

Proposed Revenue Procedure Regarding Partnership Interests Transferred in Connection With the Performance of Services

Notice 2005-43

Purpose

This notice addresses the taxation of a transfer of a partnership interest in connection with the performance of services. In conjunction with this notice, the Treasury Department and the Internal Revenue Service are proposing regulations under § 83 of the Internal Revenue Code. The proposed regulations grant the Commissioner authority to issue guidance of general applicability related to the taxation of the transfer of a partnership interest in connection with the performance of services. This notice includes a proposed revenue procedure under that authority. The proposed revenue procedure provides additional rules for the elective safe harbor under proposed § 1.83-3(l) for a partnership's transfers of interests in the partnership in connection with the performance of services for that partnership. The safe harbor is intended to simplify the application of § 83 to partnership interests and to coordinate the provisions of § 83 with the principles of partnership taxation. Upon the finalization of the proposed revenue procedure, Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191, (described below) will be obsolete. Until that occurs, taxpayers may not rely upon the safe harbor set forth in the proposed revenue procedure, but taxpayers may continue to rely upon current law, including Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191.

Effective Date

The Treasury Department and the Service intend for the revenue procedure proposed in this notice to be finalized and made effective in conjunction with the finalization of the related proposed regulations under § 83 and subchapter K of chapter 1 of the Internal Revenue Code (subchapter K).

Request for Comments

Comments are requested on the proposed revenue procedure in this notice. Although the Treasury Department and the Service request comments on all aspects of the proposed revenue procedure, comments are requested specifically on the following:

1. Whether additional guidance is needed to address the transfer of an interest in a partnership to a person who is not rendering services directly to such partnership (for example, an upper-tier partnership transfers an interest in a lower-tier partnership to a person for services rendered to the upper-tier partnership).
2. Whether election of the safe harbor described in proposed § 1.83-3(l) and the proposed revenue procedure should be permitted on Form 1065, *U.S. Return of Partnership Income*, and whether continued use of the safe harbor should be reported annually on Form 1065 and Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.

Comments may be submitted on or before August 22, 2005 to Internal Revenue Service, PO Box 7604, Washington, DC 20044, Attn: CC:PA:LPD:PR (Notice 2005-43), Room 5203. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier's Desk at 1111 Constitution Avenue, NW, Washington DC 20224, Attn: CC:PA:LPD:PR (Notice 2005-43), Room 5203. Submissions may also be sent electronically via the internet to the following email address: Notice.comments@irs.counsel.treas.gov. Include the notice number (Notice 2005-43) in the subject line.

Drafting Information

The principal authors of this notice are Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities); and Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and

Special Industries). For further information regarding this notice and the application of § 83, contact Stephen Tackney at (202) 622-6030 (not a toll-free call). For further information regarding this notice and the application of the rules contained in subchapter K, contact Audrey Ellis or Demetri Yatrakis at (202) 622-3060 (not a toll-free call).

PROPOSED REVENUE PROCEDURE

SECTION 1. PURPOSE

Proposed § 1.83-3(l) of the Income Tax Regulations allows taxpayers to elect to apply special rules (the Safe Harbor) to a partnership's transfers of interests in the partnership in connection with the performance of services for the partnership. The Treasury Department and the Internal Revenue Service intend for the Safe Harbor to simplify the application of § 83 of the Internal Revenue Code to partnership interests transferred in connection with the performance of services and to coordinate the principles of § 83 with the principles of partnership taxation. This revenue procedure sets forth additional rules for the elective safe harbor under proposed § 1.83-3(l) for a partnership's transfer of interests in the partnership in connection with the performance of services for that partnership.

SECTION 2. LAW AND DISCUSSION

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) 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, whichever occurs earlier, over (2) the amount (if any) paid for such property, is included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not

subject to a substantial risk of forfeiture, whichever is applicable.

Section 1.83-3(e) provides that, for purposes of § 83 and the regulations thereunder, the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. For these purposes, under proposed § 1.83-3(e) property includes a partnership interest. Generally, a mere right to allocations or distributions described in § 707(a)(2)(A) is not a partnership interest. Proposed § 1.83-3(e) also provides that, in the case of a transfer of a partnership interest in connection with the performance of services, the Commissioner may prescribe generally applicable administrative rules to address the application of § 83 to the transfer.

Section 83(b) provides that a service provider may elect to include in his or her gross income, for the taxable year in which substantially nonvested property is transferred, the excess of (1) the fair market value of the property at the time of the transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over (2) the amount (if any) paid for the property. If such an election is made, § 83(a) does not apply with respect to the transfer of the property upon vesting and, if the property is subsequently forfeited, no deduction is allowed to the service provider in respect of the forfeiture.

