payments may not be known or may change over time. It is not clear as a legal matter whether active business activities in a jurisdiction would cause the corporation to qualify under an "active trade or business" limitations on benefits clause for purposes of section 457A.

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64 The statute also provides as an independent ground for exemption if the service recipient demonstrates to the satisfaction of the secretary that it is a resident for tax purposes in a foreign country that has a comprehensive income tax. There is currently no relevant procedure in place for this determination to be made.

65 *See* Notice 2009-8 Q&A 12. There are a number of interpretive difficulties with this provision. First, the determination is made on a pro forma basis (*i.e.*, what would have happened had the compensation been paid in cash on the date there was no longer a substantial risk of forfeiture, even though such a payment did not in fact occur). Second, there is no apparent exception to the extent the pro forma deduction would have been capitalized, although rules may be issued treating expenses capitalized into the cost of goods sold as being deductible. It is not clear if this rule applies where the foreign corporation does not have net taxable ECI but is running an effectively connected loss, or has no gross income.

66 For a more full (and arguably fulsome) explanation, please read the NYSBA Report.

The "materially more favorable" tax regime test also may be a problem. Some relevant corporations may benefit from tax holidays or other tax incentives (*e.g.*, Swiss corporations with negotiated rates of canton tax) that may cause an issue. There are also corporations that are established under regimes that allow them to work as effectively low-tax holding companies (*e.g.*, Irish section 210 companies) that would likely be captured by this rule.

Finally, and most troublesome, the "excluded nonresidence source income" test is broad enough to capture many operating companies and in application is likely to lead to arbitrary results. For purposes of this last test, a foreign corporation "excludes" an item of nonresidence source income if the foreign corporation's taxable income does not include such income, or excludes it by reason of an exemption, exclusion (including an exclusion from gross income), deduction (including a dividends received deduction, dividends paid deduction or similar provision), taxation of the income at a rate of less than fifty percent of the generally applicable rate, or by other means.[67] Since there is no guidance on how this provision will be applied, the potential effects are expansive. It certainly is intended to apply to tax regimes that utilize a participation exemption (except to the extent the excluded income was derived from subsidiaries that are not nonqualified entities). It appears that income would be treated as "excluded" because it is treated (in the foreign country) as earned not by the service recipient but rather by a subsidiary (treated as a pass-through under U.S. principles). This would be the case, for example, where a German corporation holds a disregarded (for U.S. tax purposes) U.K. subsidiary. Similarly, income excluded in the foreign country under the permanent establishment clauses of its income tax treaties may be treated as excluded nonresidence source income. (Imagine our German corporation with a true branch in the U.K., and income from the branch is taxable solely in the U.K. and not Germany). While foreign tax credits of a type similar to those in the U.S. ought not to be treated as an "exclusion" – although no written guidance explicitly says as much – tax sparing or similar credits may be treated as an exclusion. Income offset by deductions that are inherently related to gross income may, possibly, be taken into account as "exclusions." Some types of deductible payments clearly should be covered by this (*e.g.*, Luxembourg CPECs or profit participating loans or similar hybrid instruments), while others were likely not intended but may be covered by the language in any event (*e.g.*, swap payments, payments in lieu of dividends on borrowed stock, loan participations, back-to-back license royalties, etc.). If the "deduction" prong of the exclusion test is viewed broadly then many foreign entities that have large amounts of gross income and matched deductions will still be treated as nonqualified entities even though their net income is fully taxable at normal corporate income tax rates.

The status of a partnership as a nonqualified entity may, similarly, be highly uncertain, although for different analytical reasons. A partnership (whether U.S. or foreign) will be nonqualified unless at least 80% of its gross income is (1) ECI or (2) allocated to foreign partners subject to a comprehensive foreign income tax or U.S. persons not exempt from tax. For this purpose, gross income is generally allocated

[67] Notice 2009-8, Q&A 8(c).

through upper-tier partnerships to the ultimate taxpaying entities. Strangely, the nonqualified entity tests look solely to allocations of gross income and have nothing to do with allocations of compensation expense. These tests may not be clear in application, either factually or legally. An incomplete list of some open questions gives a sense of items that may need to be considered: How does a private equity fund know the exact composition of its limited partners, where some percentage of them are likely to be fund of funds or other pass-throughs, and how does it know how income will be allocated among them? How does the fund know there will not be secondary transfers among partners after the compensation arrangement has been entered into?[68] How does the fund know whether non-ECI income, such as gains from sale of stock, is currently subject to tax by its foreign partners under their domestic rules? Does the reference to income refer to section 704(b) book income, or taxable income (and if the latter, does the answer really depend on what section 704(c) methodology is chosen)? How, if at all, are section 743 adjustments taken into account? Does the test include gross income excluded under relevant provisions of law (*e.g.*, tax exempt bond income, gain on stock of a corporate partner exempt under section 1032, COD income that is currently excluded under section 108(i))? Is income taxable to a tax-exempt partner under section 514 (regarding debt-financed income) treated as taxable in proportion to the proportion of acquisition indebtedness and, if so, is that also the case if the partnership interest itself is leveraged? Presumably guaranteed payments to partners are not taken into account, but gross income allocations are?

In the absence of clear and simple facts and/or additional, highly helpful and pellucid guidance, it may be very difficult to have a high degree of confidence that any given foreign corporation or partnership is not now and will never become a nonqualified entity. Certainty, if any, will most likely lie in the direction of knowing that a particular entity is a nonqualified entity, rather than knowing that it is not. Of course the facts of any given situation will need to be examined and it may be that a particular partnership or foreign corporation is so clearly not a nonqualified entity that there is no reason for concern. In the absence of that clarity, however, it will be important to be sure that there is no service recipient treated as a nonqualified entity or, if there is, that whatever arrangement is put in place is not treated as a plan of nonqualified deferred compensation.

Section 710

Proposed section 710 (the so called "carried interest" provision) is not yet law, may never become law, and almost certainly will not become law soon. It has, however, been introduced multiple times and may be viewed as a piece of low-hanging fruit to the extent a revenue pay-for is required for some future tax bill. On the assumption that Congress is filled with hungry bears that will be unable to resist the temptation of low-hanging fruit forever (which is to say, it is hard to be comfortable that section 710 or some amended iteration will never become law), and because no

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[68] Generally a private equity fund may refuse to permit a transfer. It may be commercially awkward, however, to prevent a transfer merely to protect the taxation of employment compensation by some portfolio company employee.

proposed draft has grandfathered existing partnerships, the potential effects of section 710 may be a relevant consideration in structuring an equity-compensation arrangement even today. Ultimately of course a determination can be made as a business matter that proposed section 710 or similar legislation is unlikely to become law and so can safely be ignored until such time as passage seems more likely.

Proposed section 710 would change the tax treatment of partnership interests owned by a person who provides "substantial amounts" of specified investment management services with respect to "specified assets" held directly or indirectly by the partnership.[69] The most recent proposals defined "investment management services" remarkably broadly, as advising on the advisability of investing in, buying, or selling a specified asset, managing, acquiring, or disposing of a specified asset, arranging financing for a specified asset, or activities in support of these activities. A "specified asset" includes stocks, securities, partnership interest (whether publicly traded or private), commodities, real estate held for rental or investment, and related derivatives. This would, as a result, cover a significant number of employees of what would ordinarily be thought of as true operating partnerships (or, as discussed below, certain foreign corporations), to the extent the company holds stock in other corporations or interests in partnerships or commodities or derivatives or real estate.

It is difficult to predict what the final legislative language will be (assuming the provision is enacted) and of course no guidance has been issued, so this reflects only the current proposals. In very brief summary, the provision as it has been currently introduced would provide that an "investment services partnership interest" (or "ISPI") is subject to the following special rules:

- Character of Distributive Share of Income: "Net income" with respect to an ISPI would be treated as ordinary income, and in the hands of an individual partner that provides specified services, subject to self-employment tax. Net loss, to the extent allowed, would also be ordinary. For individuals there may be a proration regime, so that (effectively) only a portion of the interest is subject to these new rules.[70]

  Note that although the character of the income would be ordinary, and individuals would be subject to self-employment tax, it appears that it is not intended that section 710 would recharacterize a partnership distributive share of income as actual compensation for services.[71]

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69 For a general discussion of the implications of section 710, *see* Carol Kulish Harvey et al., *I Spy an ISPI: Expansive Breadth of Carried Interest Proposals*, 128 TAX NOTES 526 (Aug. 2, 2010). *See also* ABA Comment on H.R. 2384, 2010 TNT 94-66 (May 11, 2010).

70 Although it is not clear, it is possible that this change would cause an affected ISPI to be treated as income in respect of a decent ("IRD"), with the result that no basis step up will be allowable upon death. If so this will be a surprise and disappointment to many estate tax lawyers.

71 *See* Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010" (May 28, 2010), p. 286.

This may be highly important, because even if partnership interests issued for services generate ordinary income (an adverse change from current law), the distributive share of income would not be deferred compensation subject to sections 409A or 457A.

- Loss Disallowance: Net loss with respect to an ISPI would be disallowed, except to the extent of previously allocated net income, looking *solely* at taxable periods during which the legislation is effective. Any such disallowed loss would be carried forward to succeeding taxable years (where, presumably, there might be subsequent income that it can be used to offset).[72] Disallowed loss will cease carrying forward to the extent the ISPI has been disposed of.[73] True economic losses from loss of invested capital or from a distributive share of taxable income from a period prior to the effective date of the legislation might not be recognized from a tax perspective (except to the extent associated with a qualified capital interest).

  This provision is one of the most troubling, since it appears to be unnecessary. If the concern is to prevent ordinary net loss (from the first recharacterization rule) arising from prior allocations of capital gains, this would seem most easily solved by a character matching rule rather than a loss disallowance provision.

- Character of Gain on Disposition: Notwithstanding the fact that a partnership may own capital assets as well as "carried interest" or similar sorts of service-related assets, *any* gain on disposition of an ISPI would be ordinary, and in the hands of an individual partner that provides specified services, subject to self-employment tax.[74] (This is the so-called "enterprise tax," which may be limited to the extent goodwill or other similar capital assets have been held for a minimum holding period). In addition to the "enterprise tax" issue, an ISPI is treated as inventory property (*i.e.*, a "hot asset") when owned by another partnership. As a result a person (a non-service provider) that sells an interest in an upper tier partnership may recognize ordinary income or loss attributable to the ISPI on a "look through" basis *even if* the interest in the upper tier partnership itself is not an ISPI in the hands of the seller.[75] In addition, under the "hot asset" rules, redemption transactions at the upper tier partnership may cause deemed taxable dispositions of ISPIs. (This rule may end up being

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72 Proposed section 710(a)(2).

73 There is a glitch in the current proposed legislative language, in that losses can be taken to the extent of cumulative net income, *without* any proviso reducing this cap to the extent of distributions.

74 Proposed section 710(b)(1)(A).

75 Proposed section 710(b)(7).

limited to the extent it would apply to non-service providers owning interests in certain PTPs).

- No non-recognition transactions. In general, any gain on disposition of an ISPI will be recognized without regard to any non-recognition provision.[76] The only exception is with respect to a contribution to a partnership under section 721, if an irrevocable election is made to treat the (new upper tier) partnership interest received as an ISPI.[77]

  Needless to say, this would interfere in the ability to undertake ordinary-course structural rearrangements relating to partnership interests, and may complicate tax planning related to liquidity events involving ISPIs.

- Distributions with respect to an ISPI. Distributions of property made with respect to an ISPI will be treated as a distribution of cash to the holder, which may be taxable or may be treated as a return of basis under normal rules. To the extent property is distributed, gains (if any) attributable to the property will be recognized and allocated to the holder of the ISPI, subject to allocations of built-in gains to other partners under section 704(c).[78]

- Qualified Capital Interest ("QCI"): To the extent an ISPI is a qualified capital interest treated in the same manner as qualified capital interests owned by persons who are not performing services and are not related to service providers, the adverse rules otherwise attributable to an ISPI will not apply. If there are no such non-service partners, or there are differences in returns, then the fact that there was an actual capital investment may not matter and the holder may be subject to the full panoply of rules regarding ISPIs (subject to the issuance of guidance that manages to differentiate between service-related income and investment-related income).

