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SESSION 3: Equity-Based Compensation for Partnerships and LLCs - EXAMPLES AND ILLUSTRATIONS

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EXAMPLE #1
STOCK AWARD (NO VESTING REQUIREMENT)

FACTS: ABC Company gives David, a key employee, 100 shares of stock worth $5,000 as compensation for services. David's rights in the stock are not subject to a substantial risk of forfeiture (i.e., the stock is fully vested on the date of the stock award).

TAX TREATMENT: David is required to report $5,000 as taxable income in the year he receives the stock. Under IRC §83(a), stock received as compensation for services is includible in gross income in the first tax year in which the property is no longer subject to a "substantial risk of forfeiture." The tax treatment would be the same even if the stock were subject to a requirement that it not be transferable for a period of three years. ABC will take a compensation deduction in the amount of $5,000 in the taxable year in which or with which ends the taxable year of the employee in which the income is included.

NOTE: The deferred compensation rules under IRC 409A do not apply to transfers of restricted stock subject to IRC §83.

EXAMPLE #2
STOCK AWARD (WITH VESTING REQUIREMENT)

FACTS: ABC Company gives David, a key employee, 100 shares of stock worth $5,000 as compensation for services. David's rights in the stock are subject to a substantial risk of forfeiture -- he is required to give the stock back to ABC if his employment terminates during the two-year period following the transfer (other than through death or disability). The stock is worth $5,000 when he receives it. David continues working for ABC for two more years, and at the end of those two years the stock is then worth $15,000.

TAX TREATMENT: David will defer reporting compensation income upon receipt of the shares until the end of year two because prior to that time the shares are subject to forfeiture. At the end of year two, David is required to report $15,000 as compensation income.

NOTE: David could have made an 83(b) election and reported the $5,000 as compensation income in the year of receipt (even if he would be required to forfeit the shares if he did not subsequently satisfy the two-year vesting requirement). If David had made an 83(b) election, he would not recognize additional compensation at the end of year two when the risk of forfeiture lapses.

NOTE: A 83(b) election must be made within 30 days of the transfer of the property.

EXAMPLE #3

STOCK AWARD (WITH VESTING REQUIREMENT) - §83(B) ELECTION MADE AND STOCK SUBSEQUENTLY FORFEITED

FACTS: ABC Company gives David, a key employee, 100 shares of stock worth $5,000 as compensation for services. David's rights in the stock are subject to a substantial risk of forfeiture -- he is required to give the stock back to ABC if his employment terminates during the two-year period following the transfer (other than through death or disability). David makes an §83(b) election and takes $5,000 into income in the year of receipt. David subsequently leaves ABC after one year and is required to forfeit his shares of stock back to ABC.

TAX TREATMENT: If a taxpayer forfeits property after taking the property into income pursuant to section 83(b), the results are harsh. Section 83(b)(1) provides that the taxpayer gets <u>no deduction</u> as a result of the forfeiture even though the taxpayer previously took the fair market value of the property into income.

