Partial Withdrawal of Notice of Proposed Rulemaking, Notice of Proposed Rulemaking, and Notice of Public Hearing

Partnership Equity for Services

REG–105346–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, notice of proposed rulemaking, and notice of public hearing.

SUMMARY: This document withdraws the remaining portion of the notice of proposed rulemaking published in the **Federal Register** on June 3, 1971 (36 FR 10787) and contains proposed regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services. The proposed regulations provide that the transfer of

a partnership interest in connection with the performance of services is subject to section 83 of the Internal Revenue Code (Code) and provide rules for coordinating section 83 with partnership taxation principles. The proposed regulations also provide that no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 22, 2005. Outlines of topics to be discussed at the public hearing scheduled for October 5, 2005, at 10 a.m. must be received by September 14, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–105346–03), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–105346–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–105346–03).

FOR FURTHER INFORMATION CONTACT: Concerning the section 83 regulations, Stephen Tackney at (202) 622–6030; concerning the subchapter K regulations, Audrey Ellis or Demetri Yatrakis at (202) 622–3060; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Robin Jones, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by July 25, 2005. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The following collections of information in this proposed regulation are in §1.83–3(l):

(1) Requirement that electing partnerships submit an election with the partnership tax return.

(2) Requirement that certain partners submit a document to the partnership;

(3) Requirement that such documents be retained; and

(4) Requirement that partnerships submit a termination document with the partnership tax return as one method of terminating the election.

These collections of information are required by the IRS to determine whether the amount of tax has been calculated correctly. The respondents are partnerships and partners or other service providers.

The estimated total annual reporting and/or recordkeeping burden is 112,500 hours.

The estimated annual burden per respondent/recordkeeper varies from .10 hours to 10 hours, depending on individual circumstances, with an estimated average of 1 hour for partnerships and .25 hour for a partner or service provider. The estimated number of respondents and/or recordkeepers is 100,000 partnerships and 50,000 partners or other service providers.

The estimated annual frequency of responses (used for reporting requirements only) is on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the **Office of Management and Budget**.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential as required by 26 U.S.C. 6103.

Background

Partnerships issue a variety of instruments in connection with the performance of services. These instruments include interests in partnership capital, interests in partnership profits, and options to acquire such interests (collectively, partnership equity). On June 5, 2000, the Treasury Department and the IRS issued Notice 2000–29, 2000–1 C.B. 1241, inviting public comment on the Federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership. On January 22, 2003, the Treasury Department and the IRS published in the **Federal Register** (REG–103580–02, 2003–1 C.B. 543 [68 FR 2930]), proposed regulations regarding the Federal income tax consequences of noncompensatory partnership options, convertible equity, and convertible debt. In the preamble to those proposed regulations, the Treasury Department and the IRS requested comments on the proposed amendment to §1.721–1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and on the Federal income tax consequences of the issuance of partnership capital interests in connection with the performance of services and options to acquire such interests.

In response to the comments received, the Treasury Department and the IRS are withdrawing the proposed amendment to §1.721–1(b)(1) and issuing these proposed regulations, which prescribe rules on the application of section 83 to partnership interests and the Federal income tax consequences associated with the transfer, vesting, and forfeiture of partnership interests transferred in connection with the performance of services.

Explanation of Provisions

1. Application of Section 83 to Partnership Interests

Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. The courts have held that a partnership capital interest is property for this purpose. See *Schulman v. Commissioner*, 93 T.C. 623 (1989) (section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); *Kenroy, Inc. v. Commissioner*, T.C. Memo 1984–232. Therefore, the proposed regulations provide that a partnership interest is property within the meaning of section 83, and that the transfer of a partnership interest in connection with the performance of services is subject to section 83.

The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, see, *e.g.*, *Campbell v. Commissioner*, T.C. Memo 1990–162, aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991), n. 7; *St. John v. U.S.*, 84–1 USTC 9158 (C.D. Ill. 1983), the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Moreover, some commentators have suggested that the same tax rules should apply to both partnership profits interests and partnership capital interests. These commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments. Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interests and partnership profits interests. However, a right to receive allocations and distributions from a partnership that is described in section 707(a)(2)(A) is not a partnership interest. In section 707(a)(2)(A), Congress directed that such an arrangement should be characterized according to its substance, that is, as a disguised payment of compensation to the service provider. See S. Rep. No. 98–169, 98 Cong. 2d Sess., at 226 (1984).

