

**SECTION 83(b), SECTION 409A,  
SECTION 457A  
AND SUBCHAPTER K<sup>©</sup>**

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## SECTION 83(b), SECTION 409A, SECTION 457A AND SUBCHAPTER K\*

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### I. INTRODUCTION

On May 24, 2005, the Treasury Department (“Treasury”) published proposed treasury regulations (the “proposed regulations”) and a proposed revenue procedure (the “proposed revenue procedure”) governing the issuance and vesting of capital and profits partnership interests issued in connection with the performance of services (such interests, “compensatory partnership interests”).<sup>1</sup> As discussed below, the proposed regulations represent a significant change in the government’s approach to the taxation of compensatory partnership interests.<sup>2</sup>

The proposed regulations would alter the basis for taxing compensatory partnership interests (or not), while attempting to preserve the tax consequences under the current rules. Achieving this goal may depend in large part on whether final regulations expand the scope of the liquidation value safe harbor and reduce the procedural hurdles associated with its use. Treasury has postponed work on finalizing the proposed regulations while Congress considers proposed carried interest legislation.<sup>3</sup>

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\* I’m grateful to Simon Friedman and Shelly Banoff for discussing these issues with me, posing many of the questions discussed below, and catching my mistakes.

<sup>1</sup> REG-105346-03 (May 24, 2005); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005).

<sup>2</sup> For a discussion of the current taxation of compensatory partnership interests, see Swartz, L. Z., *A Layman’s Guide to LLC Incentive Compensation*, published in the PLI LLC and Corporate Tax Conference Materials.

<sup>3</sup> If enacted, proposed legislation, which would generally tax income allocated to profits interests, *i.e.*, “carried interests”, held by service

Very generally, section 409A<sup>4</sup> limits the ability of taxpayers to defer compensation under nonqualified deferred compensation plans by imposing stringent deferral election and distribution requirements, and section 457A effectively precludes service providers of “nonqualified entities” from deferring compensation by taxing such amounts when they cease to be subject to a substantial risk of forfeiture. Treasury and the Internal Revenue Service (“IRS”) have issued only very limited guidance applying these Code sections to partnership and LLC interests.

## II. SECTION 83 GOVERNS COMPENSATORY PARTNERSHIP INTERESTS

- Section 83 generally applies to service-related transfers of property, and courts have held that a partnership capital interest is property for this purpose.<sup>5</sup> Resolving a long history of case law questioning the status of profits interests as property for section 83 purposes,<sup>6</sup> the proposed regulations

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providers at ordinary rates, could significantly affect the proposed regulations. *Partnership Guidance On Hold Pending Legislative Action, Treasury Officials Say*, 2009 TNT 100-3 (May 28, 2009) (regulation project not entirely off the table, but taxpayers should not expect to see final regulations in the near future). For a discussion of the proposed carried interest legislation, see Section VII below.

<sup>4</sup> All section references herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), or to sections of Treasury regulations promulgated thereunder.

<sup>5</sup> 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); *Mark IV Pictures*, 60 T.C.M. 1171 (CCH) (1990), *aff’d*, 969 F.2d 669 (8th Cir. 1992) (applying section 83); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. (CCH) 1749 (1984) (all partnership interests are property for section 83 purposes).

<sup>6</sup> See, e.g., *Campbell v. Commissioner*, 59 T.C.M. (CCH) 236 (1990), *aff’d in part and rev’d in part*, 943 F.2d 815 (8th Cir. 1991) (Tax Court found that partnership profits interests are property within the meaning of section 83; Eighth Circuit considered whether partnership profits interests are property without articulating a definite position); *St. John v. U.S.*, 84-1 USTC ¶ 9158 (C.D. Ill.

provide that section 83 governs the tax consequences of both capital and profits interests issued for services.<sup>7</sup>

- Although the proposed regulations apply section 83 to both capital and profits interests, they do not govern a bare right to receive allocations and distributions from a partnership described in section 707(a)(2)(A), because such a right does not constitute a partnership interest.<sup>8</sup> The preamble to the proposed regulations explains that Congress has directed that, consistent with its substance, such an arrangement is properly treated as a disguised payment of compensation to the service provider.<sup>9</sup>
- Excepting section 707(a)(2)(A) payments from the section 83 regime adopted by the proposed regulations creates considerable uncertainty regarding the type of payments the proposed regulations would govern.

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1983) (without discussion, partnership profits interests assumed to be property for section 83 purposes, but taxpayer's interest was not subject to tax since it had no value); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. (CCH) 1749 (1984) (all partnership interests are property within the meaning of section 83); *Kobor v. U.S.*, 88-2 USTC ¶ 9477 (C.D. Ca. 1987); *Pacheco v. U.S.*, 912 F.2d 297 (9th Cir. 1990). For commentary summarizing the debate, see, e.g., Schmolka, Leo L., *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 Tax L. Rev. 287 (1991) (section 83 not applicable to profits interest because it is not property); but see, e.g., Cunningham, Laura E., *Taxing Partnership Interests Exchanged for Services*, 47 Tax L. Rev. 247 (1991) (no reason a profits interest should not constitute property for section 83 purposes). For a general discussion of the taxation of compensatory partnership interests, see Kahn, Douglas A., *The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest*, 62 Tax Law. 1 (2008).

<sup>7</sup> Prop. Reg. § 1.83-3(e).

<sup>8</sup> REG-105346-03 (May 24, 2005); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 2.

<sup>9</sup> See REG-105346-03 (May 24, 2005), Preamble; S. Rep. No. 98-169, at 226 (1984).

Section 707(a) provides that a transaction between a partner and its partnership other than in his or her capacity as a partner will be treated as occurring between the partnership and a party who is not a partner. Although section 707(a)(2) authorizes Treasury to promulgate regulations to determine when allocations and distributions should be treated as such payments to a partner not acting in such capacity, Treasury has not issued such regulations.<sup>10</sup>

- Thus, the description in the 1984 Committee Report to section 707 of the factors to be considered in promulgating regulations still represents the only guidance on the scope of section 707(a)(2)(A).<sup>11</sup> Entrepreneurial risk appears to be the determining factor as to when and under what circumstances a service provider's interest should be treated as a partnership interest (and so subject to the proposed regulations).
- The proposed regulations include significant section 83-related amendments to subchapter K regulations, including changes to (i) conform the subchapter K rules to the section 83 timing rules; (ii) revise the section 704(b) regulations to take into account the fact that potentially transitory allocations with respect to an unvested interest may be forfeited; and (iii) revise the section 721 regulations to provide that a partnership generally does not recognize gain or loss on the transfer of a compensatory partnership interest.
- Revenue Procedures 93-27<sup>12</sup> and 2001-43<sup>13</sup> will be modified to reflect the proposed regulations if and

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<sup>10</sup> See I.R.C. § 707(a)(2).

<sup>11</sup> See S. Rep. No. 98-169, at 230 (1984).

<sup>12</sup> 1993-2 C.B. 343.

when they are published in final form, although the revenue procedures will remain the operative guidance until final regulations are issued.<sup>14</sup>

#### **A. Section 83(b) Elections for Compensatory Partnership Interests**

- Consistent with the principles of section 83, the proposed regulations provide that if a section 83(b) election is made for an unvested capital or profits interest, the service provider will be treated as a partner for all income tax purposes.<sup>15</sup>
- A section 83(b) election with respect to an unvested profits interest that complies with the liquidation safe harbor (described below) will typically eliminate both the service provider's ordinary income and the partnership's corresponding compensation deduction that would be allocated among the other partners.<sup>16</sup> A service provider may decide whether to make a section 83(b) election (or not) for each separate compensatory interest received.
- By contrast, if a section 83(b) election is not made for an unvested compensatory partnership interest, the service provider will not be treated as a partner until the interest becomes substantially vested. At that time, the service provider would recognize ordinary compensation income.<sup>17</sup>

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<sup>13</sup> 2001-2 C.B. 191.

<sup>14</sup> See REG-105346-03 (May 24, 2005), Preamble.

<sup>15</sup> Prop. Reg. § 1.761-1(b); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), *citing* Rev. Rul. 83-22, 1983-1 C.B. 17.

<sup>16</sup> REG-105346-03 (May 24, 2005); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), sections 5.01 and 6, Ex. 1.

<sup>17</sup> Prop. Reg. § 1.761-1(b); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 2.

- Query whether a section 83(b) election will be required only for the initial grant of a profits or capital interest to a service provider who is not then a partner, or whether separate elections will also be required for subsequent grants of interests to the same person. If so, query whether fluctuations in the relative value of a compensatory partnership interest as a result, for example, of redemptions of other partnership interests, could constitute a deemed transfer of a new interest that would require a new section 83(b) election.
  - Discussions with government officials indicate that while separate section 83(b) elections must be made for each actual grant of a separate compensatory interest, fluctuations in the value of a single interest should not require separate elections.
- Notably, the proposed regulations apply only to compensatory interests issued in connection with services provided to the issuing partnership.<sup>18</sup> As a result, the regulations do not appear to govern the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership. The government appears to recognize the need to expand these rules, as Treasury and the IRS have requested comments on the income tax consequences of such transactions.<sup>19</sup>
- Responding to comments that the presently proposed regulations would exclude many of the compensatory interests typically issued by funds, government officials have indicated that final regulations may apply on some type of affiliated partnership group basis (although no final decisions have yet been made).

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<sup>18</sup> Prop. Reg. § 1.721-1(b)(3).

<sup>19</sup> See REG-105346-03 (May 24, 2005), Preamble.

- To cover such transfers, the proposed regulations could be applied on either a control group basis, testing only general partners (or LLC member-managers), or on a commonly controlled group basis, which would cover the transfers by many fund families of varying interests in several funds within a fund family to the manager of a single fund.

## **B. Retroactive Compensatory Partnership Interests**

- The government has requested comments regarding the timing of retroactive transfers of partnership interests for section 83 purposes and what, if any, actions may be appropriate to address the associated administrative concerns.
- Query whether section 83(b) elections can be made with respect to retroactively effective profits interests, and, if so, what the operative date would be for valuing the interest, and whether the limited period during which a section 83(b) election can be made would run from the date of grant, rather than the (retroactive) effective date of the interest.
  - A strong argument can be made that the date the interest is actually granted should begin the 30 day period for making a section 83(b) election, since no property is actually transferred until such date. The retroactive share of profits and losses that accompanies the interest should be viewed as merely an attribute of the interest that would not cause the interest to be deemed transferred on an earlier date.
- Query whether retroactive profits interests can be granted to service providers who are not partners during the entire retroactive period in which they would be considered partners if a retroactive section 83(b) election were permitted, or only to individuals who held separate partnership interests during such

retroactive period. It appears that retroactive grants to non-partners would be permitted, although the proposed regulations do not address this issue.

### III. VALUATION OF COMPENSATORY PARTNERSHIP INTERESTS

- Section 83 generally requires a recipient of a vested compensatory partnership interest to recognize income equal to the fair market value of the interest, which is calculated by disregarding any lapse restrictions.<sup>20</sup> The service provider's capital account is increased by the amount he or she includes in income under section 83 as a result of receiving the interest, plus any amount he or she pays for the interest.<sup>21</sup>
- The proposed regulations do not explain how the fair market value of compensatory interests will be determined, and this unfortunate omission reopens Pandora's box for any partnership that cannot satisfy the requirements to elect, or otherwise chooses not to elect, the liquidation value safe harbor described below.

#### A. Liquidation Value Safe Harbor

##### 1. Description of Safe Harbor

- The proposed regulations create an elective safe harbor, described in more detail in Notice 2005-43, that would permit partnerships and service providers to determine the value of compensatory partnership interests for section 83 purposes based on their liquidation value, provided that certain requirements are satisfied.<sup>22</sup> This safe harbor, which applies

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<sup>20</sup> Prop. Reg. § 1.83-3(e); Treas. Reg. § 1.83-1(a)(1).