  A qualified capital interest may represent an investment into the partnership of cash or other property (with potential limits to the extent the property has built-in gain), or an interest in the partnership received for services (to the extent of the amount taken into income), or an interest reflecting prior allocations of net taxable income. An investment is *not* treated as giving rise to a qualified capital interest to the extent acquired in connection with a loan (or guarantee or other

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76 Proposed section 710(b)(1)(B).

77 Proposed section 710(b)(4). The proposed legislation also exempts *deemed* distributions of partnership interests pursuant to a partnership termination, merger or division.

78 Proposed section 710(b)(6).

credit support) extended by the partnership or any partner or any related person.

- Disqualified Interests: If a person performs (directly or indirectly) substantial investment management services for an entity and holds a "disqualified interest" in that entity, and the value of the interest or payments on it are substantially related to income or gain from the assets with respect to which services are provided, gains or income generally are subject to recharacterization as ordinary income.[79] Although unclear, it appears that the other rules that apply to ISPIs (loss disallowance, no non-recognition transactions) may not apply to disqualified interests. The statute says that rules similar to those applicable to qualified capital interests will apply.

  A disqualified interest is anything other than straight debt (*e.g.*, equity, convertible debt, an option or right to acquire property, or a derivative instrument), excluding a partnership interest or any interest in a "taxable corporation." A taxable corporation for this purpose is a domestic C corporation or S corporation or a foreign corporation substantially all of the income of which is effectively connected income or which is subject to a comprehensive foreign income tax within the meaning of section 457A(d)(2). Because the definition of "taxable corporation" looks to the rules under section 457A, it is likely the same legal and factual uncertainties that apply in the section 457A context (noted above) may also apply in the context of section 710.

  Note that while the definition of disqualified interest does require a substantial amount of investment management services, it does not appear to require a direct link between such services and the value of the interests or payments received on the interests. Rather, it appears to require only a link between the specified assets as to which services are performed and the value of the disqualified interests or payments made thereon. So, for example, if a manager at a bank incorporated in Brazil performs investment management services with respect to certain corporate subsidiaries – and the returns from those subsidiaries are material to the stock price for the bank – it is possible that common stock of the bank would be treated as a "disqualified interest" even though the activities performed by the manager standing alone would have inconsequential effects on the value of common shares or dividend payments on the shares.

  To the extent there is a underpayment of tax related to a disqualified interest, an amendment to sections 6662 and 6664 would provide for a 40% underpayment penalty, which could be mitigated for reasonable

[79] Proposed section 710(e).

cause only if the relevant facts relating to the tax treatment are adequately disclosed, there is substantial authority for the treatment and the taxpayer had a reasonable belief that the treatment was more likely than not correct.

The effect of this provision is one of the most possibly disruptive elements of the provision and, if it passes, may well upend the traditional treatment of certain compensation arrangements. For example, where an executive receives a grant of restricted stock in a foreign issuer that happens to be a nonqualified entity and makes an 83(b) election, or has options and exercises them, or simply purchases stock for cash, he or she likely assumes that any further appreciation would be capital in nature. That may well be the result, but that will depend on how the concept of a "qualified capital interest" is imported into the context of a "disqualified interest." (There also have been reports that the scope of "investment management services" or an "investment services partnership interest" may be narrowed, which may mitigate this issue to an extent).

II. CORPORATE SERVICE RECIPIENT – STOCK GRANT OR PURCHASE

The first compensatory arrangement to be discussed is the most simple. The portfolio company grants to employees shares of stock, or perhaps sells them stock at a discount, or perhaps even sells them at fair market value (*i.e.*, the fund's buy-in price) and then imposes a substantial risk of forfeiture on the shares, such as a call right to re-acquire the shares at the lesser of their cost or fair market value at the time.

Example:

Fund will acquire the portfolio company for $100 million in cash. The portfolio company grants 5% of the common shares to management for free, or for a discounted price.

General Considerations

- Where the company grants stock to employees, they enjoy the built-in value on the date of grant, rather than benefiting solely from appreciation in the shares. While it is possible to create greater focus on appreciation through vesting conditions, this is a more "expensive" arrangement from the point of view of the sponsor. Moreover, from the point of view of the employee, the value of the shares is currently taxable to them (unless the shares are unvested and no section 83(b) election is made), without cash to pay the tax, so the company will often have to provide employees with some cash for that purpose.

- A section 83(b) election is available with shares (unlike options); this provides the employees with the potential to ultimately realize

long-term capital gains. The downside is that if a section 83(b) election is made the employees pay tax on the shares and yet ultimately may not receive anything if the shares are ultimately forfeited.

Section 83 – general rule

This grant is covered by section 83 as a delivery of property in connection with services. In the absence of a substantial risk of forfeiture the employees would take into income, as compensation, the value of the shares received, less the amount paid (if any), and will be taxed on that amount at ordinary income rates plus employment taxes. The company will be required to withhold on the employment taxes.

The company will receive a compensation deduction equal to the amount of the income included by the employees. The deduction may or may not be of value to the company, depending on projections of taxable income. The value of current deductions to the company may be an important issue in the analysis.

Value

Where the private equity fund just recently purchased the shares, the value of the shares is (absent unusual circumstances) effectively set by the fund's buy-in price. For future grants of stock there may be a valuation issue, no different than valuation questions in other areas of law; no particular standard or methodology applies solely in the section 83 context.[80] To the extent employees purchase stock for (arguably) less than fair market value they may be taxed on any discount (a "cheap stock" issue).

Forfeiture restrictions

It would be unusual for employees to simply be granted shares outright. More commonly the shares are subject to forfeiture conditions. These may relate to the provision of services (*i.e.*, time based vesting), or not competing, or not being terminated for cause, or performance related conditions (the occurrence of EBITDA or revenue targets etc.). In the context of a private equity fund portfolio investment there will very often be conditions related to the returns to the fund (*e.g.*, multiple of money or IRR returns).

If a restriction qualifies as a "substantial risk of forfeiture", then for purposes of section 83 the employee is generally not currently taxed on the receipt until there is no longer a substantial risk of forfeiture. As discussed below, even if there is a substantial risk of forfeiture the employee may make a "section 83(b)" election to take the value less any amount paid for the shares into income immediately. No valuation discount is allowable with respect to a lapse restriction.

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[80] This is in contrast to the specific methodologies described under section 409A to the determination of the valuation of the stock underlying stock rights, relevant to the question of whether the stock rights are in the money at the time of grant.

If a restriction is a nonlapse restriction (*i.e.*, a permanent limitation on the shares, such as a permanent right by the issuer to repurchase the shares for something other than fair market value), then the value of the shares may reflect a discount attributable to the nonlapse restriction. When and if a nonlapse restriction is removed in a compensatory context, the increase in value is treated as compensatory income at that time.[81] Nonlapse restrictions are (or appear to the author to be) uncommon in the context of a private equity fund compensation arrangement.

Section 83(b) election

If shares are subject to a substantial risk of forfeiture (generally referred to as a vesting condition) then the recipient is allowed to make an 83(b) election to treat them as having been transferred notwithstanding the substantial risk of forfeiture. This election *must* be made within 30 days of the grant.[82]

Effect of 83(b) election.

If a section 83(b) election is made the shares are treated as owned outright as if there were no risk of forfeiture. In the event of a forfeiture, however, the holder is not entitled to a loss or deduction except to the extent the holder has paid for the shares (the loss being equal to the difference between what had been paid and what is received on forfeiture).

Upon forfeiture, the corporate issuer is required to take into income an amount equal to the prior deduction (in effect recapturing the deduction). Note that this is different than the result that otherwise would apply where an issuer is transacting in its own stock and has a call right that it exercises in the money.

Effect of no section 83(b) election.

A more interesting result occurs if no section 83(b) election is made (or perhaps more likely, should have been made but for one reason or another the election is not properly made in time). For compensatory purposes the employee is treated as if there were no delivery of property until vesting.[83] At the time the shares vest the employee is taxed on the full value of the shares (less amounts paid for them), and the corporation is entitled to a deduction. Note that even if the employee paid *full* fair market value for the shares initially, if the shares are subject to a vesting condition and no section 83(b) election is made, the employee is subject to ordinary income tax at the time of vesting.

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81 Treasury regulation section 1.83-5(b).

82 Treasury regulation section 1.83-2(b).

83 *See* Matthew Rosen, *The Many Continuing Uncertainties of Section 83,* TAX FORUM No. 541 (April 3, 2000).

Foreign corporations and Section 457A.

In general, the fact that an issuing corporation is a foreign corporation treated as a nonqualified entity is not relevant to the delivery of restricted shares. The delivery of such shares is covered by section 83 and therefore is not treated as deferred compensation.

However, dividends paid on restricted shares, in the absence of a section 83(b) election, are treated as separate compensatory payments (analogous to earnings on deferred compensation), taxable as compensation to the employees and deductible by the corporation. Since the employees, as "owners" of the restricted shares prior to forfeiture, would have a legal entitlement to the dividends, there is the potential for such dividends to be captured by the special rules regarding deferred compensation. There generally should be no issue under section 409A because if the shares are unvested, any such payment should be treated as being made within the short term deferral period (or at any rate treated as made on a fixed schedule).[84] However, *if* the issuing corporation is a nonqualified entity, the deductions are not allowable against effectively connected income, and the relevant forfeiture restriction on the shares is not service-related, there is a risk that the right to such dividends may be subject to section 457A, depending on how the section 457A short-term deferral rules apply to these earnings amounts.[85] Since the relevant amounts would not be determinable until payment, such an unlucky employee would be subject to the additional 20% tax and the interest charge on the deemed underpayment. It is fair to say that this may be a trap for the unwary.

Foreign corporations and Section 710.

Even if section 710 becomes law it does not, on its face, seem like it should be of concern to employees that have received a grant of straight common equity. For individuals providing services to a foreign corporation that is a nonqualified entity, however, it may be relevant. If the employee provides a substantial amount of investment management services for such an employer (which may have a very broad definition) with respect to specified assets (again with a broad definition), and the value of the equity is substantially related to those assets, then the "disqualified interest" rules in section 710(e) might apply. The result would be that gains on the shares, even after vesting, would be subject to tax as ordinary compensation, and an underpayment would be subject to a relatively strict 40% penalty regime.

So long as the common equity owned by the employee is entitled to returns consistent with returns on equity owned by the fund or other non-service providing owners, there are grounds for optimism that the rules analogous to the

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84 *See* Treasury regulation section 1.409A-3(e).

85 Notice 2009-8 Q&A15 provides that "[w]hen the right to earnings is specified under the terms of the plan, the legally binding right to earnings arises at the time of the deferral of the compensation to which the earnings relate." This suggests, albeit with a lack of clarity, that section 457A applies to dividends on restricted shares with respect to which the holder has a legal entitlement.

qualified capital interest rules would exclude application of section 710(e). But that would of course depend on the terms of guidance yet to be issued. Moreover, the employee might not be treated as having an exempt "qualified capital interest" for a number of reasons. One reason would be if the employee receives better returns on his or her "investment" (including the compensatory income taken into account) than other investors, for example because the employee holds only common shares and the fund holds both common and preferred. Another reason would arise if the employee borrowed from the corporation or another shareholder to acquire the shares.