Section 83(b) allows a person who receives substantially nonvested property in connection with the performance of services to elect to include in gross income the difference between: (A) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (B) the amount paid for such property. Under section 83(b)(2), the election under section 83(b) must be made within 30 days of the date of the transfer of the property to the service provider.

Consistent with the principles of section 83, the proposed regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. If a section 83(b) election is made with respect to such an interest, the service provider will be treated as a partner for purposes of Subtitle A of the Code. These rules are similar to the current rules pertaining to substantially nonvested stock in a subchapter S corporation. See §1.1361–1(b)(3) (upon an election under section 83(b), the service provider becomes a shareholder for purposes of subchapter S).

These principles differ from Rev. Proc. 2001–43. Under that revenue procedure, if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no section 83(b) election is made, provided that certain conditions are met.

Certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83. Among the changes that are proposed in these regulations are: (1) conforming the subchapter K rules to the section 83 timing rules; (2) revising the section 704(b) regulations to take into account the fact that allocations with respect to an unvested interest may be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership. In addition, Rev. Procs. 93–27, 1993–2 C.B. 343, and 2001–43, 2001–2 C.B. 191, which generally provide for nonrecognition by both the partnership and the service provider on the transfer of a profits interest in the partnership for services performed for that partnership, must be modified to be consistent with these proposed regulations. Accordingly, in conjunction with these proposed regulations, the IRS is issuing Notice 2005–43, 2005–24 I.R.B. 1221. That notice contains a proposed revenue procedure that, when finalized, will obsolete Rev. Procs. 93–27 and 2001–43. The Treasury Department and the IRS intend for these proposed regulations and the proposed revenue procedure to become effective at the same time. The proposed amendments to the regulations under section 83 and subchapter K, as well as the notice, are described in further detail below.

The proposed revenue procedure and certain parts of the proposed regulations (as described below) only apply to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership (compensatory partnership interests). The Treasury Department and the IRS request comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership.

2. Timing of Partnership's Deduction

Except as otherwise provided in §1.83–6(a)(3), if property is transferred

in connection with the performance of services, then the service recipient's deduction, if any, is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. See section 83(h). In contrast, under section 706(a) and §1.707–1(c), guaranteed payments described in section 707(c) are included in the partner's income in the partner's taxable year within or with which ends the partnership's taxable year in which the partnership deducted the payments. Under §1.721–1(b)(2) of the current regulations, an interest in partnership capital issued by the partnership as compensation for services rendered to the partnership is treated as a guaranteed payment under section 707(c). Some commentators suggested that the proposed regulations should resolve the potential conflict between the timing rules of section 83 and the timing rules of section 707(c).

Under the proposed regulations, partnership interests issued to partners for services rendered to the partnership are treated as guaranteed payments. Also, the proposed regulations provide that the section 83 timing rules override the timing rules of section 706(a) and §1.707–1(c) to the extent they are inconsistent. Accordingly, if a partnership transfers property to a partner in connection with the performance of services, the timing and the amount of the related income inclusion and deduction is determined by section 83 and the regulations thereunder.

In drafting these regulations, the Treasury Department and the IRS considered alternative approaches for resolving the timing inconsistency between section 83 and section 707(c). One alternative approach considered was to provide that the transfer of property in connection with the performance of services is not treated as a guaranteed payment within the meaning of section 707(c). This approach was not adopted in the proposed regulations due to, among other things, concern that such a characterization of these transfers could have unintended consequences on the application of provisions of the Code outside of subchapter K that refer to guaranteed payments. The Treasury Department and the IRS request comments on alternative approaches for resolving the timing inconsistency between section 83 and section 707(c).