Section 1.83-2(b) provides that an election under § 83(b) must be filed not later than 30 days after the date the property was transferred and may be filed prior to the date of the transfer. Section 1.83-2(c) provides that the election is made by filing one copy of a written statement with the Internal Revenue Service Center with which the service provider files his or her return. In addition, one copy of such statement must be submitted with the service provider's income tax return for the taxable year in which the property was transferred.

Section 1.83-1(a) provides that, unless an election under § 83(b) is made, the transferor is regarded as the owner of substantially nonvested property transferred in connection with the performance of services until such property becomes substantially vested, and any income from such property received by the service provider (or beneficiary thereof), or the

right to the use of such property by the service provider, constitutes additional compensation and is included in the gross income of the service provider for the taxable year in which the income is received or the use is made available. Under this rule, a partnership must treat as unissued any substantially nonvested partnership interest transferred in connection with the performance of services for which an election under § 83(b) has not been made. If the service provider who holds such an interest receives distributions from the partnership with respect to that interest while the interest is substantially nonvested, the distributions are treated as compensation in the capacity in which the service provider performed the services. For example, if a service provider that is not a pre-existing partner holds a substantially nonvested partnership interest that the service provider received in connection with the performance of services and the service provider did not make an election under § 83(b) with respect to that interest, then any distributions made to the service provider on account of such interest are treated as additional compensation and not partnership distributions. If, instead, the service provider who receives a substantially nonvested partnership interest in connection with the performance of services makes a valid election under § 83(b), then the service provider is treated as the owner of the property. *See Rev. Rul. 83-22, 1983-1 C.B. 17.* The service provider is treated as a partner with respect to such an interest, and the partnership must allocate partnership items to the service provider as if the partnership interest were substantially vested.

Section 1.83-3(b) provides that property is substantially nonvested for § 83 purposes when it is subject to a substantial risk of forfeiture and is nontransferable. Property is substantially vested for § 83 purposes when it is either transferable or not subject to a substantial risk of forfeiture.

Section 1.83-3(c) provides that, for § 83 purposes, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condi-

tion related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Section 1.83-3(d) provides that, for § 83 purposes, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.

Proposed § 1.83-3(l) provides that, subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin, a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the Federal Register if the following conditions are satisfied: (1) the partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election; (2) except as provided below, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective; and (3) if the partnership agreement does not contain the provisions described in clause (2) of this sentence, or the provisions are not legally binding on all of the partners of

the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that (a) the partnership is authorized and directed to elect the safe harbor, and (b) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. Proposed § 1.83-3(l) provides that the partnership must retain such records as may be necessary to indicate that an effective election has been made and remains in effect, including a copy of the partnership's election statement under this paragraph (l), and, if applicable, the original of each document submitted to the partnership by a partner under this paragraph (l). If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the election. The safe harbor election also may be terminated by the partnership preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, which states that the partnership, on behalf of the partnership and each of its partners, is revoking the safe harbor election on the stated effective date, and attaching the document to the tax return for the partnership for the taxable year that includes the effective date of the revocation.

Section 83(h) provides that, in the case of a transfer of property in connection with the performance of services or a cancellation of a restriction described in § 83(d), there is allowed as a deduction under § 162, to the person for whom the services were performed (the service recipient), an amount equal to the amount included under § 83(a), (b), or (d)(2) in the gross income of the service provider. The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which such amount is included in the gross income of the service provider. Under § 1.83-6(a)(3), if property is substantially vested upon the transfer, the deduction is

allowed to the service recipient in accordance with its method of accounting (in conformity with §§ 446 and 461).

Section 1.83-6(c) provides that if, under § 83(h) and § 1.83-6(a), a deduction, an increase in basis, or a reduction of gross income was allowable (disregarding the reasonableness of the amount of compensation) in respect of a transfer of property and such property is subsequently forfeited, the amount of such deduction, increase in basis, or reduction of gross income shall be includible in the gross income of the person to whom it was allowable for the taxable year of the forfeiture. The basis of such property in the hands of the person to whom it is forfeited shall include any such amount includible in the gross income of such person, as well as any amount such person pays upon forfeiture.

Section 704(b) requires that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) be determined in accordance with the partner's interest in the partnership, determined by taking into account all facts and circumstances, if (1) the partnership agreement does not provide otherwise as to the partner's distributive share, or (2) the allocation to a partner under the agreement does not have substantial economic effect.