<sup>21</sup> Prop. Reg. § 1.704-1(b)(2)(iv)(b)(1).

<sup>22</sup> Prop. Reg. § 1.83-3(l); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 4.02.

subchapter K valuation principles to determine the section 83 income tax consequences of compensatory partnership interest grants, may be elected with respect to both profits and capital interests.

- For purposes of the safe harbor, the liquidation value of a compensatory partnership interest is the amount of cash the service provider would receive with respect to his or her interest if, immediately after issuing the compensatory interest, the partnership were to sell all of its assets (including goodwill, going concern value, and any other intangible assets) at fair market value for cash, and then liquidate.<sup>23</sup> Under the safe harbor, the capital account of a service provider receiving a compensatory partnership interest would be increased by the liquidation value of the interest received, if any, plus any amount paid for the interest.

## 2. Qualification for Safe Harbor

- In order to qualify for the liquidation value safe harbor, a partnership's agreement must contain "legally binding" provisions that (i) "authorize and direct" the partnership to elect the safe harbor, and (ii) obligate all partners (including any service provider receiving a compensatory partnership interest, and any transferees of interests) to comply with all safe harbor requirements while the safe harbor election remains in effect.<sup>24</sup> If a partnership agreement does not contain these provisions, each partner must execute a separate, legally binding agreement that includes the same provisions.<sup>25</sup>

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<sup>23</sup> Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 4.02.

<sup>24</sup> Prop. Reg. § 1.83-3(l)(1)(ii)(A), (B); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 4.03.

<sup>25</sup> Prop. Reg. § 1.83-3(l)(1)(ii); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 4.03.

- These procedural requirements impose a unanimous consent requirement for safe harbor elections, which as a practical matter may be very difficult for many existing partnerships to satisfy, even if the partners unanimously support making the election (which is itself not a foregone conclusion).
- The tax matters partner must evidence the election by a document attached to the partnership's tax return for the year in which the partnership makes the election (which may not be made retroactively).<sup>26</sup> The document must state that the partnership elects to irrevocably apply the safe harbor to compensatory interests issued while the election remains in effect. The election may not be made with a retroactive effective date. All partners, including the service provider, must file tax returns consistently with the safe harbor during the period the election is in effect.
- Query whether the requirement that the partnership's agreement must provide that the "partnership is authorized and directed to elect" the safe harbor should be read to preclude a discretionary grant of authority to the authorized partner (*e.g.*, the tax matters partner) to elect the safe harbor in the future.<sup>27</sup>
- The safe harbor cannot be applied to partnership interests that are related to assets that generally produce a substantially certain stream of income, such as high quality fixed income securities, that represent an interest in a publicly traded partnership, or that are transferred in anticipation of a subsequent disposition.<sup>28</sup>

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<sup>26</sup> Prop. Reg. § 1.83-3(l)(1)(i).

<sup>27</sup> See Prop. Reg. § 1.83-3(l)(1).

<sup>28</sup> Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 3.02.

- Absent clear and convincing evidence to the contrary, a partnership interest will be assumed to be transferred in anticipation of a subsequent disposition if the interest is, in fact, sold or disposed of, or is puttable or callable, within two years of receipt (other than by reason of death or disability of the service provider).<sup>29</sup> The proposed regulations do not elaborate on what type of put or call would disqualify an interest from utilizing the safe harbor, or what effect a disqualified interest would have on a partnership's ability (or obligation) to continue to elect the safe harbor for other compensatory interests.
- For example, query whether a typical formula-based fair market value call triggered by a service provider's termination would preclude his or her interest from utilizing the safe harbor. If so, the utility of the safe harbor would be significantly compromised.

### 3. Termination of Safe Harbor

- The safe harbor election will automatically be terminated if and when the partnership fails to satisfy any of the conditions described in sections 3.02 and 3.03 of Notice 2005-43, or any party to the election reports income or loss inconsistently with the safe harbor requirements. In addition, the partnership may affirmatively revoke the election on a prospective basis by filing a revocation document executed by the tax matters partner on behalf of the partnership with the partnership's tax return for the year of revocation.<sup>30</sup>

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<sup>29</sup> Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 3.02.

<sup>30</sup> Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 3.04.

- A partnership whose safe harbor election was terminated (either by the partnership or by the IRS) may not make another election for five years after the year of revocation.<sup>31</sup>

#### 4. Disparate Safe Harbor Consequences

- The recipient of a compensatory capital interest may be disadvantaged by the liquidation value safe harbor, since the use of liquidation value would preclude any valuation discounts for illiquidity, minority interests, and the like. By contrast, the liquidation value safe harbor would benefit profits interest holders, as it would produce a zero value for most unvested pure profits interests for which section 83(b) elections are made.
- As these results indicate, the liquidation value safe harbor will not necessarily benefit all partners receiving compensatory interests, and/or the other historic partners receiving or foregoing the related deduction. Accordingly, partnerships issuing compensatory capital interests may find it difficult to obtain the requisite unanimous consent of its partners necessary to elect the safe harbor.
- This tension between partners illustrates the whipsaw potential that the election procedures are designed to prevent – a (high) liquidation value partnership deduction for a capital interest, while a service provider claims a (lower) fair market value when making a section 83(b) election with respect to the interest. While this is a valid concern, it should be weighed against the fact that absent the ability to make a safe harbor election, the age-old question of whether the grant (or vesting) of a profits interest

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<sup>31</sup> Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 3.05.

produces taxable income for a service provider receiving the interest will once again have to be answered.

- In light of the difficult subchapter K questions that necessarily follow from the use of fair market values to measure compensatory partnership interests, query whether, in addition to binding the service provider receiving an interest to the use of liquidation value, the government could achieve adequate whipsaw protection by either adopting a majority consent rule or authorizing the tax matters partner to make the election absent a contrary provision in a partnership agreement. Useful election mechanics that might serve as models include those found in sections 754 and 108(c).

#### **B. Valuation of Compensatory Partnership Interests for Book-ups**

- Proposed regulations concerning noncompensatory partnership options require that any revaluation of partnership property while noncompensatory partnership options are outstanding must take into account the fair market value, if any, of the outstanding options.<sup>32</sup> Subsequent proposed regulations also treat the obligation to issue a partnership interest in satisfaction of an option agreement as a liability in determining the fair market value of partnership assets after a revaluation.<sup>33</sup>

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<sup>32</sup> Prop. Reg. § 1.704-1(b)(2)(iv)(f) and (h).

<sup>33</sup> See REG-106736-00, 68 Fed. Reg. 37,434 (June 24, 2003) (relating to the assumption of certain obligations by partnerships from partners); Treas. Reg. § 1.704-1(b)(2)(iv).

#### **IV. FORFEITURE OF UNVESTED COMPENSATORY INTERESTS SUBJECT TO SECTION 83(b) ELECTIONS**

If a section 83(b) election is made with respect to a substantially unvested profits or capital interest, the service provider receiving the interest will immediately be treated as a partner, and, therefore, may be allocated partnership items that he or she could later forfeit if the interest does not vest.<sup>34</sup> The proposed regulations conclude that the potentially transitory nature of these allocations of partnership items before vesting means that the allocations cannot have economic effect.<sup>35</sup>

- The proposed regulations do not discuss whether certain issuances of compensatory interests could trigger a capital shift from the other partners (or not); accordingly, the forfeiture allocation provisions do not reverse the effects of any such capital shift. Perhaps the government has concluded that no capital shift occurs, but, if not, query whether the effect of any capital shift should also be reversed whenever the associated interest is forfeited.

##### **A. Forfeiture Allocations**

- The proposed regulations treat allocations to a partner holding an unvested interest as in accordance with the partners' interests in the partnership for section 704(b) purposes only if (i) the partnership agreement requires the partnership to make "forfeiture allocations" if the unvested interest is later forfeited, and (ii) all material allocations and capital account adjustments under the partnership agreement not pertaining to substantially unvested partnership interests for which section 83(b) elections were made are recognized under section 704(b).<sup>36</sup>

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<sup>34</sup> Prop. Reg. §§ 1.761-1(b); 1.704-1(b)(4)(xii).

<sup>35</sup> Prop. Reg. § 1.704-1(b)(4)(xii)(a).

<sup>36</sup> Prop. Reg. §§ 1.704-1(b)(4)(xii); 1.706-3(b).

- It appears that if profit and loss allocated to a service provider cannot have substantial economic effect (as the proposed regulations conclude), none of the partnership's allocations can satisfy the substantial economic effect safe harbor. Query, however, whether the partnership's allocations could satisfy the substantial economic effect safe harbor after the interests of holders of unvested interests who made section 83(b) elections have all vested.
- This safe harbor does not apply if there is a plan to forfeit the substantially unvested interest when the section 83(b) election is made.<sup>37</sup> The determination of whether a forfeiture plan exists is based on all relevant facts and circumstances, including the tax status of the holder of the substantially unvested interest. If such a plan exists, the preamble to the proposed regulations provides that partners' distributive shares of partnership items will be determined in accordance with the partners' interests in the partnership.<sup>38</sup>
  - Query what type of "plan to forfeit" concerns the government, whether a later forfeited interest would be treated as an interest in the partnership for this purpose, and if so, what type of interest.
- A forfeiting partner generally must be allocated available items of partnership gross income and gain, or gross deduction and loss, to the extent necessary to offset prior distributions (including deemed distributions under section 752(b)) and prior allocations of partnership items with respect to the forfeited partnership interest in excess of the amounts paid for, or contributed with respect to, the

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<sup>37</sup> Prop. Reg. § 1.704-1(b)(4)(xii)(e).

<sup>38</sup> Prop. Reg. § 1.704-1(b)(4)(xii)(e).

forfeited interest (including deemed contributions under section 752(a)).<sup>39</sup>

- More specifically, the preamble states that partnership income must be allocated to offset any prior distributions to the partner that reduced the partner's basis in his or her partnership interest below the amount the partner included in income with respect to his or her section 83(b) election. These allocations are thought to be required to satisfy the section 83(b)(1) prohibition on the deduction of amounts previously included in the partner's income under section 83(b).<sup>40</sup>
- Forfeiture allocations may be made out of the partnership's items for the entire taxable year in which an interest is forfeited.<sup>41</sup> Since Treasury regulation section 1.83-6(c) requires the partnership to recapture any deduction claimed with respect to a forfeited interest as gross income in the taxable year of the forfeiture, the partnership generally will have recapture income in a forfeiture taxable year equal to the amount of the deduction the partnership claimed when a section 83(b) election was made for the unvested interest, regardless of the then fair market value of the partnership's assets. Note, however, that this income may not be sufficient to offset all losses allocated in prior years with respect to the forfeited interest, in which case notional allocations (discussed below) must be utilized to offset any such remaining losses.

#### 1. Notional Reversal of Loss Allocations

- If a partnership's gross income and gain in the year of a forfeiture is insufficient to fully offset prior allocations of loss to the forfeiting partner,

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<sup>39</sup> Prop. Reg. §§ 1.704-1(b)(4)(xii)(c); 1.706-3(b); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005), section 2.

<sup>40</sup> See REG-105346-03 (May 24, 2005), Preamble; I.R.C. § 83(b)(1).

<sup>41</sup> Prop. Reg. §§ 1.704-1(b)(4)(xii)(f); 1.706-3(b).

the forfeiting partner must recapture any previously allocated losses that remain after taking into account the forfeiture allocations as phantom income.<sup>42</sup> Notably, the other partners in the partnership will not be allocated additional partnership losses or reduced shares of partnership income in a forfeiture year as a result of any forfeiting partner's recapture of previously allocated losses. Accordingly, the partnership may effectively be disallowed a deduction for a portion of its previously realized losses.