III. PARTNERSHIP SERVICE RECIPIENT – CAPITAL INTERESTS AND PROFITS INTERESTS.

A partnership may make compensatory grants of equity, just as a corporation can. Moreover a partnership can, like a corporation, sell a partnership interest (for fair market value or with a discount) in connection with the provision of services. In the partnership context, however, there is greater flexibility on the terms of the equity grants, and due to the flow-through nature of partnerships and the specific provisions of Subchapter K there are some tax issues specific to such grants. While in general the grant of an equity interest in a partnership will often be desirable if it is possible – it allows for significant commercial flexibility and as a general matter avoids sections 409A and 457A – there are a number of unsettled tax issues with such grants. More importantly, there is the potential that section 710 will pass and throw a wrench in the intended tax results.

Partnerships may issue equity that is treated either as a "capital interest" or as "profits interest." Because the tax treatment of a compensatory grant of profits interests is generally beneficial to the service provider, profits interests are far more common in practice than capital interests are. Capital interests are, however, granted (sometimes inadvertently), or capital interests may be acquired by employees for cash (subject to forfeiture restrictions), so it makes sense to discuss the treatment of a grant of a compensatory capital interest first.

Section 83 – capital interests

As in the corporate context, section 83 governs the issuance of compensatory equity. The service provider is treated as including ordinary compensation income equal to the value of the equity (less amounts paid, if any), and the partnership has a deductible expense. Because the payment is made to a person that is a partner rather than an employee there may be some small differences in the timing of the income and the deduction, and in the manner in which taxes are withheld.[86]

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[86] In general, under current law, a bona fide partner who provides services to a partnership and receives compensation (typically, as a guaranteed payment) is not treated as an "employee" for purposes of withholding tax, qualification for certain benefits available to employees, etc. *See, e.g.,* Treasury regulation section 1.707-1(c); Rev. Rul. 72-596, 1972-2 CB 395; Rev. Rul. 69-184, 1969-1 CB 256. For a discussion of these issues (among others), *see*, *e.g.,* Sheldon I. Banoff, *Use of Corporate Partner Stock and Options to Compensate Service Partners—Part 1*,

General Considerations

- Obviously this is only possible if there is an appropriate partnership in the structure.

- As with corporate stock, this is somewhat more "expensive" for the fund than other sorts of interests.

- Section 83(b) election is available. Deductions are at grant (if a section 83(b) election is made) or upon vesting.

- There is some uncertainty as to how section 83 principles apply in the context of a partnership interest. Potential passage of section 710 may drastically affect treatment.

Valuation

Under section 83 principles, the amount of the compensation and the amount of the expense is the "fair market value" of the equity. What is the fair market value of a partnership capital interest? In a corporate context it is clear that no special rules apply (aside from disregarding lapse restrictions); the value is simply an arm's length price for the interest. It is certainly possible that such a rule applies to partnership capital interests as well – there is certainly no guidance in effect that would provide a different rule – but in the context of Subchapter K the better answer appears to be that the value of the interest should generally be presumed to be the amount of the section 704(b) capital account attributable to the interest (which is to say, generally, the amount the interest would be entitled to if the partnership were to sell its assets for fair market value, satisfy liabilities and distribute proceeds in liquidation immediately after the grant). Any other valuation methodology would be largely inconsistent with the zero value "deemed liquidation" framework applicable to profits interests under Revenue Procedure 93-27, since otherwise a profits interest (without capital) would be viewed as having zero value, but a capital interest with a single dollar of capital might be viewed as having an arm's length fair market value.[87] This presumption is simple, consistent with the capital account framework that applies to partnerships, and fully satisfying except for the awkward analytical point is that in some cases the capital

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89 J. TAX'N. 12 (1999) (discussing Revenue Ruling 69-184, the author notes "The Service reasoned that a partner who devotes his time and energies in the conduct of his partnership's trade or business, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an employee."); *see also* Lori S. Hoberman, *Receipt of Partnership Interest in Exchange for Services: Still Polishing the Diamond* 15 J. PARTNERSHIP TAX'N 4 (1999) (noting Revenue Ruling 69-184, the author concludes that a partner cannot also be an employee of a partnership).

87 Use of a presumption that value equals the "capital account" would also be consistent with proposed (but unlikely ever to be effective) compensatory partnership interest regulations, assuming a "Safe Harbor" election were made under Notice 2005-43, and consistent with proposed regulations under section 108(e)(8) (the issuance of partnership equity in satisfaction of partnership debt).

account will have no more than a correlation to an arm's length valuation. Capital accounts (which reflect a current mark to market valuation of the assets) do not take into account "as exercised" dilution from options or from profits interests, nor disproportionate allocations of losses on the downside that make the capital interest either preferred or subordinate on liquidation.[88] There may well be circumstances (*e.g.*, interests that are in a publicly traded partnership or are convertible into a readily tradable instrument) in which an arm's length valuation is the more conservative position to take.

If section 704(b) capital accounts provide a presumption for fair market value, it is not clear that nonlapse restrictions should, in the ordinary case, be taken into account in determining value, either on initial grant or if the nonlapse restrictions are removed in a compensatory transaction. Similarly, to the extent the partnership has a call right to repurchase the partnership interest at its capital account value, this should not be viewed as a "substantial risk of forfeiture" merely because the capital account value is arguably less than the fair market value of the interest.

Treatment to partnership

The service recipient partnership should be treated as receiving a deduction equal to the value of the capital interest. Needless to say, the valuation for purposes of the deduction and for purposes of the compensation income should be consistent.[89]

One theoretically open issue is whether the partnership should be treated as transferring an undivided interest in the partnership assets in payment of compensation, with related recognition of gain or loss on the assets allocated among the existing partners. Since partnerships do not benefit from a provision similar to section 1032 for corporations, and for a number of purposes partnerships are treated as an aggregate of the partners, this is a possible analytical framework. Notwithstanding this, most practitioners appear to subscribe to the convenient theory that this issuance should be analyzed under a deemed "circular flow of cash" construct, under which the partnership is treated as paying cash equal to the amount of the compensation, which cash is then invested by the service provider for a capital interest.[90] (This is yet another

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88 Valuation presumptions can often have non-economic effects, however, and they are found in other areas of law as well (*e.g.*, Treasury regulation section 1.1001-1(g) and 1.1273-2, treating the value of a debt instrument in an exchange as its stated redemption price at maturity). So the mere fact that the presumed value is not correct should not necessarily be fatal.

89 Although applicable to profits interests rather than capital interests, a substantial proportion of the rules proposed for compensatory issuances of partnership interests (the "Safe Harbor" election) related to preventing the possibility that the IRS would be whipsawed with inconsistent treatment. Similarly, Revenue Procedure 2001-43 requires consistent treatment among the partners as a predicate to its applicability.

90 The proposed regulations on compensatory issuances of partnership equity, released in 2005, provide that there is no current gain to the issuing partnership. Similarly, proposed regulations on the issuance of partnership equity in cancellation of debt would not require the issuing partnership to recognize gain. It appears, therefore, that Treasury's view of matters is that in

reason to think that the compensation should be measured by the amount of capital account; otherwise the deemed contribution of cash would not be in the correct amount and some other adjustment would become necessary to explain the capital accounts). Under this deemed transaction, the partnership assets would generally be booked up or booked down, and there would be a "reverse 704(c)" layer of built-in gains or losses that would, over time, be allocated to the existing partners consistent with the regulations under section 704(c).

83(b) election

As discussed below, if a profits interest is unvested, the vesting is generally not a taxable event under Revenue Procedure 2001-43. This revenue procedure does not, however, apply in the context of a capital interest. There are a number of open questions relating to the section 83(b) election as it applies to capital interests:

Date of grant. An election under section 83(b) needs to be made within 30 days of grant. What counts as a "grant"? In the context of a partnership interest this will not always be clear.[91] The issue may be particularly murky to the extent the service providers are existing partners, since as a general rule a partner has only a single partnership interest, with a single capital account and single basis.[92] A partnership interest may be reflected solely on schedule K-1s

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ordinary circumstances the issuance of a partnership interest should not be treated as a taxable disposition of the underlying assets.

91 *See United States* v. *Frazell*, 335 F.2d 487 (5th Cir. 1964) (Taxpayer agreed to provide certain services to a partnership in exchange for which he would receive a monthly salary and certain interests in property that was acquired by the partnership through the efforts of the taxpayer at such time as the investors in the partnership had recovered their full costs and expenses with respect to the operations of the partnership and their investment therein. The taxpayer's services were terminated and the taxpayer received shares in the stock of a corporation to which the partnership's properties had been transferred. The court treated the taxpayer as receiving an interest in the partnership when his contract was terminated and subsequently deemed to have contributed that partnership interest to the relevant corporation in exchange for interests in the corporation (or, in the alternative, to have received directly shares in the relevant corporation on termination of his contract in exchange for the services provided). In either case the timing of the transfer was deemed to have occurred when the contract was terminated (when the taxpayer's interest became "possessory) not when the contract was initially signed). *See also Vestal* v. *United States*, 498 F.2d 487 ("…[W]e hold that the taxable event occurred upon acquisition of the actual joint venture interest by Vestal, not in an earlier year upon execution of the initial contract between Vestal and the El Dorado investors.")

92 *See* Treasury regulation section 1.704-1(b)(2)(iv)(b) (partners have a single capital account), Rev. Rul. 84-53, 1984-1 CB 159 (in analyzing the consequences of sale of an interest in a partnership where the transferor has a variety of interests (e.g., limited and general partner interests), the Service noted "Consistent with the provisions of Subchapter K of the Code, a partner has a single basis in a partnership interest, even if such partner is both a general partner and a limited partner of the same partnership."); *Chase v Comm'r.*, 92 TC 874 (1989); Ltr. Rul. 8350006 (Aug. 22, 1983). The bifurcation of partnership interests was an unstated requirement in the proposed regulations on compensatory partnership interests. *Cf.* Proposed Treasury regulation section 1.704-1(b)(4)(xii)(*c*) (in the context of forfeiture allocations, referring to distributions "with respect to the forfeited partnership interest").

distributed at the end of the year, or on a schedule to the partnership agreement that is kept informally. In addition, subject to section 706, a partnership may generally set the allocation of profits and losses among the partners until the due date for filing a partnership return. What is the date of grant of a partnership interest that is evidenced by a change in the proportionate interests in partnership profits and an allocation of built-in gain to a person to provide a capital account?

Subsequent forfeiture. Assuming the 83(b) election has been made with respect to a restricted capital interest, what is the tax effect to the holder of the restricted interest and to the partnership?

- Under the section 83 regulations, the partnership as service recipient should recognize income equal to the amount of the prior deduction. It is not clear that this is the correct result analytically. Suppose the holder had previously been allocated taxable income, with the result that taxable income was not allocated to the existing partners. Should the partners not be required to recognize income equal to the income that had previously been allocated to the service provider?[93] Suppose book capital had been allocated to the holder. Would the forfeiture be treated as a taxable capital shift to the partners at the time?[94] Is it permitted, or required, to allocate the recaptured income back to the partners that had been allocated the prior deduction?[95] How would amounts allocated to the forfeited interest be distinguished from capital or profits that might have been allocated with respect to another partnership interest held by the service provider (even though a partner generally has, as noted above, only a single indivisible partnership interest)? There do not appear to be any settled answers to these questions, nor relevant official guidance.[96]

- Also under the section 83 regulations, the service provider should not be entitled to a loss or deduction, except to the extent of the amount the holder has paid less the amount received upon forfeiture. Does this

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93 Alternatively this could be viewed as a redemption of the partnership interest for whatever is paid by the partnership (perhaps nothing), with a downward adjustment to the basis of partnership assets to the extent required by section 734.

94 The better view, it seems, would not be to treat this as a taxable capital shift to the other partners. First, they are not obtaining additional capital as a result of their services, and there is no provision that requires a capital shift made for non-compensatory purposes to be treated as currently taxable. Second, there is no avoidance of tax; to the extent the capital is merely book capital and not tax capital, the taxable gains will eventually be recognized by the partners.

95 This could be viewed as analogous (although the converse) to the allocation of deductions related to contingent liabilities under Treasury regulation section 1.752-7.