Proposed § 1.704-1(b)(2)(iv)(b)(I) provides that a partner's capital account includes the amount contributed by that partner to the partnership, and, in the case of a compensatory partnership interest that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date as the partner's compensation income under § 83(a), (b), or (d)(2). For these purposes, a compensatory partnership interest is an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership), including an interest that is transferred on the exercise of a compensatory partnership option. A compensatory partnership option is an option to acquire an interest in the issuing partnership that is granted in connection with the performance of services for that partnership (either before or after the formation of the partnership). See proposed § 1.721-1(b)(4).

Proposed § 1.704-1(b)(4)(xii)(a) provides that if a § 83(b) election has been

made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

Proposed § 1.704-1(b)(4)(xii)(b) provides that allocations of partnership items to a holder of a substantially nonvested interest for which a § 83(b) election has been made will be deemed to be in accordance with the partners' interests in the partnership if the partnership agreement requires that: (1) in the event that the interest for which the § 83(b) election is made is later forfeited, the partnership shall make forfeiture allocations in the year of the forfeiture; and (2) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a § 83(b) election has been made are recognized under § 704(b). Proposed § 1.704-1(b)(4)(xii)(e) provides that proposed § 1.704-1(b)(4)(xii)(b) does not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a § 83(b) election if, at the time of the § 83(b) election, there is a plan that the interest will be forfeited. In determining whether there is a plan that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest).

Proposed § 1.704-1(b)(4)(xii)(c) defines forfeiture allocations as allocations to the service provider (consisting of a *pro rata* portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to (1) the excess (not less than zero) of (a) the amount of the distributions (including deemed distributions under § 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under § 731), over (b) the amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under § 752(a)) to the partnership with respect to the forfeited partnership interest, minus (2) the cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership

interest. Proposed § 1.704-1(b)(4)(xii)(d) provides that for purposes of proposed § 1.704-1(b)(4)(xii)(c), items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Proposed § 1.721-1(b)(1) provides that § 721 generally does not apply to the transfer of a partnership interest in connection with the performance of services. Such a transfer constitutes a transfer of property to which § 83 and the regulations thereunder apply. However, under proposed § 1.721-1(b)(2), except as provided in § 83(h) or § 1.83-6(c), no gain or loss is recognized by a partnership upon: (i) the transfer or substantial vesting of a compensatory partnership interest, or (ii) the forfeiture of a compensatory partnership interest.

Proposed § 1.761-1(b) provides that if a partnership interest is transferred in connection with the performance of services, and that partnership interest is substantially nonvested (within the meaning of § 1.83-3(b)), then the holder of the partnership interest is not treated as a partner solely by reason of holding the interest, unless the holder makes an election with respect to the interest under § 83(b).

Rev. Proc. 93-27, 1993-2 C.B. 343, provides generally that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership. The revenue procedure does not apply if (1) 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) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of § 7704(b).

Rev. Proc. 2001-43, 2001-2 C.B. 191, clarifies Rev. Proc. 93-27 and provides that, for purposes of Rev. Proc. 93-27, if a partnership grants a substan-

tially nonvested profits interest in the partnership to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that: (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and 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; (2) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (3) all other conditions of Rev. Proc. 93-27 are satisfied.

SECTION 3. SCOPE

.01 *In General.* The Safe Harbor in section 4 of this revenue procedure applies to any Safe Harbor Partnership Interest transferred by a partnership if the transfer is made during the period in which the Safe Harbor Election is in effect (whether or not the Safe Harbor Partnership Interest is substantially vested on the date of transfer). Thus, for example, sections 4.02 through 4.04 of this revenue procedure apply to a Safe Harbor Partnership Interest that is transferred during the period in which the Safe Harbor Election is in effect, even if that Safe Harbor Partnership Interest does not become substantially vested until after the Safe Harbor Election is terminated, a § 83(b) election is made after the Safe Harbor Election is terminated, or that Safe Harbor Partnership Interest is forfeited after the Safe Harbor Election is terminated. Further, a Safe Harbor Election is binding on the partnership, all of its partners, and the service provider. The Safe Harbor includes all of the rules set forth in section 4 of this revenue procedure, and a partnership, its partners, and the service provider may not choose to apply only certain of the rules in section 4 of this revenue procedure or to apply the Safe Harbor only to certain partners, service providers, or partnership interests.