3. Allocation of Partnership's Deduction

The proposed regulations provide guidance regarding the allocation of the partnership's deduction for the transfer of property in connection with the performance of services. Some commentators suggested that the proposed regulations require that the partnership's deduction be allocated among the partners in accordance with their interests in the partnership prior to the transfer.

Section 706(d)(1) provides generally that, if, during any taxable year of a partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during the taxable year. Regulations have not yet been issued describing the rules for taking into account the varying interests of the partners in the partnership during a taxable year. Section 1.706–1(c)(2)(ii) provides that, in the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner's share of partnership items for the taxable year may be determined by either: (1) closing the partnership's books as of the date of the transfer (closing of the books method); or (2) allocating to the departing partner that partner's *pro rata* part of partnership items that the partner would have included in the partner's taxable income had the partner remained a partner until the end of the partnership taxable year (proration method). The Treasury Department and the IRS believe that section 706(d)(1) adequately ensures that partnership deductions that are attributable to the portion of the partnership's taxable year prior to a new partner's entry into the partnership are allocated to the historic partners.

Section 706(d)(2), however, places additional limits on how partnerships may allocate these deductions. Under section 706(d)(2)(B), payments for services by a partnership using the cash receipts and disbursements method of accounting are allocable cash basis items. Under section 706(d)(2)(A), if during any taxable year of a partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item must be determined under the proration method. To allow partnerships to allocate deductions with respect to property transferred in connection with the performance of services under a closing of the books method, the proposed regulations provide that section 706(d)(2)(A) does not apply to such a transfer.

4. Accounting for Compensatory Partnership Interests

A. Transfer of compensatory partnership interest

Under the proposed regulations, the service provider's capital account is increased by the amount the service provider takes into income under section 83 as a result of receiving the interest, plus any amounts paid for the interest. Some commentators suggested that the amount included in the service provider's income under section 83, plus the amount paid for the interest, may differ from the amount of capital that the partnership has agreed to assign to the service provider. These commentators contend that the substantial economic effect safe harbor in the section 704(b) regulations should be amended to allow partnerships to reallocate capital between the historic partners and the service provider to accord with the economic agreement of the parties.

The reallocation of partnership capital in these circumstances is not consistent with the policies underlying the substantial economic effect safe harbor and the capital account maintenance rules. The purpose of the substantial economic effect safe harbor is to ensure that, to the extent that there is an economic benefit or burden associated with a partnership allocation, the partner to whom the allocation is made receives the economic benefit or bears the economic burden. Under section 83, the economic benefit of receiving a partnership interest in connection with the performance of services is the amount that is included in the compensation income of the service provider, plus the amount paid for the interest. This is the amount by

which the service partner's capital account should be increased.

As explained in section 6 below, a proposed revenue procedure issued concurrently with these proposed regulations would allow a partnership, its partners, and the service provider to elect to treat the fair market value of a partnership interest as equal to the liquidation value of that interest. If such an election is made, the capital account of a service provider receiving a partnership interest in connection with the performance of services is increased by the liquidation value of the partnership interest received.

B. Forfeiture of certain compensatory partnership interests

If an election under section 83(b) has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership items that may later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect. Under the proposed regulations, such allocations will be treated as being in accordance with the partners' interests in the partnership if: (a) the partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and (b) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b). This safe harbor does not apply if, at the time of the section 83(b) election, there is a plan that a substantially nonvested interest will be forfeited. All of the facts and circumstances (including the tax status of the holder of the substantially nonvested interest) will be considered in determining whether there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under §1.704–1(b)(3).

Generally, forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service provider prior to the forfeiture is offset by allocations on the forfeiture of the interest. Also, to carry out the prohibition under section 83(b)(1) on deductions with respect to amounts included in income under section 83(b), these rules generally cause a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner's basis in the partnership below the amount included in income under section 83(b).

Forfeiture allocations may be made out of the partnership's items for the entire taxable year. In determining the gross income of the partnership in the taxable year of the forfeiture, the rules of §1.83–6(c) apply. As a result, the partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of the allowable deduction to the service recipient partnership upon the transfer of the interest as a result of the making of the section 83(b) election, regardless of the fair market value of the partnership's assets at the time of forfeiture.