96 The 2005 proposed regulations on compensatory partnership interests introduced the concept of "forfeiture allocations" to deal with these issues. There is no currently effective provision applicable.

mean that if the holder has been allocated taxable income, generating basis in the partnership interest, that no loss is allowable attributable to that basis? This does not seem like the correct result since basis attributable to the allocated income is substantively the same as basis resulting from an investment of after-tax cash by the service provider (who has incurred tax liability attributable to the allocated income).[97] The section 83 regulations do not seem to have contemplated this sort of circumstance. Nevertheless, it is difficult to exclude the possibility that no loss would be available to the holder related to the forfeited interest. Suppose the holder of the restricted interest had been allocated losses in prior years. Are those losses now somehow to be reversed to the holder upon forfeiture and if so, using what partnership items?

No 83(b) election

If a service provider has been granted (or acquired) a capital interest subject to a substantial risk of forfeiture and has *not* made a section 83(b) election (perhaps because the service provider missed the date of grant or did not realize there was a grant of a "new" interest), there are a number of questions as to how that interest should be treated. These questions are, as above, not answered in existing guidance.

Under general section 83 principles the holder should be treated as if he or she had not received the interest unless and until it vests. Presumably that would suggest that the service provider should be treated as a non-partner (at least with respect to the unvested interest) and should not be allocated any items of partnership gain or loss (which would instead be allocated to other partners, who may or may not ultimately be the ones that benefit from a deduction in the event the restricted partnership interest vests). The implications of this characterization do not sit easily with the rules generally applicable to partnerships, and it would certainly be easier if, in the context of a partnership, holders were always to be treated as partners notwithstanding a substantial risk of forfeiture. That personal preference aside, there is no guidance on what the result actually is. What if there is a partnership (*e.g.*, a feeder partnership for management) that has *only* partners with restricted interests – if none of them is a "partner" then what is the character of that entity? If the service provider is otherwise a partner (including, for example, a person who has time-vested into only a portion of a partnership grant), can they be allocated partnership items "as if" they held a vested partnership interest, with allocations of income reversed by an allocation of the

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[97] For a discussion of forfeiture considerations, *see* Sheldon I. Banoff, Paul Carman and John R. Maxfield, *Prop. Regs. On Partnership Equity for Services: The Collision of Section 83 and Subchapter K*, 103 J. TAX'N. 2 (2005). *See also* Jonathan L. Grob, *Profits Interests in a Service Partnership: Entrance and Forfeiture Under the 2005 Proposed Regulations*, 85 NEB. L. REV. 1093 (2006); Richard W. Harris, *Dispositions and Forfeitures of Nonvested Partnership Interests Received for Services Rendered Under Section 83*, 7 BUS. ENTITIES 2 (2005) (the author notes that "While the treatment of a partner who sells a nonvested interest subject to Section 83(b) seems logical, the treatment of a forfeiture of such interest is obtuse and punitive and without rationale or justification.").

deduction recognized upon actual vesting? If there is a subsequent "book up" event for the partnership, can (or must) the contingent obligation reflected by the restricted partnership interest be taken into account?

A service provider that receives cash distributions with respect to a restricted partnership interest would, presumably, be treated as if he or she had received employment compensation payments (possibly guaranteed payments if the person were otherwise a partner) that would potentially be subject to section 409A (unless exempt under the short term deferral rules) or section 457A (if the partnership is a nonqualified entity and the payment is not made within the short term deferral period after the lapsing of any service-related vesting conditions). It may not, however, always be possible to distinguish cash payment with respect to an unvested partnership interest from cash payments made on other, vested partnership interests owned by the same person.

Profits interests

Although the grant of partnership capital interests gives rise to interesting questions, in practice most partnerships making compensatory equity awards intend to give out "profits interests" rather than capital interests, and if the interests are capital interests then it is an inadvertent valuation mistake.

General Considerations

- Obviously this is only possible if there is an appropriate partnership in the structure.
- Very flexible in terms of commercial arrangements.
- No current deduction attributable to grant of a profits interest. Subsequent allocations can provide the effect of a deduction at the partnership level (the utility of which depends on the tax status of the partners).
- The default rule is the effect of a section 83(b) election, without the need to make the election.
- Some uncertainty as to how section 83 principles apply in the context of a partnership interest. Potential passage of section 710 may drastically affect treatment.

Revenue Procedure 93-27 and Revenue Procedure 2001-43

The definition of a "profits interest" is found in Revenue Procedure 93-27. A "profits interest" is a partnership interest other than a "capital interest," and a "capital interest" is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."

Under Revenue Procedure 93-27 the grant of a profits interest to a person providing benefits "to or for the benefit of the partnership" generally is not a taxable event, unless one of the following "no-nos" is applicable: (1) if the profits interest relates 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; (2) if within two years of receipt, the partner disposes of the profits interest; or (3) if the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b).

Under Revenue Procedure 2001-43, a substantial risk of forfeiture applicable to a profits interest that qualifies under Revenue Procedure 93-27, and any subsequent vesting, is disregarded as a taxable event, without the need for a section 83(b) election. Revenue Procedure 2001-43 requires that the holder of the profits interest is treated as a partner and is allocated a distributive share of partnership items with respect to the interest, and that neither the partnership nor any partner deducts or takes loss with respect to the fair market value of the interest.

Assuming the requirements of Revenue Procedure 93-27 and Revenue Procedure 2001-43 apply, a partner can receive a profits interest without current taxation upon receipt, is allocated a distributive share of partnership income (including most particularly long term capital gains, if the partnership should happen to have that character of income), and is not taxed upon vesting.

Failure to Qualify under the Revenue Procedures

Given the happy results possible with profits interests described above, it is perhaps uncharitable to ask what happens if something goes wrong. It is certainly simpler to view profits interests as always under the rubric of "no current tax and vesting is irrelevant," and the IRS does not seem to have had an appetite to challenge this treatment based on foot-faults. That said, it is interesting to consider what issues might arise and what the results could be.

- Suppose a threshold is specified which supposedly represents the fair market value of the partnership's assets but is actually too low? In that case it would appear that the "profits" interest actually would be a capital interest under Revenue Procedure 93-27. This sort of challenge is most likely, presumably, where a transaction occurring shortly after the grant of the interest shows that the valuation was off. In practice this is most likely to occur when the fund and management team come to a negotiated deal, but the details of documentation get delayed for a considerable period of time.

- Suppose a threshold is specified based on the value of the assets on the partnership's books for capital account purposes and no "mark to market" determination is made? Is it acceptable to look to the section 704(b) "value equals basis" rule to conclude that the interest is still a profits interest? Given the fact that the issuance of a profits interest is a permitted event for a

book up for partnership assets,[98] and the revenue procedures refer solely to "fair market value" without reference to the partnership books, it would be highly advisable to use a "true" fair market value.

- Suppose there is a catch up allocation of net profits (or gross profits), and the net profits (or, even more likely, gross profits) are substantially certain to occur? That would appear to violate the first listed no-no in Revenue Procedure 93-27. How certain is "substantially" certain in practice? (As it turns out, any number of high-quality net leases and debt instruments bore real commercial risk.)

- Suppose the profits interest has been transferred within two years?

  In a circumstance where the transfer was unexpected and not at a set value (*i.e.*, a non-abusive situation), it is difficult to believe that the IRS would in practice try to treat the grant of the interest as outside of the Revenue Procedure.

  How about a non-recognition transfer to another partnership or a corporation within two years? Certainly in the case of a partnership it would seem unwarranted to treat the contribution as a "disposition" that causes the revenue procedures not to apply; to the extent there is any built-in gain attributable to the profits interest at the time of the contribution it would be allocated to the contributing partner under section 704(c). A contribution to a corporation is a harder case; although the transaction does not create liquidity and would not necessarily establish a value for the profits interest, the characteristics of the stock received may be different enough from the original partnership profits interest that the IRS would treat the revenue procedure presumptions as inapplicable.

So what happens if the grant of the profits interest is outside the revenue procedures? Strangely, there is no clear guidance, excluding some case law that would treat the grant or vesting of the partnership interest as taxable (and other case law going the other way). Presumably the IRS would be entitled to take vesting into account, with the results described above with respect to capital interests. Possibly an interest that has a little bit of capital (*e.g.*, because of a valuation issue) could be bifurcated into a profits interest falling within the revenue procedures and a capital interest subject to the general rules under section 83(b), but there is no support for that in the guidance and it would appear to be entirely contrary to the definitional scope of the revenue procedures. As a practical matter it may be advisable to make a protective section 83(b) election so that if the interest *is* treated as a capital interest because of a valuation mistake, or otherwise, any subsequent vesting would continue to be disregarded.

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[98] *See* Treasury regulation section 1.704-1(b)(2)(iv)(f).

Tax treatment of forfeiture.

Under Revenue Procedure 2001-43, vesting is generally disregarded without the need to make an election under section 83(b). What then is the effect of a forfeiture upon the partnership and a holder? The rule generally applicable in the section 83 context clearly would not be applicable because the partnership did not take a deduction on the grant of the profits interest. As with the grant of a compensatory capital interest, it is unclear whether, if there have been allocations of taxable income or book income to a holder, the holder is entitled to a loss and whether the partnership is required to recognize gain.

Guaranteed Payment issues.

Because the issuance of a capital interest is covered by section 83, and the issuance of profits interest is technically not a taxable event, the rules regarding nonqualified deferred compensation generally do not apply. To the extent a partner has a legal entitlement to a guaranteed payment for services, however, that payment may be treated as deferred compensation (if not falling within the relevant short-term deferral periods) and be within their scope. In many circumstances it is not clear whether a guaranteed payment is or will be made. For example:

- Under section 736 a redemption payment to a partner, not in exchange for his or her interest in partnership property and determined without regard to income of the partnership, is treated as a guaranteed payment. The terms of buy-out rights need to be examined carefully to see whether they might fall within this category.[99]

- A partner may be entitled to receive a percentage payment but with a floor (*e.g.*, 5% of profits but no less than $1 million). It is clear under the regulations that a guaranteed payment is made solely to the extent the "floor" payment is made and not the payment measured by a distributive share of income.[100] If the guaranteed payment – if made in a later taxable year – would be subject to section 409A or section 457A, how if at all is it taken into account for the year in which there is no longer a substantial risk of forfeiture (since in that year it is not clear whether or not the payment will be treated as a guaranteed payment or not)?

- A partner may be entitled to a payment related (in amount) to the proceeds obtained by another partner on sale of its partnership interest. Although profits generated by the selling partner presumably reflect at least inherent

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[99] Section 409A excludes guaranteed payments under section 736, except to the extent the payments qualify under section 1402(a)(10). The rationale for this exclusion is not self-evident. *See* Notice 2005-1 Q&A 7. Presumably this would also exclude such a guaranteed payment from the scope of section 457A.

[100] Treasury regulation section 1.707-1(c) ex. 2.

appreciation in the assets of the partnership, any such the payment would not technically relate to profits *of* the partnership.

- To the extent payments are made that do not relate to profits of a partnership, the payments will be guaranteed payments. This will often be easy to identify (*e.g.*, a payment upon an IPO at a certain value, a payment upon receiving regulatory clearance, payment upon hitting a milestone). There may, however, be payments that appear to be based on profits that are not, at least from a tax perspective. This could include, for example, accounting profits (which may include returns from consolidated corporate subsidiaries), or profits on a mark to market basis (for a non-mark to market partnership).

- Payments may be made on a delayed basis, such that payments in any given year do not reflect partnership profits for that year. This would include multi-year computation periods, look back provisions (*e.g.*, looking to profits from a year but with payments only after financial accounts have been audited), or payments out of reserved profit amounts where the initial profits were allocated to another party (*e.g.*, a European waterfall where profits are allocated to the fund to match the cash, and subsequent payments to management are made out of partnership capital in the absence of profits).