.02 *Safe Harbor Partnership Interest.* (1) Except as otherwise provided in sec-

tion 3.02(2) of this revenue procedure, a Safe Harbor Partnership Interest is any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related 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, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). For the purposes of this revenue procedure, “disability” means a condition which causes a service provider to be unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment expected to result in death or to last for a continuous period of not less than 12 months.

(2) An interest in a partnership is not a Safe Harbor Partnership Interest unless at the date of transfer the requirements of section 3.03 of this revenue procedure are satisfied and a Safe Harbor Election has not terminated pursuant to section 3.04 of this revenue procedure. For the first taxable year that a partnership is subject to a Safe Harbor Election, a partnership interest may be a Safe Harbor Partnership Interest if a Safe Harbor Election is attached to the partnership tax return for the taxable year including the date of transfer, provided that the other requirements of section 3.03 of this revenue procedure are satisfied on or before the date of such transfer.

.03 *Required Conditions for Safe Harbor Election.* In order to effect and main-

tain a valid Safe Harbor Election, the following conditions must be satisfied:

(1) The partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the Safe Harbor described in Rev. Proc. 200X–XX apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the Safe Harbor Election remains in effect. The Safe Harbor Election must specify the effective date of the Safe Harbor Election, and the effective date for the Safe Harbor Election may not be prior to the date that the Safe Harbor Election is executed. The Safe Harbor Election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the Safe Harbor Election.

(2) Except as provided in section 3.03(3) of this revenue procedure, the partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. If a partner that is bound by these provisions transfers a partnership interest to another person, the requirement that each partner be bound by these provisions is satisfied only if the person to whom the interest is transferred assumes the transferring partner's obligations under the partnership agreement. If an amendment to the partnership agreement is required, the amendment must be effective before the date on which a transfer occurs for the Safe Harbor to be applied to such transfer.

(3) If the partnership agreement does not contain the provisions described in section 3.03(2) of this revenue procedure, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with

the performance of services must execute a document containing provisions that are legally binding on each partner stating that (a) the partnership is authorized and directed to elect the Safe Harbor described in this revenue procedure, and (b) the partner agrees to comply with all requirements of the Safe Harbor described in this revenue procedure with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. Each person classified as a partner must execute the document required by this paragraph (3), and the document must be effective, before the date on which a transfer occurs, for the Safe Harbor to be applied to such transfer. If a partner who has submitted the required document transfers a partnership interest to another person, the condition that each partner submit the necessary document is satisfied only if the person to whom the interest is transferred either submits the required document or assumes the transferring partner's obligations under a document required by this paragraph that was previously submitted with respect to the transferred interest.

.04 *Termination of Safe Harbor Election.* A Safe Harbor Election continues in effect until terminated. A Safe Harbor Election terminates automatically on the date that a partnership fails to satisfy the conditions and requirements described in sections 3.02 and 3.03 of this revenue procedure. A Safe Harbor Election also terminates automatically in the event that the partnership, a partner, or service provider reports income tax effects of a Safe Harbor Partnership Interest in a manner inconsistent with the requirements of this revenue procedure, including a failure to provide appropriate information returns. A partnership may affirmatively terminate a Safe Harbor Election by preparing a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, indicating that the partnership, on behalf of the partnership and each of its partners, is revoking its Safe Harbor Election under Rev. Proc. 200X–XX and the effective date of the revocation, provided that the effective date may not be prior to the date the election to terminate is executed. Such termination election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the election. The rules of

the Safe Harbor in section 4 of this revenue procedure do not apply to any partnership interests transferred on or after the date of a termination of the Safe Harbor Election under this paragraph but continue to apply to any Safe Harbor Partnership Interests transferred while the Safe Harbor Election was in effect.

.05 *Election After Termination.* If a partnership has made a Safe Harbor Election and if such Safe Harbor Election has been terminated under section 3.04 of this revenue procedure, then, absent the consent of the Commissioner, the partnership (and any successor partnerships) are not eligible to make a Safe Harbor Election for any taxable year that begins before the fifth calendar year after the calendar year during which such termination occurs. For purposes of this paragraph, a successor partnership is any partnership that (1) on the date of termination, is related (within the meaning of § 267(b) or § 707(b)) to the partnership whose Safe Harbor Election has terminated (or, if the partnership whose Safe Harbor Election has terminated does not exist on the date of termination would be related if it existed on such date), and (2) acquires (either directly or indirectly) a substantial portion of the assets of the partnership whose Safe Harbor Election has terminated.