In certain circumstances, the partnership will not have enough income and gain to fully offset prior allocations of loss to the forfeiting service provider. The proposed revenue procedure includes a rule that requires the recapture of losses taken by the service provider prior to the forfeiture of the interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service provider. This rule does not provide the other partners in the partnership with the opportunity to increase their shares of partnership loss (or reduce their shares of partnership income) for the year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service provider.

In other circumstances, the partnership will not have enough deductions and loss to fully offset prior allocations of income to the forfeiting service provider. It appears that, in such a case, section 83(b)(1) may prohibit the service provider from claiming a loss with respect to partnership income that was previously allocated to the service provider. However, a forfeiting partner is entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the interest) remaining after the forfeiture allocations have been made. See §1.83–2(a).

Comments are requested as to whether the regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership does not have enough actual tax items to make such allocations. Comments are also requested as to whether section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. In particular, comments are requested as to whether section 83 or another section of the Code provides authority for such a rule.

5. Valuation of Compensatory Partnership Interests

Commentators requested guidance regarding the valuation of partnership interests transferred in connection with the performance of services. Section 83 generally provides that the recipient of property transferred in connection with the performance of services recognizes income equal to the fair market value of the property, disregarding lapse restrictions. See *Schulman v. Commissioner*, 93 T.C. 623 (1989). However, some authorities have concluded that, under the particular facts and circumstances of the case, a partnership profits interest had only a speculative value or that the fair market value of a partnership interest should be determined by reference to the liquidation value of that interest. See §1.704–1(e)(1)(v); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *St. John v. U.S.*, 1984–1 USTC 9158 (C.D. 111. 1983). But see *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974) (holding under pre-section 83 law that the receipt of a profits interest with a determinable value at the time of receipt resulted in immediate taxation); *Campbell v. Commissioner*, T.C. Memo 1990–162,

aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).

The Treasury Department and the IRS have determined that, provided certain requirements are satisfied, it is appropriate to allow partnerships and service providers to value partnership interests based on liquidation value. This approach ensures consistency in the treatment of partnership profits interests and partnership capital interests, and accords with other regulations issued under subchapter K, such as the regulations under section 704(b).

In accordance with these proposed regulations, the revenue procedure proposed in Notice 2005–43, 2005–24 I.R.B. 1221, will, when finalized, provide additional rules that partnerships, partners, and persons providing services to the partnership in exchange for interests in that partnership would be required to follow when electing under §1.83–3(l) of these proposed regulations to treat the fair market value of those interests as being equal to the liquidation value of those interests. For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, 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.

6. Application of Section 721 to Partnership on Transfer

There is a dispute among commentators as to whether a partnership should recognize gain or loss on the transfer of a compensatory partnership interest. Some commentators believe that, on the transfer of such an interest, the partnership should be treated as satisfying its compensation obligation with a fractional interest in each asset of the partnership. Under this deemed sale of assets theory, the partnership would recognize gain or loss equal to the excess of the fair market value of each partial asset deemed transferred to the service provider over the partnership's adjusted basis in that partial asset. Other commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest. They argue, among other things, that the transfer of such an interest is not properly treated as a realization event for the partnership because no property owned by the partnership has changed hands. They also argue that taxing a partnership on the transfer of such an interest would result in inappropriate gain acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently.

Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. The Treasury Department and the IRS are still analyzing whether an exception to this general rule is appropriate on the transfer of an interest in the capital or profits of a partnership to satisfy certain partnership obligations (such as the obligations to pay interest or rent). However, the Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying section 721 — to defer recognition of gain and loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Under §1.704–1(b)(4)(i) (reverse section 704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized.

The rule providing for nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity, as defined in §301.7701–3(a) of the Procedure and Administration Regulations, that becomes a partnership under §301.7701–3(f)(2) as a result of the transfer or substantial vesting of the interest. See *McDougal v. Commissioner*, 62 T.C. 720 (1974) (holding that the service recipient recognized gain on the transfer of a one-half interest in appreciated property to the service provider, immediately prior to the contribution by the service recipient and the service provider of their respective interests in the property to a newly formed partnership).