As noted above, guaranteed payments, if deferred, may be subject to sections 409A or 457A. In many cases but not all cases a deferred guaranteed payment will be subject to performance vesting conditions, so that it will fall within the short term deferral exception for section 409A. There is much more likely to be an issue under section 457A, since the only relevant forfeiture risks relate to the performance of substantial services. It may be possible to mitigate risks of having deferred compensation by structuring payments as preferential allocations of net profits, or even gross profits, which are not (currently, at any rate) treated under the rules for deferred compensation.

Section 710

It is an obvious point, but if section 710 passes then in many circumstances partnership interests that have been issued for services will be subject to adverse tax rules – ordinary character on income or gain, mandatory gain recognition on transfer, and limitation on losses. The actual application of section 710 will depend on a number of factors including whether the service provider is providing a substantial quantity of investment management services (which will depend both on the facts on the ground and on how "investment management services" are ultimately defined) and whether the qualified capital interest rules effectively mitigate the adverse effects.

Commercial Considerations

As a tax matter, excluding the potential future effects of section 710, the issuance of a partnership interest (and particularly a profits interest) provides significant advantages. Aside from specific issues related to guaranteed payments or distributions on non-vested partnership interests, the adverse rules regarding nonqualified deferred compensation will not be relevant. A partnership profits interest may be granted without incurring a current tax or a tax upon vesting and a distributive share of capital gains may be available to the holder. (The converse of that is the detriment to the other partners that there is no current deduction.)

As a commercial matter as well the grant of a profits interest (and sometimes a capital interest) may be beneficial because it is possible to craft the commercial results attributable to the profits interest with a great deal of flexibility. Profits may be shared in differing percentages at different thresholds, and may be subject to a variety of different vesting conditions. For examples (the numbers and vesting conditions are arbitrary):

(1) A profits interest may entitle the holder to 5% of partnership net profits, or to 100% of net profits until $100,000 and then 5% thereafter.

(2) A profits interest may entitle a holder to 5% of net profits above an 8% IRR threshold and 10% of net profits above a 15% threshold.

(3) A profits interest may entitle a holder to 5% of profits, but not vest until an 8% cash return (or allocated return) has been achieved by the fund.

(4) A profits interest may entitle a holder to 5% of profits, with a "catch up" of 100% of net profits (or perhaps gross profits) until such time as the holder has met a targeted capital account of 5% of the total capital accounts. Assuming sufficient net (or gross) profits, this interest is the equivalent of a capital interest, although rather than ordinary compensation attributable to the receipt of a capital interest, it is possible that the allocated profits may be long-term capital gains. It is also possible that the "net profits" for this purpose may be book gains only recognized upon a book-up, with the result that the holder has no current tax from the allocation at all (although may eventually pay tax under the reverse section 704(c) rules).

(5) A capital interest may entitle a holder to 5% of a partnership.

(6) A capital interest may entitle a holder to 5% of a partnership, but not vest until the fund has met an 8% IRR.

(7) A capital interest may entitle a holder to 5% of a partnership, and may be allocated the first dollars of any loss (*i.e.*, a subordinate interest), or only allocated losses after all other interests have a capital account of zero (*i.e.*, a preferred interest). An arrangement where management invests cash and bears a

preferential allocation of losses may be used to craft an effective claw-back or indemnity arrangement.

In addition, the entitlement of a profits interest generally may be amended on a going-forward basis without generating current tax, and it often should be possible to exchange the profits interests for other interests without current taxation (*e.g.*, "net share settle" the interests into "ordinary" capital interests, and/or exchange for corporate stock in an incorporation).

Example:

Parent partnership acquires portfolio company (a corporation) for 100. Management is granted profits interests for 10% of the profits of the partnership.

After two years the value of the company is down to 60. In order to re-incentivize management, the profits interests are amended to provide for 5% of profits above 60, until the value is at 140, and then to flip back to 10% of the profits. This modification of the profits interests is not taxable.

Assume the fund decides to IPO the company at a value of 120. At that point it is inconvenient (from a disclosure or securities regulatory point of view) to retain the partnership holding company. So the partnership is to be liquidated and the profits interests net share settled into IPO shares. Some shares continue to have forfeiture restrictions apply and some vest. The profits interests are worth 3 (5% of the 60 of appreciation above 60), and so net share settle into 2.5% of the shares (3/120). This exchange of profits interests for distributed shares is not taxable under section 731, and should not give rise to tax either for the vested shares or the unvested shares. A section 83(b) election should be made for shares that remain subject to vesting conditions.[101]

There is considerably less flexibility with options, both with respect to their return profiles (in terms of changing percentages at different thresholds) and, as noted above in the discussion on sections 409A and 457A, amendments to options may create very adverse tax effects on the holders.

Why then would an employer ever use something other than a profits interest, assuming an appropriate partnership was in the structure? One detriment to issuance of a partnership interest (whether capital or profits) is that holders (excluding holders of restricted capital interests that do not make a section 83(b) election) are required to take into account their distributive share of income whether or not any cash is distributed. The holders may find themselves with "phantom income" (income before cash), with the result that they may actually need to go out of pocket to fund a

[101] *See* Rev. Rul. 2007-49, 2007-31 IRB 237.

tax liability. This situation most often arises if the holders are not entitled to cash distributions on non-vested interests, or because the fund is entitled to get back all of its invested capital prior to any returns of profits to employees. As negotiations between the fund and the management play out, it is commonly the case that the management individuals are entitled to receive tax distributions (usually cash equal to the notional tax payable on their allocated income) made in advance of when they would otherwise be entitled to distributions. From the point of view of the fund, this may mean that management is entitled to cash earlier than would be desirable, and earlier than would have been the case had the management held options, RSUs or SARs rather than partnership interests. This may be a material commercial disadvantage in some situations.

Other potential reasons that profits interests might not be preferable include:

(1) There may be a commercial desire not to have service providers participate in distributions unless and until they exercise options;

(2) If an IPO is expected, it may be desirable to have options that can simply roll into options on the incorporated company;

(3) There may be a desire not to issue equity to the individual service providers (to avoid K-1 reporting, to keep an entity treated as a disregarded entity rather than a partnership, for regulatory reasons, to avoid the application of attribution rules that apply to individual partners);

(4) There may be optical benefits to giving options in the sense that they meet employee expectations in a way that profits interests (which can be complicated in their details) do not; or

(5) The fund and/or employees may be worried that section 710 will pass and cause partnership interests to generate ordinary compensation income (like options), as well as be subject to additional adverse rules (loss disallowance, mandatory gain recognition).

IV. OPTIONS – CORPORATE OR PARTNERSHIP ISSUER.

Economics.

- Fixed percentage of the appreciation in the value of the underlying shares (fair market value less exercise price).

- Options may be structured to require certain thresholds (*e.g.*, multiple of money or IRR) through using an accreting strike price (*i.e.*, 100 in year 1, 110 in year 2, 121 in year 3), with the result that the participants participate only after the threshold amount. More often, options may be exercisable only after a performance condition has

been met, in which case the holders participate in dollar one of appreciation, but not until the condition has been met.

- Options may be stock-settled (*i.e.*, the holder pays cash and obtains the underlying stock), net stock settled (*i.e.*, the holder gets the spread value in shares), or cash settled (*i.e.*, the holder gets the spread value in cash), without a tax difference in the treatment of the options.[102] The last is the equivalent of – and may in fact be treated as – an SAR.[103]

- Unlike equity owned outright, options do not share in distributions unless and until exercised. If the portfolio investment is expected to distribute cash regularly this may be a material commercial point.

General Taxation

Under section 83, there is no current tax on the receipt of a compensatory option unless it has a "readily ascertainable" value (which in practice will almost never be the case for a non-publicly traded company). Once exercised or disposed of for property, the holder is taxed on the spread value as ordinary compensation income. No section 83(b) election is available with respect to options so, unlike the taxation of restricted property, this treatment is not elective.

Although it is possible for a partnership to issue options, the tax treatment of such options (in particular, on the partnership) is uncertain. There are proposed regulations under section 721 that cover non-compensatory options but the same principles may not readily apply because in the non-compensatory context the exercise of an option is not the occasion to incur a tax, unlike in a compensatory arrangement. It does seem likely that the principle that the partnership should not be deemed to recognize taxable income from the disposition of an undivided share of its assets would apply, under a circular cash flow sort of analysis. For the same reasons discussed above in respect to the grant of a capital interest, the "value" of the underlying partnership interest to take into account in determining the amount of compensation is uncertain but generally should be the capital account of the underlying interest (at least outside of a publicly traded partnership context).

In many, perhaps most, circumstances it will be preferable to issue a profits interest rather than an option on partnership interests, given the fact that a profits interest may have similar economics (a proportionate share in appreciation) and is much more flexible. There may, however, be reasons for options to be used, as noted above.

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102 The exercise price of an option may be paid through use of currently owned shares without having the shares treated as disposed of in a taxable fashion. *See* Rev. Rul. 80-244, 1980-2 CB 234 (1980) (analyzing the exchange under section 1036); Ltr. Rul. 9629028 (July 29, 1996).

103 Treasury regulation section 1.409A-1(b)(5)(vi)(A) defines an "option" as a right or privilege to purchase stock from a corporation, with the individual under no obligation to purchase.

Section 409A

Options, like other stock rights, allow for deferral of income, and as a result are subject to detailed requirements in order to qualify under section 409A. As noted above in section I, these rules require the following:

The options must be on "service recipient stock." This requires that the stock cannot have a preference on distributions and cannot be limited in its returns (*i.e.*, it must have a substantial participation in the appreciation of the company). If employees work for a particular subsidiary company rather than the issuing company, the issuing company must own at least 50% by vote or value of the subsidiary which is the direct service recipient (or in some cases down to 20%). Any such issuing company also cannot be an "investment company" that owns minority interests in other companies.

Example:

> Parent corporation owns a dozen minority interests in various joint ventures. Parent also owns a management company that has employed management. Although the management company is wholly-owned, the Parent corporation would not qualify as an issuer of options unless the employee provided services directly to Parent.

The options must not be in the money, and not legally entitled to adjustments that could cause the exercise price to decline below the fair market value of the underlying stock at the date of grant. It is possible to re-price options (*i.e.*, to take into account a subsequent decline in the value of the company), but the option holders cannot have the *right* to have their options so adjusted.

Modifications of the options must be carefully monitored, since it may cause the options to be retested (*e.g.*, as to whether the "new" option is in the money). It is possible to modify options to take into account corporate transactions, although there are restrictions.

Section 457A

Section 457A applies to a "plan" of nonqualified deferred compensation, as defined under section 409A. Therefore, so long as an option qualifies under section 409A, there generally will not be a separate issue under section 457A.[104]

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[104] In some odd circumstances an option may be treated as deferred compensation but qualify under section 409A in any event, such as if it must be exercised within two and half months after the end of a taxable year in which it vests. In these circumstances it is possible that section 409A would not apply but that section 457A would (for example because it has a different definition of substantial risk of forfeiture).

V. THIN COMMON STOCK.

A "thin common" arrangement (sometimes referred to as "A/L shares") is a modified version of a simple grant or purchase of restricted stock. Generally the portfolio company has two (or at least two) classes of stock, a preferred class that constitutes a substantial amount of the value and a common class that has a relatively low value at start but has all the upside over the fixed coupon of the preferred. The common shares may be used for compensation, either through grant of the shares (in which case the compensation is measured by the relatively low value of the shares) or through purchase by the employees; in most cases the common shares are subject to a substantial risk of forfeiture such as a buy-back right by the corporation for the lower of cost or value. The intention is to create an instrument that has economics similar to those of an option (low initial "built in" value and sharing of upside), while allowing a section 83(b) election to be made so that any future appreciation may be taxed at capital gains rates, and the common shares may participate in dividends.