.06 *Recordkeeping Requirement.* Under proposed § 1.83–3(1), the partnership is required to keep as records: (1) a copy of the Safe Harbor Election submitted by the partnership to the Service under section 3.03(1) of this revenue procedure, and (2) if applicable, the original of each document submitted to the partnership by a partner under section 3.03(3) of this revenue procedure. If the partnership is unable to produce a record of a particular document, the election will be treated as not made, generally resulting in termination of the Safe Harbor Election under section 3.04 of this revenue procedure.

SECTION 4. SAFE HARBOR

.01 *Safe Harbor.* For purposes of § 83, the rules in sections 4.02 through 4.04 of this revenue procedure apply to any Safe Harbor Partnership Interest for which a Safe Harbor Election is in effect.

.02 *Liquidation Value.* Under the Safe Harbor, the fair market value of a Safe Harbor Partnership Interest is treated as being

equal to the liquidation value of that interest. For this purpose, liquidation value is determined without regard to any lapse restriction (as defined at § 1.83-3(i)) and means the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.

.03 *Vesting*. Under the Safe Harbor, a Safe Harbor Partnership Interest is treated as substantially vested if the right to the associated capital account balance equivalent is not subject to a substantial risk of forfeiture or the interest is transferable. A Safe Harbor Partnership Interest is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, the interest terminates and the holder may be required to forfeit the capital account balance equivalent credited to the holder under conditions that would constitute a substantial risk of forfeiture, and the interest is not transferable. For these purposes, the capital account balance equivalent is the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately prior to the forfeiture, the interest vested and the partnership sold all of its assets (including goodwill, going concern value, or any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated. Notwithstanding the previous sentence, a Safe Harbor Partnership Interest will not be considered substantially nonvested if the sole portion of the capital account balance equivalent forfeited is the excess of the capital account balance equivalent at the date of termination of services over the capital account balance equivalent at the end of the prior partnership tax year or any later date before the date of termination of services.

.04 *Forfeiture Subsequent to § 83(b) Election*. If a Safe Harbor Partnership Interest with respect to which a § 83(b) election has been made is forfeited, the service provider must include as ordinary income in the taxable year of the forfeiture an amount equal to the excess, if any, of (1) the amount of income or gain that the partnership would be required to al-

locate to the service provider under proposed § 1.704-1(b)(4)(xii) if the partnership had unlimited items of gross income and gain, over (2) the amount of income or gain that the partnership actually allocated to the service provider under proposed § 1.704-1(b)(4)(xii).

SECTION 5. APPLICATION OF SAFE HARBOR TO SERVICE PROVIDER AND SERVICE RECIPIENT

.01 *Application of Safe Harbor to the Service Provider*. Under the Safe Harbor, the service provider recognizes compensation income upon the transfer of a substantially vested Safe Harbor Partnership Interest in an amount equal to the liquidation value of the interest, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested, does not make an election under § 83(b), and holds the interest until it substantially vests, the service provider recognizes compensation income in an amount equal to the liquidation value of the interest on the date the interest substantially vests, less any amount paid for the interest. If the service provider receives a Safe Harbor Partnership Interest that is substantially nonvested and makes an election under § 83(b), the service provider recognizes compensation income on the date of transfer equal to the liquidation value of the interest, determined as if the interest were substantially vested, pursuant to the rules of § 83(b) and § 1.83-2, less any amount paid for the interest.

.02 *Application of Safe Harbor to the Service Recipient*. Under § 83(h), the service recipient generally is entitled to a deduction equal to the amount included as compensation in the gross income of the service provider under § 83(a), (b), or (d)(2), but only to the extent the amount meets the requirements of § 162 or § 212. Under the Safe Harbor, the amount included in the service provider's gross income in accordance with section 4.02 of this revenue procedure is considered the amount included as compensation in the gross income of the service provider under § 83(a) or (b) for purposes of § 83(h). The deduction generally is allowed for the taxable year of the partnership in which or with which ends the taxable year of

the service provider in which the amount is included in gross income as compensation. However, in accordance with § 1.83-6(a)(3), where the deduction relates to the transfer of substantially vested property, the deduction is available in accordance with the service recipient's method of accounting.

SECTION 6. EXAMPLES

The following facts apply for all of the examples below:

SP is an individual with a calendar year taxable year. *PRS* is a partnership with a calendar year taxable year. Except as otherwise stated, *PRS*'s partnership agreement provides for all partnership items to be allocated to the partners in proportion to the partners' interests in the partnership. *PRS*'s partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with § 1.704-1(b)(2)(iv), that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in the partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. All allocations and distributions to all parties are not recast under § 707(a)(2), and § 751(b) does not apply to any distribution. The partnership, its members, and the service providers elect the Safe Harbor provided in section 4 of this revenue procedure and file all affected returns consistent with the Safe Harbor, and each partnership interest transferred constitutes a Safe Harbor Partnership Interest under section 3.02 of this revenue procedure. The issuance of the partnership interest in each example is not required to be capitalized under the rules of § 263 or other applicable provision of the Code. In examples in which the partnership interest transferred to the service provider is not substantially vested, there is not a plan that the service provider will forfeit the partnership interest.