- It is not clear why the proposed regulations do not adopt a more balanced notional allocation regime. For example, it would appear that section 704(c) remedial allocation type principles could be applied without detriment to the fisc.

## 2. Incomplete Reversal of Income Allocations

- By contrast, if a partnership's deductions and losses are insufficient to fully offset prior allocations of income to the forfeiting service provider, the preamble cautions that section 83(b)(1) "appears to" prohibit the service provider from claiming a phantom loss to offset previously allocated partnership income.<sup>43</sup> The government's concern apparently stems from the possibility that reversing the service provider's income by triggering such a loss could be treated as a deduction of amounts included in the service provider's income under section 83(b). Query whether this concern is valid, since the items of income that would be reversed would not in fact be those that the partner would have included in his or her income under section 83(b).

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<sup>42</sup> Prop. Reg. § 1.704-1(b)(4)(xii)(c).

<sup>43</sup> See REG-105346-03 (May 24, 2005), Preamble.

- The preamble explains that a forfeiting partner may instead claim a loss with respect to the partnership interest (which would generally be capital rather than ordinary) to the extent that, after taking into account forfeiture allocations, the partner has basis in his or her partnership interest that is attributable to money or property the partner contributed to the partnership (including amounts paid for the forfeited interest).<sup>44</sup>
- The government has requested comments as to whether section 83(b)(1) should be read to allow a forfeiting partner to claim a loss with respect to previously allocated partnership income that is not offset by forfeiture allocations of partnership loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the forfeiture year equal to the amount of such a loss claimed by the service provider. In particular, the government has requested comments as to whether section 83 or another section of the Code provides authority for such a rule.<sup>45</sup>
- The government has also requested comments as to whether regulations should require or allow partnerships to create notional tax items to make forfeiture allocations where the partnership has insufficient actual tax items to make such allocations.<sup>46</sup>

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<sup>44</sup> See REG-105346-03 (May 24, 2005), Preamble; Treas. Reg. § 1.83-2(a).

<sup>45</sup> See REG-105346-03 (May 24, 2005), Preamble.

<sup>46</sup> See REG-105346-03 (May 24, 2005), Preamble.

## V. PARTNERSHIP CONSEQUENCES OF ISSUING COMPENSATORY INTERESTS

### A. No Partnership Gain on Compensatory Interest Transfers

- Commentators have long debated whether a partnership could be required to recognize gain or loss in connection with the transfer of a compensatory partnership interest, under the typical rules for transfers of appreciated property to satisfy partnership obligations.<sup>47</sup> The preamble to the proposed regulations confirms the government's belief that protecting partnerships from gain recognition on the transfer of a compensatory partnership interest is generally consistent with the policies underlying section 721. Accordingly, the proposed regulations provide that partnerships generally will not be subject to tax in connection with the transfer or substantial vesting of a compensatory partnership interest.<sup>48</sup>
- The government confirms in the preamble to the proposed regulations that reverse section 704(c) principles will be applied to ensure that the historic partners will recognize any built-in gain or loss attributable to the partnership's assets, as and when the historic partnership assets are sold, depreciated, or

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<sup>47</sup> On its face, section 721, which provides that no gain or loss is recognized by the partnership or its partners on the issuance of partnership interests for property, does not apply to services. The limited scope of section 721(a) creates a negative implication that a partnership would recognize gain or loss on the issuance of compensatory partnership interests.

<sup>48</sup> The government is analyzing whether an exception to this general non-recognition rule is appropriate for the transfer of a capital or profits interest in the partnership to satisfy certain partnership obligations, such as obligations to pay interest or rent. *See* REG-105346-03 (May 24, 2005), Preamble.

amortized after a compensatory interest is granted.<sup>49</sup>

- This exception to gain recognition extends the shadow of section 1032 across subchapter K, although it may not yet reach transfers of partnership interests to satisfy interest or rent obligations. In addition, the non-recognition rule does not apply to the transfer or substantial vesting of an interest in a disregarded entity that becomes a partnership as a result of the transfer or substantial vesting of the interest.<sup>50</sup> Thus, a putative partnership with one vested partner and one or more unvested partners who do not make section 83(b) election(s) may, in fact, constitute a disregarded entity owned solely by the vested partner.

## **B. Partnership Compensation Deductions**

### **1. Timing of Deductions**

- Although the proposed regulations treat compensatory partnership interests issued to partners as guaranteed payments, they provide that section 83 principles will govern the timing of a service provider's income inclusion and a partnership's deduction, if, and to the extent, the section 83 rules conflict with the subchapter K timing rules for deducting guaranteed payments.<sup>51</sup>
- Under section 83, a partnership's deduction for the transfer of a compensatory interest

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<sup>49</sup> See Treas. Reg. § 1.704-1(b)(4)(i).

<sup>50</sup> See Treas. Reg. § 301.7701-3(a), (f)(2); see also *McDougal v. Commissioner*, 62 T.C. 720 (1974) (service recipient recognized gain on transfer of an undivided interest in property to service provider immediately prior to contribution by both parties of the property to a new partnership).

<sup>51</sup> See I.R.C. § 706(a); Treas. Reg. § 1.707-1(c).

depends on the year in which the service partner includes the interest in income.<sup>52</sup> Accordingly, the partnership is only permitted a related deduction in the partnership's taxable year that includes the end of the service provider's taxable year in which he or she includes the interest as compensation income.<sup>53</sup> Resolving the timing conflict in favor of section 83 represents a change from the usual rule that section 707(c) guaranteed payments are included in a partner's income in the year in which the partnership is entitled to deduct the payment.<sup>54</sup> The government has requested comments regarding alternative approaches for resolving the timing inconsistency between section 83 and section 707(c).

## 2. Allocation of Deductions

- The preamble to the proposed regulations confirms that partnership deductions that are attributable to the portion of the partnership's taxable year before a new partner enters the partnership, including deductions with respect to the transfer of a compensatory partnership interest, must be allocated only to historic partners.<sup>55</sup>
- The preamble notes that the allocation of these deductions by cash basis partnerships among historic partners may be further limited because payments for services are allocable cash basis items, which must be determined and allocated under the proration method during any partnership taxable year

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<sup>52</sup> See I.R.C. § 83(h); Treas. Reg. §§ 1.83-6(a)(3); 1.721-1(b)(2).

<sup>53</sup> See I.R.C. § 83(h); Treas. Reg. §§ 1.83-6(a)(3); 1.721-1(b)(2).

<sup>54</sup> See I.R.C. § 706(a); Treas. Reg. § 1.707-1(c).

<sup>55</sup> I.R.C. § 706(d)(1).

in which any partner's interest in the partnership changes.<sup>56</sup>

- To permit partnerships to allocate such deductions with respect to the issuance of compensatory partnership interests under a closing of the books method, the proposed regulations exclude compensatory transfers from the definition of cash basis items.<sup>57</sup>

## **VI. MISCELLANEOUS ISSUES REGARDING COMPENSATORY INTERESTS**

### **A. Information Reporting to Partners**

- Partnerships will report the transfer of a substantially vested compensatory partnership interest to an employee or independent contractor, or the transfer of a substantially unvested compensatory partnership interest to an employee or independent contractor for which a section 83(b) election is made, on Form W-2, "Wage and Tax Statement," or Form 1099-MISC, "Miscellaneous Income," as appropriate. The partnership would issue the Form W-2 or Form 1099-MISC to the service provider by January 31 of the year following the calendar year in which the partnership interest is transferred and would file such forms with the Social Security Administration or IRS, respectively, by February 28 (March 31, if filed electronically) of that year. The service provider would be required to report any income recognized on the receipt of the partnership interest on his or her tax return for the year of receipt.
- Although the proposed regulations do not so specify, it appears that all interests

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<sup>56</sup> See REG-105346-03 (May 24, 2005), Preamble; I.R.C. § 706(d)(2)(A), (B).

<sup>57</sup> Prop. Reg. § 1.706-3(a).

transferred to service providers who are not partners before receiving such interests will be reported on Forms W-2, in the case of employees, and Forms 1099-MISC, in the case of independent contractors.

- The proposed regulations treat the transfer of a compensatory partnership interest to a partner (presumably, someone who already holds a separate interest in that partnership) as a guaranteed payment, which would ordinarily be reported to the service provider on his or her Form K-1. However, to ensure that the partner receiving the interest has the information necessary to include the transfer in income for his or her taxable year in which the transfer occurs (rather than the partnership taxable year in which the transfer occurs), the government is considering amending the section 6041 regulations to provide that this type of guaranteed payment must be reported by the partnership on a Form 1099-MISC issued to the service provider on or before January 31 of the year following the calendar year of such a transfer. The government has requested comments as to whether such a requirement is appropriate and administrable.
- Query how the government would apply these reporting regimes in the case of retroactive interests, since the partnership could grant a compensatory interest after the date on which ownership details would be required to be reported to the recipient. Separately, such information would need to be transferred to the service provider in time to make a section 83(b) election, which could be difficult, or in some cases impossible, depending on how the election date is defined.

## B. Need for Anti-Abuse Rules

- The government has requested comments as to whether anti-abuse rules are necessary to prevent taxpayers from using the proposed regulations or Notice 2005-43 to inappropriately shift items of partnership income or loss between a service provider and the other partners.
- Query what unique circumstances could concern the government that the broad section 701 anti-abuse regulations would not adequately police. If any such circumstances do exist, it may be more logical to propose a related anti-abuse rule under section 83, rather than under subchapter K.

## VII. PROPOSED CARRIED (PROFITS) INTEREST LEGISLATION

- Currently, the grant of a carried (profits) interest to a service provider in exchange for services is generally not taxable under applicable guidance.<sup>58</sup> Further, any profits or losses allocated to the service provider retains the character of such profits or losses as earned by the partnership. Accordingly, if the partnership generates capital gain and allocates a portion of that gain to the service provider pursuant to the carried interest, the service provider would recognize capital gain. In addition, any gain recognized on the sale of a carried interest is generally treated as capital gain.<sup>59</sup>

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<sup>58</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. Lee Sheppard has noted the subtle distinction between a carried interest and pure profits interest insofar as a carried interest is a disproportionate allocation of profits when a manager has paid something for his interest whereas a pure profits interest is one for which a service provider pays nothing. See Sheppard, Lee A., *Hedge Fund Managers' Tax Benefits Compared*, 119 Tax Notes 243 (Apr. 21, 2008).

<sup>59</sup> The impetus behind the proposed carried interest legislation is the disparate tax treatment of service partners, such as private equity and hedge fund managers, who often receive capital gains treatment on

### A. Obama Administration's Fiscal Year 2010 Revenue Proposal

- In May 2009, the Obama Administration released a revenue proposal that would tax a service provider's share of partnership income attributable to a services partnership interest ("SPI") as ordinary income that is subject to self-employment tax, regardless of the character of the income at the partnership level.<sup>60</sup> Moreover, any gain recognized on the partner's sale of an SPI would be taxed at ordinary rates. The proposal would be effective as of January 1, 2011.
- An SPI is an interest in future partnership profits received by a person in exchange for services. The Obama proposal would apply to partnership interests issued for the provision of any type of services. By contrast, the Levin Bill (discussed below) would only apply to partnership interests issued for investment services.
- The proposal would not, however, recharacterize gain attributable to invested capital (*e.g.*, money or other property

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income attributable to carried interests, compared to other service providers whose receipt of compensation is generally taxed as ordinary income.

In addition to receiving capital gains treatment on their carried interests, private equity managers have attempted to convert the character of their fixed management fees from ordinary income into capital gains by waiving a portion of the fee in exchange for an increased interest in the fund's profits. *See generally* Polsky, Gregg D., *Private Equity Management Fee Conversions*, 122 Tax Notes 743 (Feb. 9, 2009); Sheppard, Lee A., *Carried Away: Management Fee Conversion*, 116 Tax Notes 532 (Aug. 13, 2007).