Example:

> The fund invests $100 million to acquire the portfolio company, divided into a class of preferred shares with an $80 million preference right and a class of common shares intended to be worth $20 million. The preferred shares bear a fixed coupon at 10%, which is intended to be an arm's length rate so that the preferred shares may be viewed as worth par. Management is granted $1 million of the common shares (or purchases $1 million of the common shares), subject to a buy-back right. Management makes a section 83(b) election, reflecting compensation income of $1 million (or, in the purchase context, $0).
>
> The economics of the common shares are similar to those of a 20% in the money option on 5% of the shares with an accreting exercise price.

Valuation Issue

Probably the main tax issue with the thin common structure is the question of relative value.[105] The common shares in this sort of arrangement are highly

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[105] One ancillary issue is to confirm that the thin common arrangement does not technically fall within the rules for "fast pay" stock. As defined, a "fast pay arrangement" is one in which a corporation has "fast pay" stock outstanding for any portion of the taxable year, and unless "clearly demonstrated otherwise" stock is treated as fast pay stock if it is structured to have a dividend that is reasonably expected to decline, or is issued for an amount that exceeds the amount by which the holder can be compelled to dispose of the stock. *See* Treasury regulation section 1.7701(l)-3(b). Since the preferred stock held by the fund is expected to be redeemed over time, and the redemption generally would be treated as a dividend under section 302(d), there is at least a theoretical possibility that it would be treated as "fast pay" stock. The regulations do have a helpful exclusion, providing that stock is not treated as fast pay stock solely because a redemption payment is treated as a dividend under section 302(d), <u>unless the principal purpose is to achieve the same economic and tax effect as a fast pay arrangement.</u> The question, of course, is what that means and how purpose is to be judged. Since usually the purpose of the arrangement is to provide an effectively leveraged equity investment for

leveraged (both by whatever leverage is at the portfolio company and also economically leveraged by the fixed coupon preferred shares), and therefore have value attributable to above-market returns. While it is possible that a Black-Scholes or similar option-value methodology might be useful in this circumstance, in practice valuation most often seems to be determined by (1) valuing the net equity of the entire company using normal metrics or arm's length transaction values, and then (2) reducing the value by the stated preference of the preferred stock, after using a comparable yield sort of analysis to establish that the coupon on the preferred stock is at an arm's length rate. As with share grants generally, there is no fixed standard for valuation methodology.[106]

If the valuations are wrong and the common shares are worth more than they were estimated to be, then of course the managers would recognize more taxable income. Conversely in such a case the preferred shares would generally be worth less than had been estimated (in effect, issued at a discount), and the fund holding the preferred might be required to include deemed dividends under section 305(c) attributable to preferred stock discount.[107]

Deemed option characterization

As noted above, the economics of a "thin" common share are similar to those of an in-the-money option, albeit one with an accreting exercise price. If for example the preferred shares were worth the entire value of the corporation less some nominal amount, and the common was viewed as having solely nominal value, then the common shares would solely share in upside appreciation like an option. Is there any risk that such common shares might be taxed as if they were options? No section 83(b) election is available for an option and, if the deemed option were "in the money" by *any* amount, it would violate section 409A.

There is no guidance directly on point, of course, and the mere fact that the economics of a common share might in some respects be similar to the economics on an option are not determinative. It is, for example, clearly the case that common shares of distressed or bankrupt companies may have returns consistent with options (*i.e.*, they share only in upside returns and have no interest on a current market value basis), without any serious consideration being given to whether they should be recharacterized as options (for example, for section 382 purposes). That said, it seems difficult to be completely comfortable that a capital structure put in place with the

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management, it should in most cases be possible to be comfortable that a principal purpose is not to achieve the tax and economic effect of a fast pay arrangement. It is very important that this is the case because in addition to a possible recharacterization, a "fast pay arrangement" (or a transaction "substantially similar" to a fast pay arrangement) is a listed transaction under the tax shelter rules and would require disclosure, list maintenance, etc. *See* Notice 2004-67, 2004-2 C.B. 600.

[106] If options are granted on the common shares, the section 409A regulations would require a "reasonable application of a reasonable method" to establish value of the underlying.

[107] To avoid this risk, the preferred stock may be crafted as a participating preferred stock, treated as a common stock for purposes of section 305.

specific intention to have stock with option-like returns works merely because the instruments are called "shares" and not options.[108] The benefit of the arrangement, inherently, is that there is potential value to sharing in the upside that is not captured by a current market valuation, and unlike the distressed corporation case, the arrangement is structured from the beginning precisely to provide option-like returns with an advantaged tax treatment. There is a provision in the section 83 regulations that treats the purchase of property with nonrecourse debt, where there is no personal liability to pay all or a substantial portion of the debt, as being in substance an option.[109] Although that regulation is not directly applicable (since, absent recharacterization as a fast pay arrangement, there is no debt securing the property) it does show that substance over form principles can apply in determining when there is a compensatory option or otherwise has not been a current "transfer" of property for purposes of section 83.[110] In this context the fact that economically the preferred stock serves the same basic leveraging function as the nonrecourse debt is troubling. It therefore seems highly advisable, particularly given the section 409A implications of getting the characterization wrong, not to structure such a transaction too aggressively, and to make sure there is both some substantial amount of equity value (20-30% makes sense) and downside risk on the common shares that is not dwarfed by the value of the upside return.

Commercial inflexibility

Putting aside the above tax issues, which presumably can be managed by not taking too aggressive a position on structuring, why is this sort of arrangement not an effective structure – subject to section 83 and so not treated as deferred compensation, inexpensive to the corporation and fund (in the sense that the value mainly inheres in upside potential), inexpensive to the employee who has to take the value of the shares into income (since the value of the common shares is relatively low), and allowing the employee to obtain capital gains on exit rather than ordinary income like an option?

One answer is that the corporation and fund get no tax deduction attributable to the leveraged appreciation ultimately obtained by the employees. In some circumstances that will be a material trade-off, depending on projections of taxable income for the employing corporation. The main answer is probably just that setting up such an arrangement is a burden (*e.g.*, having valuations done on the relative value of the shares) and, once in place, creates commercial complications for future transactions. Options cannot easily be issued; section 409A does not allow options on preferred shares, and if options are issued solely on the common shares then the

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108 In some ways this is the converse of a penny option, which in form is an option but is treated for tax purposes as a current stock interest.

109 *See* Treasury regulation section 1.83-3(a).

110 *See also* Treasury regulation section 1.83-3(a)(4) (a "transfer" of property may depend on the extent to which the conditions are *similar* to those of an option), -3(a)(6) (no "transfer" may have occurred where the transferee does not incur the risk of a beneficial owner that the value of property at the time of the transfer will decline *substantially*).

determination of fair market value becomes a highly important topic. If additional capital is necessary, does that capital come in as preferred shares (and if so, at what coupon) or as common (and if so, how is dilution determined)? If an extraordinary distribution is made, is that paid solely on the preferred (reducing implicit leverage on the common) or on the common as well? If future grants are made, what value should be ascribed to the common stock and what methodology is to be used to determine it? Once it has been determined to do an IPO or another third party investor is going to make an investment, how is the capital structure of the corporation to be simplified?

VI. LEVERAGED CO-INVESTMENT.

A leveraged co-investment arrangement is another variation on the purchase of restricted stock. In this arrangement the fund may extend a loan to management to enable management to purchase equity in the portfolio company.

Example:

> The fund invests $95 million to acquire the portfolio company, and the fund extends a $5 million loan to management to acquire $5 million of the common shares. The loan pays interest at the AFR (within the bright-line threshold established under section 7872). The loan is, in whole or part, recourse to management. The shares may be subject to a call right, under which they can be purchased for the amount of the outstanding loan.

Assuming the stock appreciates, the return to management is similar to that of an option or the thin common arrangement – the individual pays back the loan and obtains the benefit of upside returns less any interest paid on the debt. Unlike a thin common arrangement, where it is desirable to ensure that the preferred stock carries an arm's length coupon, in a leveraged co-investment arrangement it is possible to rely on the bright-line safe harbors under section 7872. As in the thin common arrangement, the appreciation on the shares is taxed as capital gains, and the corporation receives no tax deduction.

The major economic difference between a leveraged co-investment and the thin-common or an option arrangement is that in a downside scenario, the employee is still obligated to make payments on the recourse portion of the loan. This means the employee is either out of pocket after-tax dollars to repay the principal, or would recognize COD income or compensation income on any forgiveness of the debt (not offset by the capital loss on the shares). From the employee's point of view the downside risk related to the requirement to pay back the debt is often a concern, particularly because if the stock has lost value then their other compensation is likely to lag (also, the warm feeling of receiving compensation turns cold very quickly when there is a tax bill and the form of the compensation is relief from debt incurred in making a losing investment). Using nonrecourse debt, however, creates tax risk, because under the section 83 regulations the acquisition of property with nonrecourse debt may be recharacterized as an option unless the employee is liable to pay a

substantial portion of the debt. (And, if the recharacterized option were in the money, then section 409A would apply). There is no guidance on what a "substantial portion" of the debt may be for this purpose; a conservative but reasonable amount would be 50%.

A greater impediment to this sort of structure may be that under Sarbanes-Oxley, a registered issuer may not make or arrange a loan to directors and executive officers. "Registered" for this purpose includes a class of securities registered under section 12 of the `34 Act or an issuer that is required to file section 15(d) reports, so even registered debt would cause the issuer to be registered for these purposes. Although the fund would be lending, rather than the issuer itself, it would be difficult to argue in any case where issuer employees were a majority of the participants and the purpose is to serve as a compensation arrangement that the issuer did not "arrange" for the loan.

VII. COMPENSATION PAYMENTS – RSUs, SARs AND BONUS PAYMENTS.

Rather than granting actual stock (restricted or not), or options, it is also possible to make compensatory payments to employees measured by the value of stock (RSUs), or appreciation in the value of stock (SARs), or based on some other formula return (*e.g.*, bonus payments tied to profits or revenues or otherwise). RSUs and SARs may be stock-settled (which is to say, paid in stock with a value equal to the required pay-out) or cash-settled (obviously, paid in cash).

Although the economics of RSUs are comparable to those of issuances of restricted stock, they are subject to differing tax treatment. Restricted stock is treated as delivered on the date of grant and a section 83(b) election can be made to take income into account as of grant, or compensation is deferred until there is no longer a substantial risk of forfeiture. RSUs, by contrast, are treated as paid when actually paid (in stock or cash) and at that point the value is taken into income as ordinary compensation; no section 83(b) election is available. To the extent RSUs constitute deferred compensation (payable more than two and a half months after the year in which there is no longer a substantial risk of forfeiture), they are subject to section 409A (requiring payment on a fixed date or on a permitted payment date) and, if the service recipient is a nonqualified entity, subject to section 457A.

The economics of SARs are comparable to those of options and are generally taxed on a comparable basis. SARs are taxed when paid out, in the same way that options are taxed upon exercise (when, effectively, they are exchanged for stock or cash). To the extent subject to deferral, SARs are exempt under section 409A under the same rules as apply to options. To the extent SARs are issued with respect to a service recipient that is a nonqualified entity they are potentially subject to section 457A; the main applicable exceptions would be if the nonqualified entity is a corporation and the SAR must in all events be stock-settled, or if the SAR is paid within the short term deferral period applicable under section 457A.

Cash compensatory payments are, simply, compensation payments measured under a formula amount and, as such, are taxed upon receipt as ordinary compensation income. As with RSUs, deferred cash compensation payments may be subject to section 409A and/or section 457A.

RSUs and SARs are most likely to be used, commercially, in a situation in which an actual grant of equity or options is inadvisable, for example because of foreign law implications or regulatory considerations. (There are also accounting differences, which may cut against cash-settled compensatory instruments.) A compensatory bonus payment obviously provides the benefit of extreme flexibility in its formula return; for example, it allows notional reinvestment of amounts over time.