7. Revaluations of Partnership Property

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003, contained special rules regarding the revaluations of partnership property while noncompensatory partnership options were outstanding. Specifically, the regulations proposed modifications to §1.704–1(b)(2)(iv)(*f*) and (*h*) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options. These proposed regulations do not contain similar provisions, because under recently proposed modifications to the regulations under §1.7041(b)(2)(iv), the obligation to issue a partnership interest in satisfaction of an option agreement is a liability that is taken into account in determining the fair market value of partnership assets as a result of a revaluation. See REG–106736–00, 2003–2 C.B. 60 [68 FR 37434] (June 24, 2003) (relating to the assumption of certain obligations by partnerships from partners).

8. Characterization Rule

The proposed regulations concerning noncompensatory partnership options published on January 22, 2003, contained a rule (§1.761–3) providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. However, the Treasury Department and the IRS have concluded that these proposed regulations should not contain a similar rule for partnership options transferred in connection with the performance of services because of the possibility that constructive transfers of property, subject to section 83, may occur under circumstances other than those described in the proposed rules for treating the holder of a noncompensatory option as a partner. The Treasury Department and the IRS request comments on whether anti-abuse rules are necessary to prevent taxpayers from using the rules in these proposed regulations or the rules in Notice 2005–43 to inappropriately shift items of partnership income or loss between the service provider and the other partners.

9. Retroactive Allocations

Section 761(c) generally allows a partnership to modify its agreement at any time on or prior to the due date for the partnership's return for the taxable year (without regard to extensions). Thus, for example, a partnership could, at the end of its taxable year, amend its partnership agreement to provide that a service provider was entitled to a substantially vested or nonvested interest in partnership profits and losses from the beginning of the partnership's taxable year. It is expected that, if a substantially vested compensatory partnership interest is transferred to an employee or independent contractor (or an election under section 83(b) is made with respect to the transfer of a substantially nonvested compensatory partnership interest to an employee or independent contractor), the partnership will report the transfer on Form W–2, "*Wage and Tax Statement*," or Form 1099–MISC, "*Miscellaneous Income*," as appropriate. The Form W–2 or Form 1099–MISC would be issued to the service provider by the partnership by January 31 of the year following the calendar year in which the partnership interest is transferred, and the partnership would file such forms with the Social Security Administration or IRS, respectively, by February 28 (March 31 if filed electronically) of the year following the calendar year in which the partnership interest is transferred. The service provider would be required to report any income recognized on the transfer of the partnership interest on the service provider's return for the taxable year (of the service provider) in which the transfer occurs.

It is unclear whether the retroactive commencement date of such an interest should be treated as the date of the transfer of the interest for purposes of section 83 and other provisions of the Code outside of subchapter K. If the retroactive effective date of the interest is treated as the transfer date for all purposes, a number of administrative concerns arise. For example, the partnership may not, by the January 31 deadline, have the information necessary to issue Form W–2 or Form 1099–MISC to the service provider. Also, the service provider may not, by the due date for filing the section 83(b) election, have the information necessary to file the election. The Treasury Department and the IRS request comments on the timing for section 83 purposes of retroactive transfers of partnership interests and on any actions that may be appropriate to address the associated administrative concerns.

10. Information Reporting to Partners

As explained above, the proposed regulations treat the transfer of a partnership interest to a partner in connection with the performance of services as a guaranteed payment. To ensure that the service provider partner has the information necessary to include the transfer in income for the taxable year in which the transfer occurs (rather than the taxable year in which or with which ends the partnership taxable year in which the transfer occurs), the Treasury Department and the IRS are considering the possibility of amending the section 6041 regulations to provide that this type of guaranteed payment must be reported by the partnership on Form 1099–MISC, which is required to be issued to the service provider on or before January 31 of the year following the calendar year of such transfer. The Treasury Department and the IRS request comments on whether such a requirement is appropriate and administrable.