<sup>60</sup> General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, Department of the Treasury (May 2009), available at: <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>. *But see* Postlewaite, Philip F., 15 and 35: *Class Warfare in Subchapter K*, 122 Tax Notes 503 (Jan. 26, 2009) (suggesting that current tax treatment of profits interests is consistent with the overall approach of the Code).

contributed to the partnership), including any gain recognized on the sale of an SPI that is attributable to invested capital, provided the partnership reasonably allocates its income and losses between the invested capital and the remaining interest. Invested capital does not include any loan proceeds or other advances made or guaranteed by any partner or partnership.

- The proposal contains an anti-abuse rule that would treat any income or gain received with respect to a “disqualified interest” as ordinary income.<sup>61</sup> The anti-abuse rule is designed to prevent the avoidance of the above rules through compensatory arrangements other than partnership interests.
- The proposal will not adversely affect the qualification of a real estate investment trust owning a carried interest in a real estate partnership.

#### **B. Levin Bill<sup>62</sup>**

- In April 2009, Congressmen Sander Levin introduced a bill (the “Levin Bill”) that would tax as ordinary income or, to the extent allowed,<sup>63</sup> loss any

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<sup>61</sup> A “disqualified interest” includes convertible or contingent debt, an option, or any derivative instrument with respect to the entity, excluding a partnership interest or stock in certain taxable corporations.

<sup>62</sup> For a more detailed discussion of the Levin Bill, see Jackel, Monte A. and Crnkovich, Robert J., *Partnership Deferred Compensation and Carried Interest*, 2009 TNT 74-9 (Apr. 20, 2009). For discussions of prior versions of proposed carried interest legislation, see Scharfstein, Joel, *Proposed Carried Interest Legislation: The Interaction of Invested Capital and Book-ups*, 87 Taxes 151 (Mar. 2009), Carman, Paul, *Taxation of Carried Interests*, 87 Taxes 111 (Mar. 2009), Sheppard, Lee A., *Hedge Fund Managers’ Year-End Tax Planning*, 121 Tax Notes 1216 (Dec. 15, 2008), Schler, Michael L., *Taxing Partnership Profits Interests As Compensation Income*, 119 Tax Notes 829 (May 26, 2008).

<sup>63</sup> The Levin Bill would disallow losses greater than the excess, if any, of the aggregate net income with respect to such interest for all prior

allocation of net income or net loss with respect to any investment services partnership interest (“ISPI”).<sup>64</sup>

- The Levin Bill would also tax as ordinary income or loss gain or loss from the disposition of an ISPI, subject to certain limitations.<sup>65</sup>
- An ISPI is a partnership interest held by any person if it was reasonably expected at the time the interest was acquired that the person or certain related persons (as defined in section 267 or 707(b)) would provide, directly or indirectly, a substantial quantity of any of the following services (i) advising on the investment in, purchase or sale of any “specified asset,”<sup>66</sup> (ii) managing, acquiring or disposing of any specified asset, (iii) arranging financing relating to the acquisition of specified assets, or (iv) any activity in support of the foregoing services (clauses (i)-(iv), collectively, “ISPI Services”).

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taxable years, over the aggregate net loss with respect to such interest allowed pursuant to the bill for all prior partnership taxable years.

<sup>64</sup> H.R. 1935, 111th Cong. (2009). For an alternative proposal, see Borden, Bradley T., *A Win-Win Proposal for Analyzing Profits-Only Partnership Interests*, 121 Tax Notes 75 (Oct. 6, 2008) (suggesting that, instead of changing the character of allocations to partners, tax law should disregard any arrangements that fail to satisfy the definition of a tax partnership and determine whether any partners act in a nonpartner capacity).

<sup>65</sup> The Levin Bill would tax any loss on the disposition of an ISPI as an ordinary loss to the extent of the excess, if any, of the aggregate net income with respect to such interest for all partnership taxable years over the aggregate net loss with respect to such interest allowed pursuant to the bill for all partnership taxable years.

<sup>66</sup> Specified assets include securities (as generally defined in section 457(c)(2)), real estate held for rental or investment, partnership interests, commodities (as defined in section 457(e)(2)), options or derivative contracts with respect to any of the foregoing.

- The Levin Bill would generally not recharacterize allocations to holders' "qualified capital interests," if (i) the allocations are provided in the same manner as allocations made to partners that do not provide any ISPI Services, and (ii) the allocations made to such partners are significant compared with the allocations made pursuant to the qualified capital interest. A partner can hold both an ISPI and a qualified interest, *e.g.*, if the partner has contributed capital, or has undistributed assets previously taxed as ordinary income under the ISPI rules.<sup>67</sup>
- The Levin Bill would also treat certain other income or gain as ordinary income if (i) a person performs, directly or indirectly, "investment management services"<sup>68</sup> for any entity, (ii) the person holds a "disqualified interest"<sup>69</sup> in the entity, and (iii) the

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<sup>67</sup> A "qualified capital interest" is a partner's interest in partnership capital attributable to (i) the fair market value of any money or other property contributed to the partnership in exchange for the interest, (ii) any amounts included in gross income under section 83 with respect to the transfer of the interest, and (iii) the excess of any items of income and gain taken into account under section 702 with respect to the interest for taxable years to which the Levin Bill applies less any items of deduction and loss similarly taken into account. A "qualified capital interest" does not include any interest acquired in connection with any loan proceeds or other advance made or guaranteed, directly or indirectly, by any partner or the partnership, or by certain related persons.

<sup>68</sup> "Investment management services" means a substantial quantity of any of the ISPI Services.

<sup>69</sup> A "disqualified interest" is (i) any interest in the entity other than indebtedness, (ii) convertible or contingent debt of the entity, (iii) any option or other right to acquire any of the foregoing property, or (iv) any derivative instrument entered into, directly or indirectly, with the entity or any investor in the entity. However, a "disqualified interest" does not include a partnership interest, stock in a "taxable corporation", or stock acquired in an S corporation (except as otherwise provided by the Secretary). A "taxable corporation" is a domestic C corporation or a foreign corporation, substantially all of the income which is (i) effectively connected with

value of the interest, or payments thereunder, is substantially related to the amount of income or gain from the assets with respect to which the investment management services are performed.

- Any income or loss treated as ordinary as a result of the Levin Bill would be taken into account in determining net earnings from self-employment.

## VIII. SECTION 409A<sup>70</sup>

### A. Overview

- Section 409A generally applies to compensation that is deferred under a nonqualified deferred compensation plan after December 31, 2004. In brief, section 409A results in immediate taxation of, and an additional tax of 20% on, vested deferred compensation that does not satisfy the election and distribution requirements of section 409A.
- When section 409A was enacted as part of the American Jobs Creation Act of 2004, its application to compensatory transfers of partnership and LLC interests, together with many other issues, was left to be resolved by subsequent Treasury guidance. These compensatory transfers were addressed for the first time in Notice 2005-1.<sup>71</sup> Proposed treasury regulations providing extensive guidance on section 409A were issued on September 29, 2005 (the “proposed 409A regulations”) and final regulations were issued on April 17, 2007 (the “final 409A regulations”).<sup>72</sup> Neither the proposed nor final 409A regulations address the application of section

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a U.S. trade or business or (ii) subject to a comprehensive foreign income tax, as defined in section 457A(d)(2).

<sup>70</sup> This section of the outline is an updated version of an outline entitled Section 409A and Subchapter K, by Rolf Zaiss and Linda Swartz. My thanks to Mark Holdsworth and Megan Stombock for updating this section.

<sup>71</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005).

<sup>72</sup> REG-158080-04 (Sept. 29, 2005); T.D. 9321, 2007-1 C.B. 1123.

409A to arrangements between partners and partnerships. However, the preamble to the final 409A regulations did confirm that taxpayers may continue to rely on the interim guidance with respect to the issuances of partnership interests in connection with the performance of services in Notice 2005-1, and it provides additional interim guidance with respect to guaranteed payments under section 707(c) and payments subject to section 736.<sup>73</sup>

- The enactment of section 409A marks a sea change in the treatment of deferred compensation. The broad scope of section 409A extends beyond traditional deferred compensation arrangements to encompass certain equity-based compensation arrangements and thus makes tax-effective structuring of such arrangements more challenging. This overview briefly outlines the aspects of section 409A that are most relevant to LLC compensatory interests.

#### 1. Arrangements Covered by Section 409A

- Subject to certain limited exceptions, section 409A defines a “nonqualified deferred compensation plan” as any plan that provides for the deferral of compensation.<sup>74</sup> The overarching principle is that compensation is subject to section 409A if the income is not recognized in the first tax year in which the right to receive the income is no longer subject to a substantial risk of forfeiture.<sup>75</sup> For purposes of section 409A, a “plan” includes any agreement, method or arrangement, including one that applies to only one person.<sup>76</sup>

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<sup>73</sup> T.D. 9321, 2007-1 C.B. 1123, Preamble, section III.G.

<sup>74</sup> I.R.C. § 409A(d)(1).

<sup>75</sup> See Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 1.

<sup>76</sup> I.R.C. § 409A(d)(3). In addition, similar types of plans (*e.g.*, account balance plans) with respect to a given service provider are aggregated for purposes of applying section 409A.

- According to Notice 2005-1 and the proposed 409A regulations, a deferral of compensation occurs when a service provider has a legally binding right to receive compensation that is only payable (i) in a taxable year after the year in which the compensation was earned, *and* (ii) more than 2½ months after the end of the taxable year in which the compensation is no longer subject to a substantial risk of forfeiture.<sup>77</sup>
- Similarly, under the final 409A regulations, a plan generally provides for the deferral of compensation if the service provider has a legally binding right to compensation that is or may be payable in a later taxable year, unless the plan under which the payment is made does not provide for a deferred payment and the service provider actually or constructively receives such payment not more than 2½ months after the end of the first taxable year in which the payment is no longer subject to a substantial risk of forfeiture.<sup>78</sup> The final 409A regulations also clarify that a payment is treated as actually or constructively received if and when the payment is includible in income.<sup>79</sup>

## 2. Election Rules

- Initial Deferral Election Section 409A generally requires each participant in a plan to make an initial deferral election prior to the close of the year before the year in which the compensation is earned which specifies 409A a compliant time or form of distribution.
  - New Participants A newly eligible participant may make a deferral election for the year in which the participant becomes eligible to participate in a deferred compensation plan

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<sup>77</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4; Prop. Reg. § 1.409A-1(b).

<sup>78</sup> Treas. Reg. §1.409A-1(b)(1), (4).

<sup>79</sup> Treas. Reg. §1.409A-1(b)(4)(i)(B).

within 30 days of eligibility, but the election will only apply to defer compensation earned after the election is made.<sup>80</sup>

- Performance Based Compensation A special rule for “performance-based compensation” payable in respect of services to be performed over a period of at least twelve months permits deferral elections to be made as late as six months before the end of the relevant performance period.
- Change in Election Section 409A allows a deferred compensation plan to provide that a participant may elect to change the timing or form of distributions with respect to previously deferred amounts if (i) the election has a deferred effective date of at least one year, (ii) no payments are scheduled to begin within one year of the election, and (iii) distributions are deferred as a result of the election for at least an additional five years (except in the case of distributions relating to death, disability or unforeseeable emergency).

### 3. Distribution Rules

- In general, distributions from a deferred compensation plan may only be made upon one of the following: (i) a participant separates from service; (ii) a participant becomes “disabled”; (iii) a participant dies; (iv) at a specified time or on a fixed schedule that was determined at the time of deferral; (v) a change in ownership or effective control of the corporation; or (vi) an “unforeseeable emergency,” in which case payments may be made only to the extent necessary to satisfy the emergency and pay any taxes due in respect of the distribution.<sup>81</sup> Moreover, a deferred compensation plan may not accelerate the time or schedule of any payment under the plan.