ILLUSTRATION #1

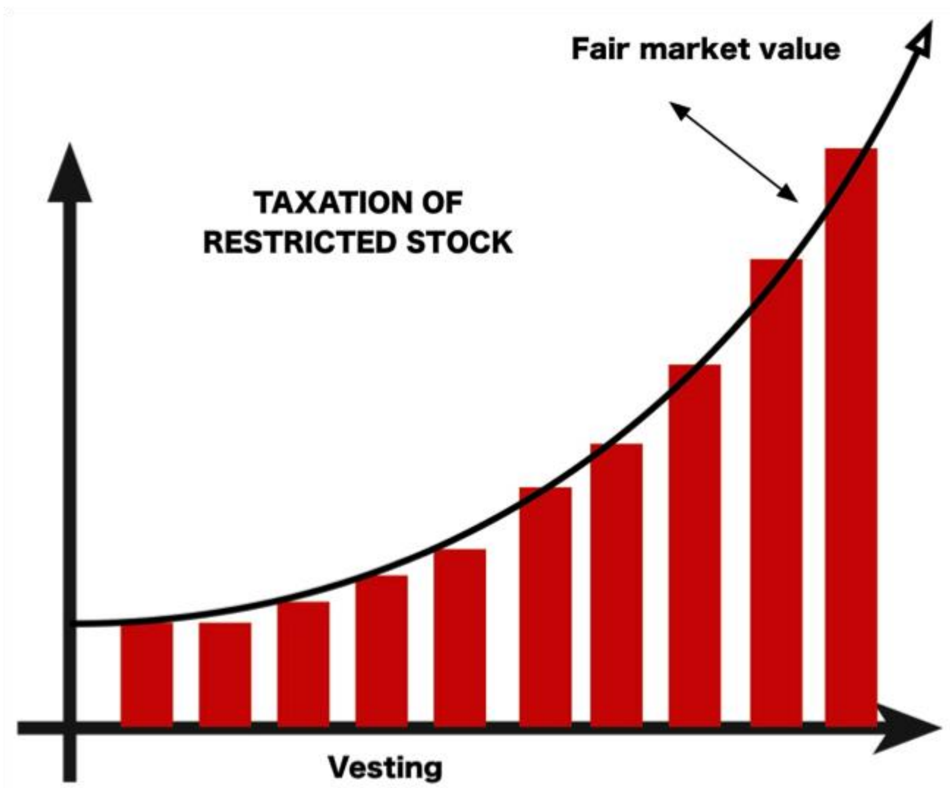
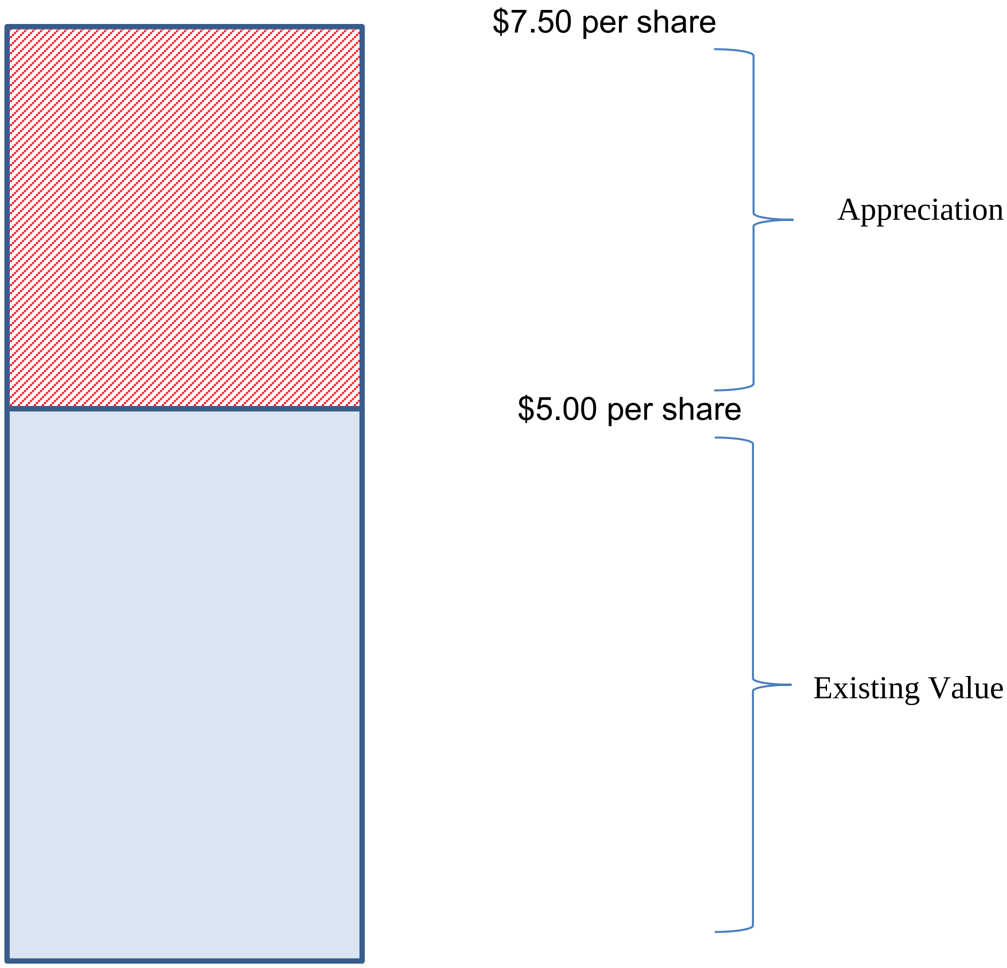