(1) *Example 1: Substantially Vested Profits Interest*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On March 1, 2005, *SP* agrees to perform services for the partnership in exchange for a partnership interest. Under the terms of the partnership agreement, *SP* is entitled to 10% of the future profits and losses of *PRS*, but is not entitled to any of the partnership's capital as of the date of transfer.

Although *SP* must surrender the partnership interest upon termination of services to the partnership, *SP* will not surrender any share of the profits accumulated through the end of the partnership taxable year preceding the partnership taxable year in which *SP* terminates services.

Conclusion: Under section 4.03 of this revenue procedure, *SP*'s interest in *PRS* is treated as substantially vested at the time of transfer. Under section 4.02 of this revenue procedure, the fair market value of the interest for purposes of § 83 is treated as being equal to its liquidation value (zero). Therefore, *SP* does not recognize compensation income under § 83(a) as a result of the transfer, *PRS* is not entitled to a deduction, and *SP* is not entitled to a capital account balance.

(2) *Example 2: Substantially Vested Interest*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On March 1, 2005, *SP* pays the partnership \$10 and agrees to perform services for the partnership in exchange for a 10% partnership interest that is treated as substantially vested under section 4.03 of this revenue procedure. Immediately before *SP*'s \$10 payment to *PRS* and the transfer of the partnership interest to *SP* in connection with the performance of services, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is \$90.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value of *SP*'s interest in *PRS* at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2005, *SP* includes \$90 (\$100 liquidation value less \$10 amount paid for the interest) as compensation income under § 83(a), *PRS* is entitled to a deduction of \$90 under § 83(h), and *SP*'s initial capital account is \$100 (\$90 included in income plus \$10 amount paid for the interest).

(3) *Example 3: Substantially Nonvested Interest; No § 83(b) Election; Pre-Existing Partner*

Facts: *PRS* has two partners, *A* and *SP*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* agrees to perform services for the partnership in exchange for a 10% increase in *SP*'s interest in the partnership from 50% to 60%. *SP* is not required to pay any amount in exchange for the additional 10% interest. Under the terms of the partnership agreement, if *SP* terminates services on or before January 1, 2008, *SP* forfeits any right to any share of accumulated, undistributed profits with respect to the additional 10% interest. The partnership interest transferred to *SP* is not transferable and no election is made under § 83(b). *SP* continues performing services through January 1, 2008. *PRS* has taxable income of \$500 in 2005 and \$1,000 in each of 2006 and 2007. No distributions are made to *A* or *SP* during such period. On January 1, 2008, the value of the partnership's assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) is \$3,500.

Conclusion: Under section 4.03 of this revenue procedure, the 10% partnership interest transferred to *SP* on December 31, 2004, is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, *SP* does not include any amount as compensation income attributable to the transfer,

and correspondingly, *PRS* is not entitled to a deduction under § 83(h).

In accordance with the partnership agreement, *PRS*'s taxable income for 2005 is allocated \$250 to *A* and \$250 to *SP*, and *PRS*'s taxable income for each of 2006 and 2007 is allocated \$500 to *A* and \$500 to *SP*.

On January 1, 2008, *SP*'s additional 10% interest in *PRS* is treated as becoming substantially vested under section 4.03 of this revenue procedure. At that time, the additional 10% interest in the partnership has a liquidation value of \$350 (10% of \$3,500). Under section 4.02 of this revenue procedure, the fair market value of the interest at the time it becomes substantially vested is treated as being equal to its liquidation value at that time for purposes of § 83. Therefore, in 2008, *SP* includes \$350 as compensation income under § 83(a), *PRS* is entitled to a deduction of \$350 under § 83(h), and *SP*'s capital account is increased by \$350.