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<sup>80</sup> I.R.C. § 409A(a)(4).

<sup>81</sup> I.R.C. § 409A(a)(2).

#### 4. Effective Dates

- As promulgated, Section 409A applied to (i) amounts deferred in respect of compensation earned in 2005 or thereafter, and (ii) previously deferred amounts that had not vested as of January 1, 2005. In general, deferred amounts that were vested before 2005 (and earnings on such deferrals) are grandfathered and generally may be paid out under the existing provisions of a deferred compensation plan. However, if an otherwise grandfathered deferred compensation plan is “materially modified” after October 3, 2004, amounts under the plan that were deferred and vested before 2005 will be subject to the requirements of section 409A.<sup>82</sup>
- As originally enacted, operational compliance with the section 409A requirements was required as of January 1, 2005. Documents governing deferred compensation arrangements were required to be amended no later than December 31, 2008 to comply with section 409A.<sup>83</sup>

#### 5. Penalties

- If a nonqualified deferred compensation plan that is subject to section 409A fails to satisfy the applicable section 409A requirements, either in form or operation, the participant would be subject to tax on his or her deferred amounts and any earnings thereon in the taxable year in which such amounts vest. In addition, the participant would be subject to an additional 20% tax on the deferred compensation and associated earnings in such tax year and interest on such tax at the underpayment

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<sup>82</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005); Section D; Prop. Reg. § 1.409A-6(a); Treas. Reg. § 1.409A-6(a).

<sup>83</sup> Notice 2007-86, 2007-2 C.B. 990 (extending to December 31, 2008 the transitional relief that was scheduled to expire on December 31, 2007 pursuant to Notice 2006-79), Notice 2006-79, 2006-2 C.B. 763; T.D. 9321, 2007-1 C.B. 1123, Preamble, section XIII(B).

rate plus 1% for the period during which the income was deferred.<sup>84</sup>

- Treasury recently released proposed regulations addressing the calculation of amounts includible in income under section 409A(a) and the additional 20% tax plus interest applicable to the income.<sup>85</sup>
  - The proposed regulations clarify that each tax year will be analyzed separately for purposes of determining compliance with section 409A.<sup>86</sup>
  - The proposed regulations permit the IRS to disregard a substantial risk of forfeiture for purposes of determining when nonvested deferred compensation is includible in income if the facts and circumstances indicate that a service recipient has a pattern or practice of allowing impermissible changes in the time and form of payment for nonvested deferred amounts under one or more plans.<sup>87</sup>

## B. Additional Guidance

### 1. Notice 2005-1 LLC Provisions

- Treasury issued Notice 2005-1, which provides the government's initial guidance regarding certain key issues raised by section 409A, on December 20, 2004. With respect to the compensatory transfer of partnership (and presumably LLC) interests, Notice

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<sup>84</sup> I.R.C. § 409A(a)(1).

<sup>85</sup> REG-148326-05, 73 Fed. Reg. 74,380 (Dec. 8, 2009). Treasury officials have acknowledged that the proposed regulations are burdensome to taxpayers and have requested suggestions for a safe harbor calculation method. *IRS Struggling with Income Inclusion Safe Harbor for Deferred Compensation*, 2009 TNT 101-6 (May 29, 2009).

<sup>86</sup> Prop. Reg. § 1.409A-4(a)(1)(ii)(A). Accordingly, a violation of the requirements of section 409A would apply only to amounts deferred in that year and prior years.

<sup>87</sup> Prop. Reg. § 1.409A-4(a)(1)(ii)(B).

2005-1 states that “section 409A is not limited to arrangements between an employer and an employee” and “may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan.”<sup>88</sup>

- Notice 2005-1 permits taxpayers to “treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock” under section 409A.<sup>89</sup> Notice 2005-1 also addresses the treatment of stock options and stock appreciation rights, and transfers of restricted property.<sup>90</sup>
- Notice 2005-1 sets forth the following interim rules for applying section 409A to partnerships, all of which are subject to change upon the issuance of further guidance:<sup>91</sup>
  - The issuance of a profits interest in connection with the performance of services will not be treated as resulting in a deferral of compensation if the issuance of the interest is not treated as includible in a service provider’s income under applicable guidance.
  - The issuance of a capital interest in connection with the performance of services may be treated in the same manner as the issuance of stock.

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<sup>88</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7. Although Notice 2005-1 does not specifically mention LLCs, this outline assumes that references to partnerships also apply to LLCs taxable as partnerships.

<sup>89</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

<sup>90</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4.

<sup>91</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

- The treatment of equity-based compensation grants determined by reference to partnership equity may be determined by analogy to the section 409A rules governing other stock-based compensation.
- Payments subject to section 736 may be excluded from section 409A unless they qualify as periodic retirement payments that may be excluded from the self-employment earnings of the retired partner under section 1402(a)(10).
- Payments to a partner not acting in the capacity of a partner under section 707(a)(1) are subject to section 409A if such payments would otherwise constitute a deferral of compensation under a nonqualified deferred compensation plan.
- As these rules illustrate, the principles of section 409A are not easily applied to the partnership tax rules under subchapter K.<sup>92</sup>

## 2. Proposed 409A Regulations

- Although the proposed 409A regulations do not address the application of section 409A to arrangements between partners and partnerships, the preamble to the proposed 409A regulations contains guidance with respect to the application of section 409A to guaranteed payments for services and confirms that taxpayers may continue to rely on the guidance provided in Notice 2005-1 in this area.
- The preamble provides that, pending further guidance, section 409A will apply to guaranteed

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<sup>92</sup> See Jackel, Monte A. and Crnkovich, Robert J., *Partnership Deferred Compensation and Carried Interest*, 2009 TNT 74-9 (Apr. 20, 2009) (noting that sections 409A and 457A properly have, and should continue to have, limited application to partnerships because partnerships are not income deferral vehicles and at least one partner is required to report the income earned by the partnership annually).

payments for services described in section 707(c) (and rights to receive guaranteed payments in the future) in cases where the partner providing services does not include the payment in income within 2 ½ months following the end of the taxable year in which the partner obtained a legally binding right to the payment, or, if later, the taxable year in which such payment vests.

- In the preamble, the government acknowledged that the application of section 409A to arrangements between partnerships and partners raises a number of issues relating to both the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to arrangements that are subject to section 409A, and specifically requested additional comments.

### 3. Final 409A Regulations

- Like the proposed 409A regulations, the final 409A regulations do not address the application of section 409A to arrangements between partners and partnerships. The preamble acknowledges that the statute and legislative history of section 409A neither specifically address nor expressly exclude such arrangements.
- Accordingly, the government is continuing to analyze issues in this area, including the coordination of the provisions of subchapter K and section 409A. Treasury representatives have indicated that guidance addressing the application of section 409A to partnerships and LLCs will not be provided until after the IRS addresses partnership equity compensation under section 83<sup>93</sup> and have further noted that guidance on the application of section 409A to partnership interests

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<sup>93</sup> *Deferred Compensation Section 409A Final Rules May Be Delayed Beyond Year's End, Treasury Official Says*, 212 DTR G-1 (Nov. 2, 2006); *Two IRS Officials Discuss Guidance For Reserved Issues Under Section 409A*, 75 DTR G-10 (Apr. 19, 2007).

is “in limbo” pending resolution of the proposed carried interest legislation.<sup>94</sup>

- The preamble provides that until further guidance is issued taxpayers may continue to rely on the interim guidance contained in Notice 2005-1 and the preamble to the proposed 409A regulations.
  - In particular, the preamble to the final regulations confirms that taxpayers may apply the principles applicable to stock options under the final 409A regulations to options to purchase a partnership interest. This approach is consistent with Q&A-7 of Notice 2005-1.
  - As indicated in the preamble to the proposed 409A regulations, section 409A will apply to guaranteed payments under section 707(c), and rights to receive guaranteed payments in the future, only where the guaranteed payment is for services and the partner providing the services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the payment or, if later, the taxable year in which the right to the guaranteed payment becomes vested.
  - Arrangements providing for payments subject to section 736 (payments to a retiring partner or deceased partner’s successor in interest) may be treated as not subject to section 409A, except for arrangements that provide for payments that are exempt from Self-Employment Contributions Act (“SECA”) tax under section 1402(a)(10).<sup>95</sup> In addition, the preamble to the final 409A regulations treats the legally binding right to payments excludible from SECA tax

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<sup>94</sup> *Partnership Guidance on Hold Pending Legislative Action, Treasury Officials Say*, 2009 TNT 100-3 (May 28, 2009).

<sup>95</sup> See Section VIII.B.6. for a detailed discussion of this issue.

under section 1402(a)(10) as arising on the last day of the partner's taxable year before the first taxable year in which such payments are excludible and treats the services for which the payments are compensation as being performed in the first taxable year in which such payments are excludible.

4. Technical Issues With the Application of Section 409A to Subchapter K

a. Scope of Section 409A

- General Approach Notice 2005-1 generally treats partnership interests as similar to the equity compensation arrangements of corporations, which creates ambiguities and uncertainties in situations where no effective deferral of partnership income occurs, as in the case of a service partner who recognizes his or her allocable share of the partnership's income as it is earned. The root of the problems that arise in applying section 409A to partnerships in accordance with the rules in Notice 2005-1 and the preambles to the proposed and final 409A regulations is that most compensatory arrangements under subchapter K result in taxation of compensatory payments (including transfers of certain partnership interests) to a service partner no later than when, and sometimes even before, the compensation-related payment is made. The subchapter C and section 83 principles of section 409A do not function effectively with respect to subchapter K, and income-inclusion principles such as constructive receipt are often not germane.
- The resulting mismatch in tax principles creates unusual (and likely unintended) outcomes that are traps for the unwary. A more effective approach may be to apply section 409A only in the limited situations in which compensatory arrangements under subchapter K provide an opportunity for

meaningful deferral of income. Until the application of section 409A to partnerships is limited, well-advised partnerships can comply, with some difficulty, with the guidance in Notice 2005-1 and the preambles to the proposed and final 409A regulations by carefully structuring their arrangements.

- “Deferred” Compensation The final 409A regulations generally define deferred compensation as a payment to a service provider pursuant to a legally binding right that is or may be payable in a later taxable year, unless the plan under which the payment is made does not provide for a deferred payment and the service provider actually or constructively receives such payment within 2½ months after the end of the first taxable year in which the payment is no longer subject to a substantial risk of forfeiture.<sup>96</sup> Because partnership arrangements are generally more fluid than compensatory arrangements of corporations, this concept can be challenging to apply to income under subchapter K.
  - It is not clear whether allocations under a partnership arrangement constitute legally binding rights, such as those encountered in the corporate context, because partnership allocations are commonly subject to amendment, including retroactive amendment, by a vote of the partners. However, the preamble to the final 409A regulations indicates that a legally binding right includes a contractual right that is enforceable under applicable law, indicating that the government may view legally binding rights as including enforceable rights to allocations, notwithstanding the possibility of retroactive amendment.<sup>97</sup> Of

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<sup>96</sup> Treas. Reg. § 1.409A-1(b)(1), (4).

<sup>97</sup> T.D. 9321, 2007-1 C.B. 1123, Preamble, section III(B).

course, to the extent income is allocated pursuant to a compensation agreement, a legally binding right would also exist.