ILLUSTRATION #2
THE UPSIDE OF A STOCK OPTION



<u>NOTE!</u> Stock option exercise price of $5.00 per share must be not less than the fair market value of underlying stock at the time of grant in order to avoid application of IRC 409A.

EXAMPLE #4
STATUS AS PARTNER WHEN NONVESTED PARTNERSHIP INTEREST IS RECEIVED - NO §83(B) ELECTION

Year 1 Formation. Arnie and Jack formed a 50/50 partnership, Eagle Co., by each contributing $200,000. Eagle Co. then purchased a building. On January 1, Year 1, in exchange for an agreement to manage the building, Gary was admitted to the partnership with a 10% interest in partnership capital, profits, and losses. Arnie's and Jack's capital accounts were each reduced to$180,000. Gary was credited with a $40,000 capital account and was entitled to share in income, losses, and current distributions based on his 10% interest. Under the agreement, however, Gary would forfeit the entire 10% partnership capital interest if he ceased performing building management services prior to July 1, Year 2. Gary did not make the Section 83(b) election for this transfer.

Year 1 Activity. For the partnership year ending December 31, Year 1, Gary was allocated $10,000 as his distributive share of the partnership's income (for book purposes only).

Eagle Co. is treated as the owner of Gary's interest before July 1, Year 2. Therefore, Gary apparently has no distributive share of Eagle Co.'s income before that date. The amount that otherwise would have been allocated to Gary is instead allocated between Arnie and Jack.

Year 2 Activity. On January 15, Year 2, Gary received a $6,000 cash distribution from the partnership. Again, since Eagle Co. is treated as the owner of Gary's interest until it is vested, the $6,000 January Year 2 distribution is not treated as a distribution to a partner. Instead, it is taxable as compensation paid to Gary. The partnership is entitled to deduct or capitalize the amount of the payment.

Year 2 Vesting. On July 1, Year 2, Gary's partnership interest became fully vested (no longer subject to substantial risk of forfeiture) when Eagle Co.'s net worth was $500,000. On that date Gary recognizes compensation equal to the FMV of the partnership interest. Assuming the FMV of the interest is measured by its share of Eagle Co.'s capital ($500,000), Gary will recognize $50,000 of income with respect to the receipt of the partnership interest. (If the interest had fully vested on January 1, Year 1, he would have recognized only $40,000 on that date.)

EXAMPLE #5
PARTNERSHIP INTEREST RECEIVED -NO §83(B) ELECTION

Year 1 Formation. On May 1, Year 1, Joe, Dave, and Anne formed Tower Partnership to construct and operate an office building. Joe and Dave each contributed land with a total value of $600,000 for their one-third partnership interests. Anne agreed to contribute services in supervising the construction of the building for the remaining one-third capital interest. Anne will forfeit her partnership interest if she fails to perform the agreed-upon services through the completion of construction.

Year 2 Vesting. The building is completed on April 15, Year 2, at which time Anne's interest vests. At that time, the FMV of the land, building, and related property is $8 million and the property is subject to a $6.5 million mortgage.

Without a Section 83(b) election, Anne is taxed on the partnership interest when construction of the building is completed (the risk of forfeiture lapses). At that time, Anne recognizes compensation income of $500,000-one-third of the $1.5 million equity of the partnership. Income, loss, and distributions during the interim are taxed as if Anne is not a partner. Moreover, because Tower Partnership's compensation expense relates to the construction of the building, it must be capitalized.