VIII. COMPENSATION ARRANGEMENTS AMONG AFFILIATED ENTITIES.

It is not uncommon for equity compensation, or other forms of compensation, to be issued by one entity, while another affiliated entity is the actual service recipient. Although there are many different factual scenarios, the paradigm examples are a parent corporation with a subsidiary service recipient or a parent partnership with a subsidiary service recipient. It is also common to have one entity be a direct service recipient and have it perform services for an affiliate, with back-to-back compensation arrangements between the affiliates and the individual ultimately performing services (*e.g.*, a management company arrangement, a payroll company, or a secondment arrangement).

As a general principle, the entity that is the service recipient is the one entitled to the deduction (and is treated as paying the compensation to the service provider), and the issuing entity (the one actually issuing the equity or otherwise making the payment) is deemed to have engaged in a transaction with the entity that is actually the service recipient.[111] One potential issue, however, is how to identify which entity or entities is the service recipient. This matters most particularly in determining the tax consequences of a deferred compensation arrangement although may be of relevance for other purposes as well.

Although there is some guidance on determining the identity of a service recipient, it is most often applied in distinguishing between a payroll company and a "true" employer, and there is surprisingly little discussion of how to determine the identity of a service recipient among related entities. The IRS established a twenty-factor test to be used in determining whether sufficient control is present to establish an employer-employee relationship between a provider of services and the respective recipient of such services.[112] While this test is often used to distinguish between

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[111] *See Interstate T. Lines* v. *Comm'r*, 319 U.S. 590 (1943) (allocation of deductions as between parent and subsidiary); Treasury regulation 1.1032-3 generally covers the treatment of a parent corporation issuing equity (restricted or unrestricted) or options to a person providing services to a corporate or partnership subsidiary.

[112] *See* Rev. Rul. 87-41, 1987-1 C.B. 296. The Tax Court considers similar factors, including the degree of control exercised by the employer; which party invests in the work facilities used by

employees and independent contractors, it is said to be also helpful in identifying which entity should be considered the common law employer of a particular service provider.[113] Unfortunately, since the factors are not really designed to differentiate which among a group of affiliates is receiving services, they may leave an advisor with a distinct lack of certainty.

As is often the case with twenty-factor tests, "[t]he degree of importance of each factor varies depending on the…factual context in which the services are performed,"[114] and in the context of determining which entity among affiliates is truly the service recipient a number of the factors will, as a practical matter, be useless. The twenty factors are: (1) whether the worker is required to follow the employer's instructions as to when, where and how to work; (2) whether the employer provides training (which indicates standards for how services are to be performed); (3) integration of the worker into the employer's operations; (4) whether the services must be rendered personally; (5) whether the employer hires, supervises and pays the worker's assistants; (6) the existence of a continuing relationship between the worker and the employer; (7) whether the employer sets the hours of work; (8) whether the worker must work full time (and therefore cannot work for another person); (9) whether the work must be performed on the employer's premises; (10) whether the order of tasks is set by the employer; (11) whether the worker must file oral or written reports; (12) whether the worker is paid by hour, week or month; (13) whether business and/or traveling expenses are paid by the employer; (14) whether the employer furnishes tools and materials; (15) whether the worker makes a significant investment; (16) whether the worker stands to realize any profit or loss apart from that as an employee; (17) whether the worker may work for more than one firm at a time; (18) whether the worker makes his or her services available to the general public; (19) whether the employer has the right to discharge; (20) whether the worker has the right to terminate without penalty. The IRS later also summarized and re-grouped this analysis into three buckets, which may be more useful although they are still vague and still not well-directed towards

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the worker; the worker's opportunity for profit or loss; whether the employer can discharge the worker; whether the work is part of the employer's regular business; and the permanency of the relationship. The Tax Court views the degree of control exercised by the person for whom the work is performed over the individual who renders the services as the fundamental factor in these determinations. *See*, *e.g.*, *Levine* v. *Comm'r*, TC Memo 2005-86 (Apr. 14, 2005); *Keating* v. *Comm'r*, TC Memo 1995-101 (Mar. 13, 1995). *See also Professional & Executive Leasing Inc.* v. *Comm'r*, 63 AFTR 2d 89-427, *aff'd*, 862 F.2d 751 (9th Cir. 1988) (employee leasing company not considered employer, where it merely performed a bookkeeping and payroll service function and did not have a real right to control the employees).

113 *See*, *e.g.*, *U.S.* v. *Garami*, 76 AFTR 2d 95-5691, 95-5694 (June 28, 1995) (citing Rev. Rul. 87-41 and providing that "[T]hese criteria are ordinarily used to distinguish between an employee and an independent contractor but are equally applicable to determine by whom an individual is employed."); IRS Field Service Advice 199917010 (Apr. 30, 1999) ("The determination of the identity of an employer is based on an application of the common law rules that are also used to determine whether an employer-employee relationship exists."). *See also Bartels* v. *Birmingham*, 332 U.S. 126 (1947).

114 Rev. Rul. 87-41, 1987-1 C.B. 296.

allocating services among related entities: (1) behavioral control, or the right to direct and control how the work is performed; (2) financial control, or whether the worker has a significant investment or significant expenses; and (3) the relationship of the parties, including the intent of the parties in forming the relationship and their respective abilities to terminate the relationship at will.[115]

Section 83 payments (stock or options)

For payments of compensation that fall within the scope of section 83, it is generally not a material concern as to whether a parent entity or a subsidiary technically is the service recipient.

Parent corporation

If the parent is the service recipient then the normal rules under section 83, described above, apply. If the subsidiary is the service recipient, then it is treated as paying over the equity compensation, but in general there should be no adverse tax effects from this. Treasury regulation section 1.1032-3 describe the treatment of the deemed transactions that occur between the parent corporation and a subsidiary corporation or partnership.[116] Under these regulations, assuming the requirements are met, the parent corporation is treated as contributing cash to the subsidiary in an amount sufficient (after taking into account actual payments by the subsidiary or amounts provided by reason of an option exercise, discount purchase etc.) to allow the subsidiary to acquire the shares for fair market value at the time of the compensatory event.[117] The identity of the direct service recipient is relevant only in a few isolated circumstances.

Example 1: Parent issues stock worth $100 to employee of Subsidiary. Parent is treated as contributing $100 cash to Subsidiary, which purchases the stock for $100 immediately prior to delivery. If Subsidiary in reality paid Parent $40 of cash, then Parent would be deemed to have contributed only $60.

Example 2: Parent issues restricted stock worth $100 to employee of Subsidiary. No section 83(b) election is made. In year 3 when the stock vests it

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115 *See* Chief Counsel Advice 200029030 (July 21, 2000); Chief Counsel Advice 199948001(Dec. 3, 1999).

116 *See* Treasury regulation 1.1032-3.

117 One requirement is that the subsidiary would have received the stock with a basis determined, in whole or in part, by the basis in the hands of the contributing corporation. Since a (parent) corporation would not have a basis in its own stock, this might (in the absence of other rules) have given rise to a "zero basis" problem for the subsidiary disposing of the stock. In order to have a carry-over basis in this way, the regulations effectively assume that the parent contribution to a corporate subsidiary would qualify under section 351 (which in most cases means that the parent would need 80% ownership of the subsidiary, unless other transactions were occurring at the same time). It also would apply if a corporate parent corporation contributes stock to a partnership subsidiary under section 721.

is worth $300. Parent is treated as contributing $300 cash to Subsidiary in year 3, which purchases the stock for $300 immediately prior to delivery.

Recall that if the stock is restricted and dividends are paid on the stock, the dividends are treated as compensation payments. Depending on the terms of the substantial risk of forfeiture and the treatment of earnings amounts under section 457A, these dividends might be treated as deferred compensation for purposes of section 457A. The determination of whether section 457A applies will depend on whether the Subsidiary (and not the Parent actually making the payment) is a nonqualified entity.

Example 3: Parent issues to employee of Subsidiary an option to acquire Parent stock for $100 at a time when the stock is worth $100. In year 3, when the option is exercised, the stock is worth $300. Parent is treated as receiving from Subsidiary $100 (which Subsidiary is treated as having received from the employee), and as contributing $200 to the capital of Subsidiary. Subsidiary is then treated as acquiring the shares for $300 and immediately delivering them to the employee.

Recall that for section 409A purposes, an option must be on good "service recipient stock." Assuming employee provides services directly for Subsidiary, this requires that the Parent must own at least 50% (or in certain circumstances 20%) of Subsidiary. In addition, in the event that Parent is an "investment company" that primarily owns minority interests in entities other than the service recipient subsidiary, the option will not be treated as being issued with respect to service recipient stock.

Parent partnership

A structure in which a holding partnership owns an operating subsidiary corporation (*i.e.*, the portfolio company) is very common in the private equity field. Such partnerships are often used to aggregate investments by multiple funds, which may be controlled by the same fund sponsor or sometimes multiple fund sponsors. It is also common to have such partnerships issue or sell equity to management of the portfolio company, and/or to employees of the fund management company or independent contractors who work for a time for the company (operations personnel).

The fact that the service recipient is the corporation should not lead to adverse tax effects (or no more adverse than those noted above in the corporate context). Although Treasury regulations section 1.1032-3 does not technically apply to a partnership issuing equity for the benefit of its subsidiary, the same analysis can apply by analogy. It may be advisable to exercise self-help and document the compensation arrangement as a contribution of cash to the corporation and a purchase of partnership equity for cash. Although the IRS could try to disregard the arrangement as a circular flow of cash, there seems to be no policy reason to think that a parent partnership ought to be treated differently than a parent corporation in this respect.

Deferred compensation payments (RSUs, cash settled SARs, bonuses)

Once outside of the context of a section 83 transfer and in the scope of a deferred compensation arrangement, the identity of the service recipient becomes important in determining whether section 457A might apply. Notice 2009-8 actually uses the term "plan sponsor" which it defines as the entity that "if the entity paid the amount deferred in cash to the service provider in the relevant taxable year, would be entitled to a compensation deduction under U.S. federal income tax principles." Although not explicitly stated in the Notice, the relevant test likely looks to the facts and circumstances illustrated by the twenty-factor (three group) test of relevant facts described above. Since the Notice uses a counter-factual pro forma analysis (looking to the entity which would be entitled to the deduction if cash *were* paid, even though by definition nothing is paid since the compensation is deferred), the determination will need to be made independently of actual tax filing positions relating to deductions.

Unfortunately there may, in certain cases, be considerable uncertainty. In those cases self-help in establishing the terms of employment, or structural solutions, may help to mitigate risk.

Example 1:

U.S. parent corporation holds its foreign subsidiaries through a Dutch BV treated as a corporation. A U.S. citizen is employed as an expat by the BV. The BV pays his salary, rents the office space, hires his secretary, and sets the standards for his work. The BV has granted the employee cash-settled SARs on the parent corporation.

- The BV is the plan sponsor, and is the entity that should be tested for nonqualified entity status.

Same facts, but the BV is treated as a disregarded entity.

- The U.S. parent is the plan sponsor (since under U.S. principles it is entitled to the deduction) and will not be a nonqualified entity.

- If the BV is later "incorporated" through a check the box election then it would become the relevant entity to be tested.

Same facts, but the BV is treated as a partnership owned 99% by the U.S. parent and 1% by a U.K. subsidiary of parent.

- The BV is the plan sponsor (since it is a foreign partnership). It likely would not be a nonqualified entity (since 99% of tax items generally would be allocated to the U.S.), but this may depend on the facts (whether section 704(c) is relevant), etc.

Example 2:

U.S. parent corporation holds its foreign subsidiaries through a Dutch BV treated as a corporation. A U.S. citizen is employed by the U.S. parent. He is seconded to the BV for no more than six months. While in Amsterdam he uses the office of the BV and a temporary secretary. While in Amsterdam he is entitled to statutory holidays under Dutch law and under the general standards of the office. As a high-level employee he establishes his day to day work mostly by himself, and reports both to the president of the BV and his superior in the U.S. The BV reimburses the U.S. parent the base salary of the employee but does not make a payment related to the SARs.