- Query whether, as some commentators have suggested, even where a legally binding right does exist, such right may effectively be subject to a substantial risk of forfeiture until the partnership income is actually earned and allocated to the partners because compensation is subject to a substantial risk of forfeiture under Notice 2005-1 if it “is conditioned . . . on the occurrence of a condition related to the purpose of the compensation,” including, “for example, the attainment of a prescribed level of earnings, equity value or a liquidity event.”<sup>98</sup> Perhaps allocations based on partnership income could be viewed as contingent to the same extent as the payment of compensation upon the attainment of prescribed earnings levels.
- Delayed Distributions and Retained Capital and Tax Year Mismatch Notice 2005-1 and the proposed 409A regulations each provide that deferral is avoided only if the income has been both “actually or constructively received *and* included in gross income” (emphasis added).<sup>99</sup> On its face, this test would not provide any relief for partnership distributions made more than 2½ months after the end of a taxable year, because a partner is not treated as constructively receiving income that is allocated to the partner and included in the partner’s taxable income.
- This surprising result could cause part of the partner’s income to be treated as deferred

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<sup>98</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 10. Similar definitions apply under the proposed and final 409A regulations. *See* Prop. Reg. § 1.409A-1(d); Treas. Reg. § 1.409A-1(d).

<sup>99</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4(a); Prop. Reg. § 1.409A-1(b)(1).

compensation, even though the service partner would have been subject to tax on such allocated amounts in his or her prior taxable year. Similarly, retained capital of a partnership could be treated as “deferred” under the provisions of Notice 2005-1 and the proposed 409A regulations even though a partner will already have paid tax on his or her retained capital.

- The final 409A regulations provide additional guidance on these issues by providing that a payment is treated as actually or constructively received if the payment is includible in income.<sup>100</sup> Under this approach, partnership income would be treated as constructively received when allocated to service partners under section 704 in the year the partnership realizes the income. This approach should also ameliorate many potential deferral issues resulting from a mismatch between the tax years of a partnership and a partner.
- Section 706 Section 706 also essentially requires a partner to recognize partnership income in accordance with the accrual method of accounting (even if the partner is otherwise a cash basis taxpayer) whenever the partnership is on the accrual method. The caveat in Notice 2005-1 that section 409A does not apply to arrangements between taxpayers if all the taxpayers use the accrual method would not technically apply to cash basis partners.<sup>101</sup> Similarly, the exception under the proposed and final 409A regulations for deferrals by a service provider using an accrual method of accounting would not technically apply.<sup>102</sup> As a policy matter, however, section 409A should not apply

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<sup>100</sup> Treas. Reg. § 1.409A-1(b)(4)(i)(B).

<sup>101</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 8.

<sup>102</sup> Prop. Reg. § 1.409A-1(f)(2); Treas. Reg. § 1.409A-1(f)(2).

to income in respect of a partnership that uses the accrual method. It would be helpful if subsequent guidance confirms this result with respect to cash-basis partners in accrual-basis partnerships.

- *Caveat Payor* Unless and until further guidance resolves the foregoing issues, it may be advisable for partnerships to structure their compensatory arrangements, to the extent possible, to avoid exceeding the 2½ month distribution requirement or causing “deferrals” due to tax year mismatches or retained capital.

#### 5. Applying Section 409A to Section 707 Payments

- Section 707(a) Payments Notice 2005-1 provides that “section 409A may apply to payments covered by section 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under nonqualified deferred compensation plan.”<sup>103</sup> In general, like the receipt of a capital interest, most payments governed by section 707(a) would not result in a deferral of compensation. However, certain section 707(a)(1) payments could provide an opportunity for deferral, *e.g.*, where a service partner has a vested right to payment that is not due to be paid until a subsequent year. Such arrangements are appropriately subject to section 409A.
- Further guidance should clarify that subchapter K principles will determine whether a payment is made by a partnership to a partner not acting in his or her capacity as a partner for section 409A purposes. Moreover, due to the inherently fact-based nature of such a determination, it should not be subject to retroactive recharacterization absent clear error.

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<sup>103</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

- Guaranteed Payments To the extent determined without regard to the income of a partnership, section 707(c) treats payments made by a partnership to a partner for services as payments “made to one who is not a member of the partnership, but only for the purposes of section 61(a), relating to gross income and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).”
- The preambles to the proposed and final 409A regulations provide that, until further guidance is issued, section 409A will apply to a guaranteed payment for services (and rights to receive guaranteed payments in the future) only in cases where the partner providing services does not include the payment in income within 2½ months following the end of the taxable year in which the partner obtains a legally binding right to the payment, or, if later, the taxable year in which the payment vests.
- Since a partner includes guaranteed payments in his or her income in the taxable year during which the partnership deducts the payments as paid or accrued under the partnership’s accounting method,<sup>104</sup> a partner in an accrual basis partnership could be subject to tax on a section 707(c) payment before the payment is actually made. In no event would a partner be subject to tax later than the tax year of the partner ending in or with the tax year of the partnership in which payment is made. Therefore, guaranteed payments by an accrual basis partnership do not permit deferral of income from a prior taxable year, and thus should not be governed by section 409A as “deferred” payments. However, a vested right to receive guaranteed payments

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<sup>104</sup> Treas. Reg. § 1.707-1(c).

in a future year and guaranteed payments by a cash basis partnership could provide opportunities for deferral, as in the case of section 707(a) payments, where the timing of the payment to a service partner is delayed beyond the tax year in which a partner's right to the payment vests. These arrangements are appropriately subject to section 409A.

- As discussed above, on May 24, 2005, the IRS issued the proposed regulations on exchanges of partnership interests for services and the proposed revenue procedure addressing related issues.<sup>105</sup> The proposed regulations would amend the existing regulations under section 707(c) to provide that section 83 principles of income inclusion override the rule that guaranteed payments are included in a partner's income in the taxable year during which the partnership deducts the payments as paid or accrued under the partnership's accounting method. Therefore, under the proposed regulations, guaranteed payments would be includible in income when no longer subject to a substantial risk of forfeiture or earlier if an 83(b) election is made.<sup>106</sup> While this is a significant change in approach, it would not change the impact of section 409A on guaranteed payments generally because, as under the current section 707(c) regulations, unless the timing of the payment to a service partner is delayed beyond the tax year in

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<sup>105</sup> See REG-105346-03 (May 24, 2005); Notice 2005-43, 2005-1 C.B. 1221 (May 24, 2005).

<sup>106</sup> This would in turn determine the timing of the partnership's deduction, turning the timing rules under section 707(c) on their head.

which a partner's right to the payment vests, there would be no deferral of income.<sup>107</sup>

#### 6. Applying Section 409A to Section 736 Payments

- Section 736(a) governs most payments in respect of the liquidation of a retiring or deceased partner's interest in the partnership.<sup>108</sup> Such payments are treated as (i) a distributive share of partnership income if the amount is determined with reference to partnership income, or (ii) a guaranteed payment if it is not. Pending further guidance, Notice 2005-1 and the preamble to the final 409A regulations provide that section 409A applies to section 736(a) payments that are considered distributive shares of partnership income or guaranteed payments only if such payments are exempt from SECA tax under section 1402(a)(10).<sup>109</sup>
- SECA tax generally applies only to section 736(a) payments received by a partner who is still rendering services to the partnership, because such amounts can be viewed as current compensation. Once a partner has ceased to render services, his or her receipt of section 736(a) payments that otherwise comply with the exemption requirements in section 1402(a)(10), are no longer subject to SECA tax (such payments, "SECA-exempt payments"). The preamble to the final 409A regulations states that Treasury and the IRS believe it appropriate for such SECA-exempt payments to be subject to section

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<sup>107</sup> However, the timing of income inclusion might be accelerated in certain cases. *See* Section X below.

<sup>108</sup> Section 736 covers two types of payments in respect of a retiring or deceased partner. Section 736(b) governs payments made in exchange for the partner's interest in partnership property; the taxation of these payments is not covered by section 409A.

<sup>109</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7; T.D. 9321, 2007-1 C.B. 1123, Preamble, section III.G.

409A because they are intended to provide deferred compensation and do not raise coordination issues between sections 409A and 736.

- The preamble to the final 409A regulations provides additional relief concerning the application of the section 409A deferral election timing rules for SECA-exempt payments. The preamble provides that, until further guidance is issued, the legally binding right to SECA-exempt payments may be treated as arising on the last day of the partner's taxable year before the first taxable year in which such payments are excludible from SECA tax. Further, the services for which the payments are made may be treated as performed in the first taxable year in which such payments are excludible from SECA tax. As a result, for purposes of section 409A, the time and form of payment of such amounts generally may be established, and an election to defer may be made by the partner, on or before the final day of the partner's taxable year immediately preceding the first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10).<sup>110</sup> Accordingly, such payments could be structured to comply with the distribution requirements of section 409A.
- In the case of partial or "phased" retirement, a partner typically begins to receive a stream of section 736(a) payments while still rendering some services to the partnership. Since any section 736(a) payments made to a partner still rendering any services to a partnership cannot qualify as SECA-exempt

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<sup>110</sup> This interim relief does not apply a second time where, for example, a SECA-exempt payment is made in year one, and a payment in a subsequent year is not excludible from SECA tax under section 1402(a)(10), *e.g.*, because the partner performed services in that subsequent year. T.D. 9321, 2007-1 C.B. 1123, Preamble, section III.G.

payments, such payments would not be subject to section 409A.<sup>111</sup> However, continuing section 736(a) payments made after the partner fully retires and no longer provides any services during the partnership's taxable year would generally qualify as SECA-exempt payments, and would thus be subject to section 409A.<sup>112</sup> Under the special rules in the preamble, the time and form of payment of these continuing section 736(a) payments could be structured to comply with section 409A.

## IX. SECTION 457A

### A. Overview

- Congress enacted section 457A as part of the Emergency Economic Stabilization Act of 2008.<sup>113</sup> Section 457A targets deferred compensation plans of “nonqualified entities”, *i.e.*, offshore investment funds and other tax indifferent entities, and generally applies to amounts deferred which are attributable to services performed by a service provider after December 31, 2008.<sup>114</sup>

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<sup>111</sup> See Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

<sup>112</sup> See Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005); T.D. 9321, 2007-19, I.R.B. 1123, Preamble, section III.G.

<sup>113</sup> Pub. L. No. 110-343 (Oct. 3, 2008). For a discussion of section 457A and certain related issues see, Leeds, Mark and Keinan, Yoram, *The End of Deferral As We Know It: The New Rules Prohibiting the Deferral of Compensation Paid to U.S. Managers by Off-Shore Hedge Funds*, 26 J. Tax'n Inv. 9 (2009).

<sup>114</sup> Treasury officials have noted that section 457A's scope is broader than the original intent to tax U.S. managers of offshore hedge funds, as it may apply to any U.S. taxpayer who receives deferred compensation from a foreign employer, or to a nonresident alien with an existing deferred compensation arrangement who becomes a U.S. resident for U.S. federal income tax purposes. *Speakers Say Section 457A Complicates Deferred Compensation Programs*, 75 DTR G-7 (Apr. 22, 2009).

- Section 457A is similar to, and builds on certain concepts and rules in, section 409A. As the Joint Committee on Taxation has explained, section 457A supplements the requirements of section 409A.<sup>115</sup> Notice 2009-8, which interprets section 457A, highlights certain similarities and differences between sections 409A and 457A.<sup>116</sup>
- Section 457A authorizes Treasury to issue regulations that are necessary or appropriate to carry out the purposes of section 457A, including disregarding a substantial risk of forfeiture in certain cases.<sup>117</sup> No such regulations have been issued to date.
- In general, section 457A requires a taxpayer to include in gross income any compensation which is deferred under a “nonqualified deferred compensation plan” of a “nonqualified entity” when there is no “substantial risk of forfeiture” of the rights to the compensation.<sup>118</sup> If the amount of deferred compensation cannot be determined when there is no longer a substantial risk of forfeiture, the amount is includible in income when it becomes determinable and, at that time, is subject to an additional 20% tax plus interest at the underpayment rate plus 1%.<sup>119</sup>

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<sup>115</sup> Joint Committee on Tax’n, Explanation of Tax Legislation Enacted in the 111th Congress, JCS-1-09 (Mar. 2009).