(4) *Example 4: Substantially Nonvested Interest; No § 83(b) Election*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* pays the partnership \$10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if *SP* terminates services on or before January 1, 2008, *SP* forfeits any rights to any share of accumulated, undistributed profits, but is entitled to a return of *SP*'s \$10 initial contribution. *SP*'s partnership interest is not transferable and no election is made under § 83(b). *SP* continues performing services through January 1, 2008. *PRS* earns \$500 of taxable income in 2005, and \$1,000 in each of 2006 and 2007. *A* and *B* each receive distributions of \$225 in 2005, but neither *A* nor *B* receive distributions in 2006 and 2007. *PRS* transfers \$50 to *SP* in 2005, but does not make any transfers to *SP* in 2006 or 2007. On January 1, 2008, *SP*'s partnership interest has a liquidation value of \$300 (taking into account the unpaid partnership income credited to *SP* through that date).

Conclusion: Under section 4.03 of this revenue procedure, *SP*'s partnership interest is treated as substantially nonvested at the time of transfer. Because a § 83(b) election is not made, *SP* does not include any amount as compensation income attributable to the transfer and, correspondingly, *PRS* is not entitled to a deduction under § 83(h). Under proposed § 1.761-1(b), *SP* is not a partner in *PRS*; therefore, none of *PRS*'s taxable income for the years in which *SP*'s interest is substantially nonvested may be allocated to *SP*. Rather, *PRS*'s taxable income is allocated exclusively to *A* and *B*. In addition, the \$50 paid by *PRS* to *SP* in 2005 is compensation income to *SP*, and *PRS* is entitled to a deduction of \$50 under § 162 in accordance with its method of accounting.

On January 1, 2008, *SP*'s interest in *PRS* is treated as becoming substantially vested under section 4.03 of this revenue procedure. Under section 4.02 of this revenue procedure, the fair market value of the interest at the time the interest becomes substantially vested is treated as being equal to its liquidation value at that time for § 83 purposes. Therefore, in 2008, *SP* includes \$290 (\$300 liquidation value less \$10 amount paid for the interest) as compensation income under § 83(a), *PRS* is entitled to a \$290 deduction, and *SP*'s capital account is increased to \$300 (\$290

included in income plus \$10 amount paid for the interest).

(5) *Example 5: Substantially Nonvested Interest; § 83(b) Election*

Facts: The facts are the same as in *Example 4*, except that *SP* makes an election under § 83(b) with respect to *SP*'s interest in *PRS*. The liquidation value of the interest is \$100 at the time the interest in *PRS* is transferred to *SP*. *SP* continues performing services through January 1, 2008.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of *SP*'s interest in *PRS* at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for § 83 purposes. Because a § 83(b) election is made, in 2004 *SP* includes \$90 (\$100 liquidation value less \$10 amount paid for the interest) as compensation income, *PRS* is entitled to a \$90 deduction, and *SP*'s initial capital account is \$100 (\$90 included in *SP*'s income plus \$10 amount paid for the interest). Under proposed § 1.761-1(b), as a result of *SP*'s election under § 83(b), *SP* is treated as a partner starting from the date of the transfer of the interest to *SP*. Accordingly, *SP* includes in 2005 taxable income *SP*'s \$50 distributive share of *PRS* income, and the \$50 payment to *SP* by *PRS* in 2005 is a partnership distribution under § 731. *SP* includes in 2006 and 2007 taxable income *SP*'s \$100 distributive shares of *PRS* income for those years.

(6) *Example 6: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Profit*

Facts: The facts are the same as in *Example 5*, except that *SP* terminates services on September 30, 2007, and is repaid the \$10 that *SP* paid for the *PRS* interest in 2004. The partnership agreement provides that if *SP*'s partnership interest is forfeited, *SP*'s distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited.

Conclusion: The tax consequences for 2004 through 2006 are the same as in *Example (5)*. As a result of the forfeiture in 2007, *PRS* is required under § 1.83-6(c) to include in gross income \$90 (the amount of the allowable deduction on the transfer of the interest to *SP*). In accordance with the partnership agreement, *PRS* also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to *SP* and partnership distributions to *SP* prior to the forfeiture. Cumulative net income of \$150 was allocated to *SP* prior to the forfeiture (\$50 in 2005 and \$100 in 2006) and *SP* received a total of \$60 of distributions from *PRS* (\$50 in 2005 and \$10 in 2007 (the repayment of *SP*'s initial contribution to *PRS*)). Under proposed § 1.704-1(b)(4)(xii), the total forfeiture allocations to *SP* is \$100 of partnership loss and deduction, the difference between \$50 (\$60 of distributions to *SP* less \$10 of contributions to *PRS* by *SP*) and \$150 (cumulative net income allocated to *SP*). Pursuant to the partnership agreement, none of the partnership income for the year 2007 is allocated to *SP*. In accordance with § 83(b)(1) (last sentence), *SP* does not receive a deduction or capital loss for the amount (\$90) that was included as *SP*'s compensation income as a result of the election under § 83(b).