- This situation is less clear. The BV is picking up some of the employee's expenses, has some control in terms of general standards and some reporting oversight. The sixth month period is fixed, however, and the fact that the BV is not reimbursing for the expense of the SARs is indicative in establishing the primary ties to the U.S. On balance the U.S. parent is likely the service recipient.

Same facts but the service period is two years.

- The situation is still unclear, but given a two-year period of service it is much harder to justify treating the U.S. corporation as the service recipient.

Same facts but the service period is undefined.

- The situation is even more unclear, and the result may change over time as the service period continues. It might be desirable to set a fixed period.

Example 3.

U.S. corporation owns its foreign operations through a Dutch BV, as in the examples above. The employee is legally employed by a Caymans company in order to avoid Dutch social charges. The Caymans company has a significant number of employees (all the expatriates), but no actual operations or personnel that can provide oversight. (This example is solely to illustrate the tax point; it may or may not be a workable arrangement in reality). As in example 1, the control over the employee is practically under the control of the Dutch BV, although the Caymans company legally is stated to have control over the employee.

- The legal employment relationship with the Caymans company is relevant, but should not outweigh all the other

factors suggesting that the employee is providing services to the Dutch BV.

Same facts but the Dutch BV is a nonqualified entity and the U.S. corporation arranges to utilize a U.S. payroll company (third party, or a subsidiary) to technically employee the employee and pay compensation.

- The fact that the employee is technically employed by a U.S. entity does not change the substantive result that the service recipient is the Dutch BV.

Example 4:

U.S. parent partnership owns a U.S. corporation. Management of the corporation is entitled to receive cash-settled capital interests in the partnership after they have successfully achieved a milestone related to the business of the corporation (the partnership equivalent of a cash-settled RSU), and the RSU is subject to being forfeited if the company does not undertake a qualified IPO at a certain market valuation or other exit event within seven years. Once the RSU is granted there is no time vesting requirement.

- In most circumstances the relevant service recipient would appear to be the corporation and, as a result, there would be no nonqualified entity. When payment is made, the partnership would be deemed to contribute cash to the corporation and the corporation would take a deductible expense.

Same facts, but partnership owns only 25% of the corporation (the other 75% is owned by a consortium of private equity funds), and the forfeiture condition on the RSUs includes as well an IRR condition relevant to the particular fund making the investment.

- These facts have some elements suggesting that perhaps the service recipient is the partnership since the forfeiture condition relates to the fund itself and not the corporation, and the economic burden of the payment is borne solely by the fund and not by the other owners of the corporation. Notwithstanding this, control over management is legally held by, and practically conducted by, the corporation, management obtains other compensation from the corporation, and the fund is able to benefit indirectly from services provided to the corporation. On balance the U.S. corporation is likely the service recipient and the expense by the partnership likely should be treated as a capital expenditure with respect to its stock investment. A different answer might apply to the

operations personnel with a long-term relationship with the fund and under the fund's general control.

Example 5:

U.S. (or foreign) parent partnership owns a management company formed as a U.S. corporation. The management company has a management contract with a Caymans corporation, which provides for deferred compensation related to appreciation in a pool of investment assets.[118] This compensation is paid on a back-to-back basis to individual employees of the management company, less a spread to cover overhead costs and a small profit.

- This appears to be a back-to-back arrangement with the individuals providing services to the U.S. management company and the U.S. management company performing services for the Caymans corporation. Payments by the management company to the managers are not covered by section 457A (since it is a U.S. corporation), but payments by the Caymans corporation to the U.S. management company appear to be subject to section 457A. (Unlike section 409A, the fact that management company is on an accrual method of accounting does not prevent section 457A from applying.) The additional 20% tax applies to gross income and without regard for the fact that the management company obtains only a small amount of net income from the arrangement.

Same facts, but instead of a management contract between the Caymans corporation and the U.S. management company, the Caymans corporation pays dividends to the U.S. partnership, and the U.S. partnership funds the U.S. management company from time to time with capital contributions sufficient to cover its expenses.

- This is not in form a back to back service relationship, and so its appears not to be subject to section 457A. The U.S. partnership obviously would not receive a (current) deduction for the capital contribution although it would obtain basis in the stock of the management company, and the management company would generate a net operating loss when it made its compensatory payments to its employees.

- The situation is not free from risk. If, for example, the U.S. management company had little substance then it would be

[118] Another structuring alternative would be to ensure that the payments under the management contract are not treated as "deferred compensation" because they are subject to an effective service-related substantial risk of forfeiture. This may or may not be practicable.

similar, substantively, to the payroll company in example 3. It is possible that the IRS could treat the capital contributions as, in substance, compensation payments from the partnership to the U.S. management company,[119] or possibly as compensation payments from the Caymans corporation. In that event, the status of the partnership (or Caymans corporation) as a nonqualified entity would be relevant. A set of facts under which the management company does not simply run flat or at a small spread, has significant assets, and is factually a stand-alone business that may generate profits and establish goodwill, would be helpful in establishing a business purpose for the partnership to make capital contributions for the benefit of the management company.[120]

Example 6:

U.S. (or foreign) partnership is or may be a nonqualified entity because more than 20% of its partners are tax-exempt or foreign. It is desirable for it to enter into an arrangement to pay deferred compensation to its management team, and for one reason or another individuals cannot hold profits interests in the partnership that would permit them to receive equivalent amounts in an acceptable form. Partnership sets up a U.S. corporation as a management company to make the payment. Partnership also sets up a subsidiary partnership owned by itself and the management company which holds substantially all of the assets. Management company holds an interest in the subsidiary partnership that allocates it profits (net profits or gross profits) in an amount sufficient to make the compensatory payment to management plus a small spread.

- In form, there is no nonqualified entity making a payment of deferred compensation, so this would appear to prevent section 457A from being applicable. Note that if the payments from subsidiary partnership to management company were

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119 There is considerable case law and other guidance recharacterizing a "dividend" by a subsidiary to a shareholder to be in substance payment of compensation expense. This would be a converse case in which a capital contribution is treated as compensation to a subsidiary. There does not appear to be any precedent for this sort of recharacterization.

It is also possible that section 269 could apply to disregard the existence of the U.S. management corporation, if a principal purpose for its incorporation is to avoid the application of section 457A. Section 269 would not obviously apply in this situation, however, since the existence of the corporation serves to protect the employees from the application of section 457A, which would increase their tax burden but would not adversely affect the payors of the compensation.

120 *See Interstate T. Lines*, supra note 111 (respecting the existence of a subsidiary corporation and not allocating its expenses to the parent).

guaranteed payments rather than a distributive share of income, then management company would likely be treated as receiving deferred compensation from subsidiary partnership, and would be subject to section 457A on receipt of those payments. As a result, in substance this only allows an intermediate company to stand in the role of receiving a distributive share of income (not deferred compensation subject to section 457A), if for other reasons it is not desirable to have individual managers receive compensatory partnership interests.

- It will be necessary to establish employment terms so that the management company may be seen as the service recipient.

Same facts, but management company is a U.S. partnership (held 99% by partnership and 1% by another person). Partnership specially allocates to its U.S. taxable partners all items of income and deduction attributable to the management company (effectively a distributive share of gross income from the subsidiary partnership, less compensation expense on payments to management). So long as the management company is the service recipient, section 457A looks to the allocation of *its* gross income and not the gross income of the U.S. partnership. Because all tax items from management company are allocated to U.S. taxable partners, the management company does not appear to be a nonqualified entity.

- This is structural self-help to solve for the problem that the section 457A nonqualified entity test for partnerships looks to the tax status of partners to which it allocates its gross income, rather than the tax status of partners to whom it allocates its gross compensation expense (which makes considerably more sense from a policy perspective). This structure isolates the gross compensation expense and matches it with partnership income plus a spread.

- The special allocation of partnership items from the management company needs to meet the test for substantial economic effect. So long as the management company partnership is respected as an entity, could generate goodwill value, etc. it would appear to do so. If it were disregarded (*e.g.*, under abuse of entity principles) then the special allocation of gross income matched with gross expense might not be treated as having economic effect.[121] The activity

[121] Treasury regulation section 1.704-1(b)(2)(ii)(b) provides that if there are "shifting" allocations that cause the net increases and decreases in capital accounts to not differ substantially from what they would have been had the allocations not been in the agreement, the allocations might not be viewed as having "substantial" economic effect. However, the second prong of the regulation requires that the total tax liability of the partners is reduced as a result. In this case

necessary to have the management company treated as a service recipient would presumably go some way to avoid having the entity disregarded.

IX. CONCLUSION.

The answer back to the private equity fund client may well be filled with uncertainty and caveated with assumptions, particularly if services are, or may be, performed for a foreign corporation or partnership. The arrangements may have similar economic returns to the managers, although that may depend on the likely exits, dividend projections and the like. There may be trade-offs between capital gains to management and deductions to the corporation, but those can be compromised in negotiating the size and terms of the equity pool. There may be commercial impediments to one structure or another; options and SARs are hedged in with detailed requirements to avoid section 409A, and co-investment or thin common arrangements may be unavailable or commercially unworkable. The potential passage of section 710 is a wild card.

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the special allocations would potentially benefit employees (by making them not subject to section 457A) and would not necessarily affect the tax liability of the partners at all. It is therefore arguable, although in a highly technical manner, that this sort of special allocation might be acceptable generally as a solution.

SUMMARY OF TAX AND COMMERICIAL CONSIDERATIONS

	Restricted stock	**RSU**	**Partnership Capital Interest**
Economics	Value of full share Thin common shares may have low built-in value Shares in dividends Corporate deduction at time of income	Value of full share Does not share in dividends Corporate deduction at time of income	Value of full interest (measured by capital account) Shares in dividends. Distributive share may be phantom income; possible tax distributions required
Commercial flexibility	Simple Thin common or leveraged co-investments create complications	Simple	Simple Requires appropriate partnership in structure
Section 83(b) available?	Yes If elected, tax up front, possibly with no liquidity (and notwithstanding potential forfeiture)	No. Income always ordinary at time of pay-out	Yes Treatment of forfeiture uncertain
Section 409A applicable?	No (generally not even for dividends)	Yes	No (generally not even for guaranteed payments)
Section 457A applicable?	No (possibly excluding dividends on unvested stock with no section 83(b) election)	Yes	No (possibly excluding distributions on unvested stock with no section 83(b) election)
Section 710 applicable?	No, unless disqualified interest in which case, potentially yes	Ordinary income in any event.	Potentially yes
Other Considerations	Managers treated as owning equity (assuming 83(b) election). Relevant for attribution, entity status, regulatory, etc.	Managers do not own equity. Tax clearly delayed until liquidity	Managers treated as owning equity (assuming 83(b) election). Relevant for attribution, entity status, regulatory, etc.

	Partnership Profits Interest	**Option**	**SAR (cash settled)**	**Bonus**
Economics	Upside only No deduction. Allocations of profits may act effectively as a deduction	Upside only Deduction at time of income	Upside only Deduction at time of income	Depends on terms Deduction at time of income
Commercial flexibility	Simple Shares in dividends. Distributive share may be phantom income; possible tax distributions required	No, section 409A establishes substantial limitations on terms, modifications No sharing in dividends. (Modifications possible on extraordinary dividends)	No, section 409A establishes substantial limitations on terms, modifications No sharing in dividends. (Modifications possible on extraordinary dividends)	If deferred, subject to section 409A; substantial limitations on changes
Section 83(b) election available?	Effectively applies by default	No	No	No
Section 409A applicable?	No, except for guaranteed payments (and short term deferral exception may apply)	No, assuming restrictions complied with	No, assuming restrictions complied with	Yes
Section 457A applicable?	No, except for guaranteed payments	No, assuming restrictions complied with	Yes	Yes
Section 710 applicable?	Potentially yes	Ordinary income in any event	Ordinary income in any event	Ordinary income in any event
Other considerations	Requires partnership in structure	Understood by management, others	Variable accounting	Depends on terms