<sup>116</sup> 2009-4 I.R.B. 347.

<sup>117</sup> I.R.C. § 457A(e). Officials have stated that Treasury would consider safe harbors when it issues regulations that follow Notice 2009-8. *Treasury Officials Address Guidance on COD Income, Nonqualified Deferred Compensation*, 2009 TNT 88-2 (May 11, 2009).

<sup>118</sup> I.R.C. § 457A(a).

<sup>119</sup> I.R.C. § 457A(c). The Joint Committee report states that it is intended that an amount of deferred compensation is not determinable at the time the amount is no longer subject to a substantial risk of forfeiture if the amount varies depending on the satisfaction of an objective condition. Joint Committee on Tax’n,

- The term “nonqualified deferred compensation plan” generally has the same meaning as under section 409A, but also includes any plan that provides for a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient.<sup>120</sup>
- Compensation is not treated as deferred, and thus is not subject to section 457A, if the service provider receives payment no later than 12 months after the end of the service recipient’s taxable year during which the right to payment of the compensation ceases to be subject to a substantial risk of forfeiture.<sup>121</sup>
- A “nonqualified entity” is (i) any foreign corporation, unless substantially all of its income is effectively connected with the conduct of a U.S. trade or business or subject to a “comprehensive foreign income tax,”<sup>122</sup> or (ii)

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Explanation of Tax Legislation Enacted in the 111th Congress, JCS-1-09 (Mar. 2009).

<sup>120</sup> I.R.C. § 457A(d)(3).

<sup>121</sup> I.R.C. § 457A(d)(3)(B). A payment is also not treated as deferred if it is made by the later of the 15th day of the third month following the end of the service provider’s or the service recipient’s first taxable year in which the right to the payment is no longer conditioned upon the future performance of services. Notice 2009-8, 2009-4 I.R.B. 347 (referring to amounts that qualify as short-term deferrals under Treasury regulation section 1.409A-1(b)(4)).

<sup>122</sup> The term “comprehensive foreign income tax” means, with respect to any foreign person, the income tax of a foreign country if that person is eligible for the benefits of a comprehensive income tax treaty between such foreign country and the United States, or demonstrates to the satisfaction of the Secretary that the foreign country has a comprehensive income tax. I.R.C. § 457A(d)(2). Treasury officials have requested comments on the meaning of “comprehensive income tax treaty”, and have explained that it is based on a facts and circumstances test. *Section 457A Compliance Questioned; Officials Ask for Comments on Guidance*, 89 DTR G-9 (May 12, 2009); *Treasury Officials Discuss Gaps in Nonqualified*

any partnership (U.S. or foreign) that does not allocate substantially all of its income to persons other than (a) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (b) organizations that are exempt from U.S. federal income tax.<sup>123</sup>

- A partnership is not a nonqualified entity, and thus is not subject to section 457A, if at least 80% of its gross income is allocated to persons other than (i) foreign persons with respect to which the income is not subject to a comprehensive foreign income tax, or (ii) tax-exempt organizations.<sup>124</sup>
- For a partnership that is either (i) required to file a U.S. partnership income tax return, or (ii) determines the distributive share of any partner's income for U.S. federal income tax

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*Deferred Compensation Guidance*, 2009 TNT 75-1 (Apr. 21, 2009).  
See also Notice 2009-8, 2009-4 I.R.B. 347.

<sup>123</sup> I.R.C. § 457A(b). Treasury officials have stated that, for purposes of determining whether an entity is “nonqualified”, only the U.S. government’s view of the entity is relevant; it does not matter how other jurisdictions view the entity. *Treasury Officials Discuss Gaps in Nonqualified Deferred Compensation Guidance*, 2009 TNT 75-1 (Apr. 21, 2009); *Section 457A Compliance Questioned; Officials Ask for Comments on Guidance*, 89 DTR G-9 (May 12, 2009). Future guidance may address issues not covered by Notice 2009-8 and/or modify the guidance provided in the Notice, including, for example, by expanding the definition of a “nonqualified entity”. See Notice 2009-8, 2009-4 I.R.B. 347.

<sup>124</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 11(a). Whether a partnership constitutes a nonqualified entity is determined as of the last day of the service provider’s taxable year based on the allocations (or deemed allocations) of gross income by the partnership to its partners for the partnership’s taxable year ending with or within the service provider’s taxable year. If a partnership does not yet have a taxable year that has ended or ends on the last day of the service provider’s taxable year, a reasonable, good faith estimate of such allocation (or deemed allocation) of the partnership for its current taxable year must be used to make the determination. Notice 2009-8, 2009-4 I.R.B. 347, Q&A 13(b).

purposes, the gross income of the partnership for section 457A purposes is the same as for U.S. federal income tax purposes and allocations of income to the partners are the actual tax allocations of the partnership for the relevant taxable year (such partnerships, “U.S. relevant partnerships”).<sup>125</sup>

- By contrast, gross income is determined for all other partnerships by using any reasonable method that incorporates the gross income principles of U.S. federal income tax law, and amounts are deemed allocated to a partner to the extent the partner includes the income in its gross income on a current basis under the income tax laws of the partner’s resident country, whether or not the income is distributed to the partner (“non-U.S. relevant partnerships”).<sup>126</sup>
- Gross income of a tiered partnership that is allocated to a partner under the rules for U.S. relevant and non-U.S. relevant partnerships may be treated as income allocated to any direct or indirect owner of such partner that includes the income in its gross income on a current basis under the income tax laws of the partner’s resident country, other than under an anti-deferral regime, regardless of whether the income is distributed to the partner.<sup>127</sup>
- A “substantial risk of forfeiture” exists when the taxpayer’s right to compensation is conditioned on the future performance of substantial services

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<sup>125</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 11(b).

<sup>126</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 11(c).

<sup>127</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 11(d).

by any individual.<sup>128</sup> Notably, unlike the definition of substantial risk of forfeiture under sections 83 and 409A, substantial risk of forfeiture for section 457A purposes does not include satisfaction of a compensation-based condition.

- In addition, to the extent provided by any future Treasury regulations, if compensation is determined solely by reference to the amount of gain recognized on the disposition of an “investment asset”<sup>129</sup> (without offset or adjustment for losses on other assets), the compensation will be treated as subject to a substantial risk of forfeiture until the asset is disposed of.<sup>130</sup>
- Treasury officials have confirmed in response to practitioners’ questions regarding how regulations would interpret this exception that the investment asset exception is not effective unless and until Treasury issues regulations.<sup>131</sup>
- Performance fees paid to fund managers with respect to “side pockets” (separate accounts used to manage illiquid or hard-to-value securities of a fund) typically relate to

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<sup>128</sup> I.R.C. § 457A(d)(1)(A).

<sup>129</sup> An “investment asset” is any single asset (other than an investment fund or similar entity) (i) acquired directly by an investment fund or similar entity, (ii) with respect to which neither the entity nor any person related to the entity participates in the active management of the asset (or if the asset is an interest in an entity, in the active management of the activities of the entity), and (iii) substantially all of any gain on the disposition of which (other than the deferred compensation) is allocated to investors in the entity. I.R.C. § 457A(d)(1)(B).

<sup>130</sup> I.R.C. § 457A(d)(1)(B).

<sup>131</sup> *Section 457A Compliance Questioned; Officials Ask for Comments on Guidance*, 89 DTR G-9 (May 12, 2009).

more than one asset and therefore would be subject to section 457A. If “side pocket” performance fees can be restructured as profits interests, section 457A would not apply under current guidance.

## **B. Notice 2009-8 LLC Guidance**

- With respect to the compensatory transfer of partnership (and presumably LLC) interests, Notice 2009-8 permits taxpayers to rely on the applicable guidance under section 409A.<sup>132</sup> This guidance includes Notice 2005-1, which permits taxpayers to “treat the issuance of a partnership interest (including a profits interest), or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock”, section II.E of the preamble to the proposed 409A regulations and section III.G of the preamble to the final 409A regulations.<sup>133</sup>
- Notice 2009-8 also addresses the treatment of stock options and stock appreciation rights. Like section 409A, Notice 2009-8 exempts from section 457A non-statutory stock options that satisfy the requirements in the final 409A regulations, *i.e.*, (i) the option is related to service recipient stock, (ii) the option’s exercise price is never less than the fair market value of the underlying stock on the date of grant and the number of shares subject to the option is fixed on the date of grant, (iii) the transfer or exercise of the option is subject to taxation under section 83, and (iv) the option does not generally include any deferral features.<sup>134</sup> Notice 2009-8 also

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<sup>132</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(a) (permitting reliance on Notice 2005-1, 2005-1 C.B. 274, Q&A 7; section II.E. of the preamble to the proposed section 409A regulations; and section III.G. of the final section 409A regulations).

<sup>133</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

<sup>134</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(b).

exempts statutory stock options from section 457A.<sup>135</sup>

- Notice 2009-8 also exempts from section 457A stock appreciation rights that must be and are settled in service recipient stock, and that satisfy the requirements in the final 409A regulations, *i.e.*, (i) compensation payable under the stock appreciation right cannot be greater than excess of the fair market value of the stock on the exercise date over the stock appreciation right exercise price with respect to the number of shares fixed on or before the grant date, (ii) the exercise price of the right may never be less than the fair market value of the underlying stock on the grant date, and (iii) the right does not generally contain any deferral features.<sup>136</sup>
  - Notably, cash-settled stock appreciation rights are not exempt from section 457A.
- Taxpayers' permitted reliance on the current guidance under section 409A with respect to arrangements between partners and partnerships means that section 457A will only apply to guaranteed payments for services under section 707(c), and other rights to receive such guaranteed payments in the future, where the partner providing the services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the payment or, if later, the taxable year in which the right to the guaranteed payment becomes vested.
  - Arrangements providing for payments to a retiring partner or deceased partner's successor in interest under section 736 may be treated as not subject to section 457A, except for

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<sup>135</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(b).

<sup>136</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(b) (cross-referencing Treas. Reg. § 1.409A-1(b)(5)(i)(A)).

arrangements that provide for payments that are exempt from SECA tax under section 1402(a)(10). In addition, the legally binding right to payments excludible from SECA tax under section 1402(a)(10) is treated as arising on the last day of the partner's taxable year before the first taxable year in which such payments are excludible and the services for which the payments are compensation are treated as being performed in the first taxable year in which such payments are excludible.

**X. APPLICATION OF SECTION 409A AND SECTION 457A TO TRANSFERS OF COMPENSATORY LLC INTERESTS**

The proposed regulations apply section 83 to all compensatory partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Under the proposed regulations, a partnership interest that is transferred in connection with the performance of services for that partnership (either before or after the formation of the partnership) is treated as a guaranteed payment. Although the proposed regulations and the proposed revenue procedure clarify certain aspects of existing guidance (*e.g.*, that a section 83(b) election can be made with respect to a restricted capital interest), address certain open issues (*e.g.*, that liquidation value can be used as a measure of fair market value if certain requirements are met) and modify some existing guidance (*e.g.*, by making a profits interest taxable upon vesting), there are only limited instances in which the proposed regulations and the proposed revenue procedure may impact the tax consequences under section 409A and section 457A. These are noted below where appropriate.