Proposed Effective Date

These regulations are proposed to apply to transfers of property on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the reporting burden, as discussed earlier in this preamble, is not expected to be significant. Partnerships with partnership agreements that contain the binding provisions referred to in §1.83–3(l) only will be required to submit a single election form in order to rely on the safe harbor described in that paragraph. Partnerships that desire to elect to use the safe harbor described in §1.83–3(l), but which do not have partnership agreements containing these provisions, are required to obtain partner-level consents to the election. However, these partnerships are expected to be rare. Moreover, in most cases the partners in such partnerships are not expected to be small businesses. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 5, 2005, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight

(8) copies) by September 14, 2005. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Audrey Ellis and Demetri Yatrakis of the Office of Associate Chief Counsel (Passthroughs and Special Industries), and Stephen Tackney of the Office of Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §1.721–1(b) of the notice of proposed rulemaking that was published in the **Federal Register** on June 3, 1971 (36 FR 10787) is withdrawn.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.83–3 is amended as follows:

1. Paragraph (e) is amended by adding two new sentences after the first sentence.

2. Paragraph (l) is added.

The revision and addition read as follows:

§1.83–3 Meaning and use of certain terms.

* * * * *

(e) *Property*. * * * Accordingly, property includes a partnership interest. The previous sentence is effective for transfers on or after the date final regulations are published in the **Federal Register**. * * *

* * * * *

(l) *Special rules for the transfer of a partnership interest*. (1) 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 (see §601.601(d)(2)(ii)(*b*) of this chapter), 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:

(i) 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.

(ii) Except as provided in paragraph (l)(1)(iii) of this section, 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.

(iii) If the partnership agreement does not contain the provisions described in paragraph (l)(1)(ii) of this section, 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.

(2) The specified effective date of the safe harbor election may not be prior to the date that the safe harbor election is executed. 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.

Par. 3. Section 1.83–6 is amended by revising the first sentence of paragraph (b) to read as follows:

§1.83–6 Deduction by employer.

* * * * *

(b) *Recognition of gain or loss*. Except as provided in section 721 and section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property. * * *

* * * * *

Par. 4. Section 1.704–1 is amended as follows:

1. In paragraph (b)(0), an entry is added to the table for §1.704–1(b)(4)(xii).

2. In paragraph (b)(1)(ii)(*a*), a sentence is added at the end of the paragraph.

3. Paragraph (b)(2)(iv)(*b*)(*1*) is revised.

4. Paragraph (b)(2)(iv)(*f*)(*5*)(*iii*) is revised.

5. Paragraph (b)(4)(xii) is added.

6. Paragraph (b)(5) *Example 29* is added.

The additions and revisions read as follows:

§1.704–1 Partner's distributive share.

* * * * *

(b) * * *(0) * * *

* * * * *

Substantially nonvested interests.....1.704–1(b)(4)(xii)

* * * * *

(1) * * *

(ii) * * * (*a*) * * * In addition, paragraph (b)(4)(xii) and paragraph (b)(5) *Example 29* of this section apply to compensatory partnership interests (as defined in §1.721–1(b)(3)) that are transferred on or after the date final regulations are published in the **Federal Register**.

* * * * *

(2) * * *

(iv) * * *

(*b*) * * *

(*1*) the amount of money contributed by that partner to the partnership and, in the case of a compensatory partnership interest (as defined in §1.721–1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, the amount included on or after that date in the partner's compensation income under section 83(a), (b), or (d)(2).

* * * * *

(*f*) * * *

(*5*) * * *

(*iii*) In connection with the transfer or vesting of a compensatory partnership interest (as defined in §1.721–1(b)(3)) that is transferred on or after the date final regulations are published in the **Federal Register**, but only if the transfer or vesting results in the service provider recognizing income under section 83 (or would result in such recognition if the interest had a fair market value other than zero).

* * * * *

(4) * * *

(xii) *Substantially nonvested interests*—(a) *In general*. If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.

(*b*) *Deemed Compliance with Partners' Interests in the Partnership*. If a section 83(b) election has been made with respect to a substantially nonvested interest, allocations of partnership items while the interest is substantially nonvested will be deemed to be in accordance with the partners' interests in the partnership if—

(*1*) The partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and

(*2*) All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b).