(7) *Example 7: Substantially Nonvested Interest; § 83(b) Election; Forfeiture; Net Loss*

Facts: *PRS* has two partners, *A* and *B*, each with a 50% interest in *PRS*. On December 31, 2004, *SP* pays the partnership \$10 and agrees to perform services for the partnership in exchange for a 10% partnership interest. Under the terms of the partnership agreement, if *SP* terminates services before January 1, 2008, *SP* forfeits any right to any share of accumulated, undistributed profits, but is entitled to a return of *SP*'s \$10 initial contribution. *SP*'s partnership interest is not transferable. The partnership agreement provides that if *SP*'s partnership interest is forfeited, *SP*'s distributive share of all partnership items (other than forfeiture allocations) will be zero with respect to the interest for the taxable year of the partnership in which the interest is forfeited. At the time of the transfer, the liquidation value of the 10% partnership interest is \$100, and *SP* makes an election under § 83(b) with respect to the interest. In 2005, *PRS* earns \$500 of taxable income, which is allocated and distributed \$225 to each of *A* and *B* and \$50 to *SP*. In 2006, *PRS* has net taxable loss of \$1,000, \$100 of which is allocated to *SP*. *PRS* does not make any distributions in 2006. *PRS* has no items of income, gain, loss, or deduction in 2007, other than gross income recognized under § 1.83–6(c). *SP* terminates services on September 30, 2007, and is repaid the \$10 that *SP* paid for the *PRS* interest in 2004. *PRS* does not make any distributions in 2007, other than the return of *SP*'s \$10 contribution.

Conclusion: Under section 4.02 of this revenue procedure, the fair market value (disregarding lapse restrictions) of *SP*'s interest in *PRS* at the time of transfer is treated as being equal to its liquidation value (disregarding lapse restrictions) at that time for purposes of § 83. Because a § 83(b) election is made, *SP* includes as compensation income in 2004 \$90 (\$100 liquidation value less \$10 amount paid for the interest), *PRS* is entitled to a \$90 deduction under § 83(h), and *SP*'s initial capital account is \$100 (\$90 compensation income plus \$10 amount paid for the interest). Under proposed § 1.761–1(b), as a result of *SP*'s election under § 83(b), *SP* is treated as a partner starting from the date of the transfer of the interest to *SP*. Accordingly, *SP* includes in 2005 taxable income *SP*'s \$50 distributive share of *PRS*'s income, and the \$50 payment to *SP* in 2005 is a partnership distribution under § 731. *SP* includes in computing 2006 taxable income *SP*'s \$100 distributive share of *PRS*'s loss.

As a result of the forfeiture in 2007, *PRS* is required under § 1.83–6(c) to include in gross income \$90 (the amount of the allowable deduction on the transfer of the interest to *SP*). In accordance with the partnership agreement, *PRS* also makes forfeiture allocations in 2007 to offset partnership income and loss that was allocated to *SP* and partnership distributions to *SP* prior to the forfeiture. Cumulative net loss of \$50 was allocated to *SP* prior to the forfeiture (\$50 of income in 2005 and \$100 of loss in 2006) and *SP* received a total of \$60 of partnership distributions (\$50 in 2005 and \$10 in 2007 (the repayment of *SP*'s initial contribution to *PRS*)). If *PRS* had unlimited items of gross income and gain, the total forfeiture allocations to *SP* under proposed § 1.704–1(b)(4)(xii) would be \$100 of partnership income and gain, the difference between \$50 (\$60 distributions to *SP* less \$10 of contributions to *PRS* by *SP*) and -\$50 (cumulative net loss allocated to *SP*). However, *PRS*'s only income in 2007 is the \$90 of income recognized by

PRS under § 1.83–6(c), all of which must be used to make forfeiture allocations to *SP*. Under section 4.04 of this revenue procedure, in 2007, *SP* must include in ordinary income \$10 (the difference between the forfeiture allocations that would be required under proposed § 1.704–1(b)(4)(xii) if *PRS* had an unlimited amount of gross income and gain, \$100, and the actual forfeiture allocations to *SP*, \$90). *PRS* is not entitled to a deduction for the amount (\$10) that *SP* is required to include in income under section 4.04 of this revenue procedure.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 93–27, 1993–2 C.B. 343, and Rev. Proc. 2001–43, 2001–2 C.B. 191, are obsoleted.