Making a Section 83(b) election. Assuming the same facts as in example above, if Anne makes a Section 83(b) election, she recognizes $200,000 (1 /3 of $600,000) of compensation income on May 1, Year 1, and is treated thereafter as a partner for tax purposes. Anne defers recognizing income from the $300,000 increase in the value of her share of the partnership's property until she transfers her partnership interest or the partnership transfers its assets. If the value were to decline after the vesting date, some of the value at the time of vesting might never be taxed. By making the election, however, Anne recognizes $200,000 of income on which she pays tax. She also assumes the risk of having neither the property nor a tax loss if she subsequently forfeits the interest.

EXAMPLE #6

COMPARING TAX CONSEQUENCES OF NOT MAKING SECTION 83(B) ELECTION UPON RECEIPT OF A NONVESTED PARTNERSHIP INTEREST FOR SERVICES AND PAYMENT OF CONSIDERATION

Assume instead that (a) Joe and Dave each contributed $400,000 (instead of $300,000) and agreed to guarantee any loans required by Tower Partnership, and (b) Anne, instead of receiving her one-third interest for services only, also contributed $400,000 but is obligated to sell her interest at her cost to the partnership or to Joe and Dave if she fails to perform the agreed-upon services through the completion of construction. Under these circumstances, if Anne does not make a Section 83(b) election and performs services through the completion of construction, the restriction lapses and Anne becomes the owner of the interest for tax purposes. At that time, the value of her interest in the partnership is $500,000. As a result, Anne recognizes compensation income of $100,000, the difference between the FMV of the interest at the time the condition lapses and the $400,000 she paid for the interest. Anne is required to recognize this income even though she paid full FMV for the partnership interest at the time the partnership was formed.

In a situation such as this, the practitioner should recommend that the taxpayer make a Section 83(b) election, because making the election involves no tax cost or risk and could provide a potentially significant tax benefit (tax deferral on the appreciation of the partnership interest). As the amount paid for the property and its FMV at the time of receipt were identical, the taxpayer recognizes no compensation income when she makes the election. However, by making the election, the taxpayer defers recognizing income from appreciation occurring prior to the vesting date until either she transfers her partnership interest or the partnership sells the building.

EXAMPLE #7

PROFITS INTEREST GRANTED IN COMPLIANCE WITH REV. PROC. 93-27

FACTS: ABC Enterprises, LLC is engaged in the business of selling skateboards. As consideration for services, ABC grants to its key employee David the right to share in the prospective profits of ABC. There is no vesting requirement to retain the interest. David is 100% vested in the interest on the date of grant. ABC "books up" the capital accounts of existing members A, B, and C prior to the grant so that David is not be entitled to any proceeds if the company were to liquidate the day after the grant of the interest. The grant agreement provides that David may not dispose of his interest for a period of two years.

TAX TREATMENT: The grant of the profits interest to David meets the requirements of Rev. Proc. 93-27 and therefore is not taxable to David. The safe harbor of Rev. Proc. 93-27 applies to the transaction because -

- David may not dispose of the interest within two years of receipt;
- ABC is not a publicly traded partnership (within meaning of IRC 7704(b)); and
- The profits interest does not relate to a substantially certain and predictable stream of income

EXAMPLE #8
PROFITS INTEREST GRANTED IN COMPLIANCE WITH REV. PROC. 2001-43

FACTS: ABC Enterprises, LLC is engaged in the business of selling skateboards. As consideration for services, ABC grants to its key employee David the right to share in the prospective profits of ABC. David's rights in the profits interest are subject to a substantial risk of forfeiture. He will forfeit the interest if he leaves within two-year period following the transfer (other than through death or disability). ABC "books up" the capital accounts of existing members A, B, and C prior to the grant so that David is not be entitled to any proceeds if the company were to liquidate the day after the grant of the interest.

TAX TREATMENT: The grant of the *unvested* profits interest to David will not be taxable and will be treated as received on the date of grant provided that the following requirements are met: (a) both the partnership and the service provider treat the service provider as a partner from the date the profits interest is granted; (b) the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; (c) no compensation deduction is taken by the partnership or any partner in connection with the grant of the profits interest; and (d) all of the requirements of Rev. Proc. 93-27 are satisfied.