(*c*) *Forfeiture allocations*. Forfeiture allocations are 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 the—

(*i*) Amount of distributions (including deemed distributions under section 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 section 731); over

(*ii*) Amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under section 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.

(*d*) *Positive and negative amounts*. For purposes of paragraph (b)(4)(xii)(*c*) of this section, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

(*e*) *Exception*. Paragraph (b)(4)(xii)(*b*) of this section shall not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a section 83(b) election if, at the time of the section 83(b) election, there is a plan that the interest will be forfeited. In such a case, the partners' distributive shares of partnership items shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. 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).

(*f*) *Cross references*. Forfeiture allocations may be made out of the partnership's items for the entire taxable year of the forfeiture. See §1.706–3(b) and paragraph (b)(5) *Example 29* of this section.

* * * * *

(5) * * *

Example 29. (i) In Year 1, A and B each contribute cash to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for equal units in LLC. Under LLC's operating agreement, each unit is entitled to participate equally in the profits and losses of LLC. The operating agreement also provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that liquidation proceeds will be distributed in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in that partner's capital account following the liquidation of the partner's interest must restore that deficit to the partnership. At the beginning of Year 3, SP agrees to perform services for LLC. In connection with the performance of SP's services and a payment of $10 by SP to LLC, LLC transfers a 10% interest in LLC to SP. SP's interest in LLC is substantially nonvested (within the meaning of §1.83–3(b)). At the time of the transfer of the LLC interest to SP, LLC's operating agreement is amended to provide that, if SP's interest is forfeited, then SP is entitled to a return of SP's $10 initial contribution, and SP's distributive share of all partnership items (other than forfeiture allocations under §1.704–1(b)(4)(xii)) will be zero with respect to that interest for the taxable year of the partnership in which the interest was forfeited. The operating agreement is also amended to require that LLC make forfeiture allocations if SP's interest is forfeited. Additionally, the operating agreement is amended to provide that no part of LLC's compensation deduction is allocated to the service provider to whom the interest is transferred. SP makes an election under section 83(b) with respect to SP's interest in LLC. Upon receipt, the fair market value of SP's interest in LLC is $100. In each of Years 3, 4, 5,

and 6, LLC has operating income of $100 (consisting of $200 of gross receipts and $100 of deductible expenses), and makes no distributions. SP forfeits SP's interest in LLC at the beginning of Year 6. At the time of the transfer of the interest to SP, there is no plan that SP will forfeit the interest in LLC.

(ii) Because a section 83(b) election is made, SP recognizes compensation income in the year of the transfer of the LLC interest. Therefore, SP recognizes $90 of compensation income in the year of the transfer of the LLC interest (the excess of the fair market value of SP's interest in LLC, $100, over the amount SP paid for the interest, $10). Under paragraph (b)(2)(iv)(*b*)(*1*) of this section, in Year 3, SP's capital account is initially credited with $100, the amount paid for the interest ($10) plus the amount included in SP's compensation income upon the transfer under section 83(b) ($90). Under §§1.83–6(b) and 1.721–1(b)(2), LLC does not recognize gain on the transfer of the interest to SP. LLC is entitled to a compensation deduction of $90 under section 83(h). Under the terms of the operating agreement, the deduction is allocated equally to A and B.

(iii) As a result of SP's election under section 83(b), SP is treated as a partner starting from the date of the transfer of the LLC interest to SP in Year 3. Section 1.761–1(b). In each of years 3, 4 and 5, SP's distributive share of partnership income is $10 (10% of $100), A's distributive share of partnership income is $45 (45% of $100), and B's distributive share of partnership income is $45 (45% of $100). In accordance with the operating agreement, SP's capital account is increased (to $130) by the end of Year 5 by the amounts allocated to SP, and A's and B's capital accounts are increased by the amounts allocated to A and B. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in years 3, 4 and 5 are deemed to be in accordance with the partners' interests in the partnership.

(iv) As a result of the forfeiture of the LLC interest by SP in year 6, LLC is required to recognize income ($90) equal to the amount of the allowable deduction on the transfer of the LLC interest to SP under §1.83–6(c). LLC repays SP's $10 capital contribution to SP, reducing SP's capital account to $120. Under the terms of the operating agreement, because SP forfeited SP's interest, SP's distributive share of all partnership items (other than forfeiture allocations) is zero for Year 6. To reverse SP's prior allocations of LLC income, LLC makes forfeiture allocations of $30 of deductions ($0 (the difference between the $10 distributed to SP and the $10 contributed to LLC by SP) minus $30 (the cumulative net LLC income allocated to SP) to SP in Year 6. Notwithstanding section 706(c) and (d), these allocations may be made out of LLC's partnership items for the entire taxable year of the forfeiture. Thus, in Year 6, $30 of deductions are allocated to SP, and the remaining $220 of net operating income ($200 of gross receipts and $90 of income under §1.83–6(c) less $70 of remaining deductions) are allocated to A and B equally for tax purposes. In accordance with section 83(b)(1) (last sentence), SP does not receive a deduction or capital loss for the amount ($90) that was included in SP's compensation income. Because LLC satisfies the requirements of paragraph (b)(4)(xii) of this section, LLC's allocations in year 6 are deemed to be in accordance with the partners' interests in the partnership.

* * * * *

Par. 5. Section 1.706–3 is added to read as follows.

§1.706–3 Property transferred in connection with the performance of services.

(a) *Allocations of certain deductions under section 83(h).* The transfer of property subject to section 83 in connection with the performance of services is not an allocable cash basis item within the meaning of section 706(d)(2)(B).

(b) *Forfeiture allocations.* If an election under section 83(b) is made with respect to a partnership interest that is substantially nonvested (within the meaning of §1.83–3(b)), and that interest is later forfeited, the partnership must make forfeiture allocations to reverse prior allocations made with respect to the forfeited interest. See §1.704–1(b)(4)(xii). Although the person forfeiting the interest may not have been a partner for the entire taxable year, forfeiture allocations may be made out of the partnership's items for the entire taxable year.

(c) *Effective date.* This section applies to transfers of property on or after the date final regulations are published in the **Federal Register**.

Par. 6. In §1.707–1, paragraph (c) is amended by revising the second sentence to read as follows:

§1.707–1 Transactions between partner and partnership.

* * * * *

(c) *Guaranteed Payments.* * * * However, except as otherwise provided in section 83 and the regulations thereunder, a partner must include such payments as ordinary income for that partner's taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. * * *

* * * * *

Par. 7. In §1.721–1, paragraph (b) is revised to read as follows.

§1.721–1 Nonrecognition of gain or loss on contribution.

* * * * *

(b)(1) Except as otherwise provided in this section or §1.721–2, section 721 does not apply to the transfer of a partnership interest in connection with the performance of services or in satisfaction of an obligation. The transfer of a partnership interest to a person in connection with the performance of services constitutes a transfer of property to which section 83 and the regulations thereunder apply. To the extent that a partnership interest transferred in connection with the performance of services rendered by a decedent prior to the decedent's death is transferred after the decedent's death to the decedent's successor in interest, the fair market value of such interest is an item of income in respect of a decedent under section 691.

(2) Except as provided in section 83(h) and 1.83–6(c), no gain or loss shall be 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. See §1.704–1(b)(4)(xii) for rules regarding forfeiture allocations of partnership items that may be required in the taxable year of a forfeiture.

(3) For purposes of this section, 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).

(4) To the extent that a partnership interest is—

(i) Transferred to a partner in connection with the performance of services rendered to the partnership, it is a guaranteed payment for services under section 707(c);

(ii) Transferred in connection with the performance of services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under Chapter 1 of the Code.

(5) This paragraph (b) applies to interests that are transferred on or after the date final regulations are published in the **Federal Register**.

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Par. 8. Section 1.761–1(b) is amended by adding two sentences to the end of the paragraph to read as follows.

§1.761–1 Terms defined.

* * * * *

(b) * * * 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 section 83(b). The previous sentence applies to partnership interests that are transferred on or after the date final regulations are published in the **Federal Register**. * * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

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