**A. Capital Interests**

- Under Notice 2005-1, the issuance of a compensatory capital interest is treated in the same manner as the issuance of stock, *i.e.*, pursuant to the section 83 rules (which is consistent with the

approach of the proposed regulations).<sup>137</sup> For purposes of section 457A, Notice 2009-8 permits taxpayers to rely on the existing guidance under section 409A with respect to an arrangement between a partner and a partnership and, thus, would also treat the issuance of a compensatory capital interest in a nonqualified entity in the same manner as the issuance of stock.<sup>138</sup>

- Like an outright grant of stock, the issuance of an unrestricted capital interest would not result in the deferral of compensation because its value would be included in the recipient's income upon issuance. Subsequent income earned in respect of the capital interest would also typically not result in the deferral of compensation, as the concept is commonly understood, because a partnership's income is immediately allocated among its partners, who are subject to tax on such income. This is true even if a compensatory capital interest is issued to a partner not acting in the capacity of a partner, because a partnership's taxable income is not susceptible to deferral in either the partnership's or the partner's hands.<sup>139</sup> The receipt of an unrestricted compensatory capital interest is an immediately taxable event and since subsequent income earned in respect of the capital interest is not susceptible to deferral, it would be appropriate to exclude the issuance and holding of a compensatory capital interest from section 409A and section 457A.
- Subsequent guidance would ideally exempt both grants of unrestricted capital interests,

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<sup>137</sup> See Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4 and Q&A 7.

<sup>138</sup> See Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(a) (permitting reliance on Notice 2005-1, 2005-1 C.B. 274, Q&A 7; section II.E. of the preamble to the proposed section 409A regulations; and section III.G. of the final section 409A regulations).

<sup>139</sup> See, e.g., Rev. Rul. 70-435, 1970-2 C.B. 100.

and annual changes in a partner's share of capital, income, and unrealized appreciation, in order to clarify that such changes do not constitute deferred compensation, even if viewed as new transfers of partnership interests.

- The receipt of a restricted compensatory capital interest is not a taxable event at the time of transfer, unless the recipient makes a section 83(b) election, which the proposed regulations clarify is permissible. If the service partner is taxed on the fair market value (as opposed to the liquidation value) of the capital interest when the capital interest vests or when a section 83(b) election is made, no compensation would be deferred. In general, there is no meaningful opportunity to defer income with respect to a restricted capital interest beyond the period of the associated substantial risk of forfeiture, *i.e.*, once the interest vests. However, it may be appropriate for section 409A and section 457A to apply to a transfer of a restricted compensatory capital interest, or a promise to deliver a capital interest in the future, where such interest or promise is not contingent on the performance of substantial future services if such a transfer or promise were considered a form of deferred compensation.<sup>140</sup>

## **B. Profits Interests**

- Notice 2005-1 specifically exempts profits interests from the application of section 409A, as long as the recipient of the profits interest is not required to include the value of the interest in income at the time of issuance under applicable guidance.<sup>141</sup> For purposes of section 457A, Notice 2009-8 permits

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<sup>140</sup> The same would be true of a restricted profits interest with respect to which there is a failure to book up capital accounts upon grant or vesting, as this failure would result in a capital shift when the profits interest vests.

<sup>141</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7.

taxpayers to rely on existing guidance under section 409A with respect to an arrangement between a partner and a partnership and, thus, section 457A should not apply to such a profits interest.<sup>142</sup>

- In general, under currently applicable guidance, neither the receipt nor vesting of a compensatory profits interest is a taxable event.<sup>143</sup> Therefore, as a policy matter, the value of such a profits interest, if any, should not be subject to section 409A or section 457A. Since no income is recognized currently, no income can be deferred. Of course, to the extent a profits interest has a readily ascertainable value at the time of grant, it is unclear whether Notice 2005-1 would continue to exempt profits interests from section 409A and Notice 2009-8 would continue to exempt profits interests from section 457A.<sup>144</sup>
- Under section 83 principles that would apply to a compensatory profits interest under the proposed regulations, the vesting of a compensatory profits interest would be a taxable event requiring the service provider to include the value of the profits interest in income.

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<sup>142</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(a) (permitting reliance on Notice 2005-1, 2005-1 C.B. 274, Q&A 7; section II.E. of the preamble to the proposed section 409A regulations; and section III.G. of the final section 409A regulations). Treasury officials have stated that “if a taxpayer is comfortable with respect to carried interest under section 409A, the taxpayer should be comfortable under section 457A.” *Speakers Say Section 457A Complicates Deferred Compensation Programs*, 75 DTR G-7 (Apr. 22, 2009).

<sup>143</sup> Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. After the receipt, or vesting of a restricted profits interest, the service provider (now a service partner) would, of course, recognize his or her allocable share of future partnership income as and when earned by the partnership.

<sup>144</sup> Rev. Proc. 93-27 carves out exceptions to the tax-free receipt of a profits interest that (i) relates to a substantially certain stream of income from LLC assets, (ii) is disposed of within two years of receipt, or (iii) is a limited interest in a publicly traded LLC.

- Similarly, under the proposed regulations, an unrestricted compensatory profits interest, which is vested at issuance (or a restricted profits interest with respect to which an 83(b) election is made), would be includible in income at the time of issuance (presumably even if the value of the interest at the time was zero). In that case, the issuance of the profits interest would not be exempt from section 409A, under Notice 2005-1 or from section 457A under Notice 2009-8. However, since any income in respect of the issuance would be recognized at the time of issuance under section 83, there would be no deferral. In the case of a non-partner service provider who is issued an unrestricted compensatory profits interest, or a restricted profits interest with respect to which a section 83(b) election was made, subsequent distributions in respect of his or her profits interest would be treated as partnership distributions under subchapter K.
- By contrast, in the case of a restricted profits interest for which no section 83(b) election was made, subsequent distributions would be treated as compensation, *i.e.*, ordinary income. It is not clear whether such distributions would be guaranteed payments. Query whether the same payments to a service provider who is already a partner at the time of the issuance of a restricted profits interest would be treated compensation income in respect of such interest if a section 83(b) election were not made.

### **C. LLC Options and Equity Appreciation Rights**

- The application of section 409A and section 457A to partnership options and appreciation rights is more meaningful and appropriate than their application to capital or profits interests. This logical distinction results because an option or an appreciation right with respect to either corporate stock or partnership equity that is granted below fair market value represents an inherent deferral of

income to the extent of the discounted exercise price.

- As discussed below, several issues remain with respect to the application of section 409A and section 457A to options and appreciation rights for partnerships and LLCs.
- The utility of options and appreciation rights for partnerships and LLCs is limited by the restrictive definition of “service recipient” contained in Notice 2005-1 and the proposed and final 409A regulations. The Notice adopts the controlled group test of sections 414(b) and 414(c), essentially requiring an 80% ownership relationship (*i.e.*, parent-subsiary or brother-sister) among entities in order to treat them as a single service recipient under section 409A.<sup>145</sup> The proposed and final 409A regulations expand this definition of “service recipient” by allowing the controlled group test of sections 414(b) and 414(c) to be applied using a 50% threshold (instead of 80%) and, where the grant of a stock option or stock appreciation right is due to legitimate business criteria, by using a 20% threshold.<sup>146</sup> This approach may be generally workable in the corporate context. However in the partnership context, arrangements often exist whereby the member is granted an option or appreciation right of a related entity (*e.g.*, a general partner, joint venturer or portfolio company) where the grant is directly related to the member’s activities, but the necessary controlled group relationship is lacking. This difficulty is inherent in the variable structure of partnerships and might be better addressed by using a more appropriate standard, such as a control-based test, for partnerships and LLCs.

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<sup>145</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 5.

<sup>146</sup> Prop. Reg. § 1.409A-1(b)(5)(iii)(D); Treas. Reg. § 1.409A-1(b)(5)(iii)(D).

- Another important issue that must be addressed is the appropriate measure of value, either liquidation value, which is typically utilized throughout subchapter K or the fair market value, of the partnership or LLC interest (as modified by the proposed regulations and proposed revenue procedure if enacted), which is typically utilized for corporate equity interests.
- The issues raised by the section 409A requirements described below and section 457A in the case of nonqualified entities are likely to encourage LLCs to grant compensatory profits interests rather than options or appreciation rights.

a. LLC Options

- According to Notice 2005-1 and the preamble to the final 409A regulations, the treatment of compensatory issuances of LLC-based awards other than capital or profits interests may be governed, by analogy, to the section 409A rules covering equity-based awards.<sup>147</sup> Therefore, the treatment of compensatory LLC options can be determined by reference to the section 409A treatment of nonstatutory stock options.<sup>148</sup> Similarly, for purposes of section 457A, the treatment of compensatory LLC options can be determined by analogy to the section 409A rules governing nonstatutory stock options of corporations.<sup>149</sup>

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<sup>147</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 7; T.D. 9321, 2007-1 C.B. 1123, Preamble, section III.G. The preamble to the final 409A regulations also confirms that taxpayers may apply the principles contained in the final 409A regulations to compensatory partnership options and appreciation rights.

<sup>148</sup> The application of section 409A to compensatory partnership options and appreciation rights on the same basis as corporate awards together with the imposition of the section 83 regime on such options under the proposed regulations would simplify a previously complex and uncertain area of tax law.

<sup>149</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(b); Treas. Reg. § 1.409A-1(b)(5)(i)(A).

- Notice 2005-1 and the proposed and final 409A regulations state that the grant of a nonstatutory stock option with respect to stock of a service recipient does not result in a deferral of compensation, and therefore avoids section 409A, *only if* (i) the option exercise price is never less than the fair market value of the underlying stock on the date of grant, (ii) the receipt, transfer or exercise of the option is subject to taxation under section 83 (which is made clear under the proposed regulations), and (iii) the option does not include any additional deferral features.<sup>150</sup> If any of these requirements are not satisfied, the option would be subject to section 409A, and if issued by a nonqualified entity, would also be subject to section 457A.
- LLC options should be able to satisfy requirements two and three above. However, the requirement that the exercise price of an option at least equal the fair market value of the underlying equity interest may be difficult to satisfy with certainty, except perhaps upon formation of an LLC, due to the impracticability of valuing intangible or other illiquid LLC assets in connection with each option grant. LLCs may wish to coordinate option grants with valuation events to minimize this problem.
- The fair market value requirement with respect to options raises a potential issue due to the fact that under subchapter K, liquidation value is used to determine the value of compensatory partnership interests.<sup>151</sup> Although this discontinuity could be resolved by treating liquidation value as fair market value for purposes of valuing partnership options, that solution would in turn create discontinuities between the taxation of corporate and

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<sup>150</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4(d)(ii); Prop. Reg. § 1.409A-1(b)(5); Treas. Reg. § 1.409A-1(b)(5).

<sup>151</sup> Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.

partnership options. The fair market value requirement raises the same issues for equity appreciation rights for purposes of section 409A.

- The proposed regulations and proposed revenue procedure address, but do not entirely resolve, the valuation issue by providing a safe harbor under which the liquidation value of an interest in a partnership that is transferred to a service provider by a partnership in connection with the provision of services to the partnership will be treated as its fair market value. Therefore, to the extent a safe harbor election under the proposed regulations is in effect at the time of the grant of a compensatory option to acquire an interest in the partnership, the fair market value requirements of section 409A and section 457A should be satisfied. Although it would be useful for subsequent guidance to state this explicitly, the safe harbor requirements may be somewhat cumbersome for certain partnerships to satisfy. In that case, the fair market valuation problem remains.
- If the requirements applicable to nonstatutory stock options are not satisfied with respect to an option to acquire an LLC capital or profits interest, the option holder would presumably recognize income when the option vests equal to the excess of the fair market value of the LLC interest underlying the option, over the amount of the exercise price, on the vesting date. This amount would also be subject to an additional 20% tax, with interest, under section 409A. Similarly, if the requirements applicable to nonstatutory stock options are not satisfied with respect to an option to acquire an LLC capital or profits interest in a nonqualified entity, the option holder would be taxed under section 457A upon vesting. If the amount includible in income under section 457A is not then determinable, it would also be subject to an

additional 20% tax, with interest when it becomes determinable.

b. LLC Equity Appreciation Rights

- Notice 2005-1 initially provided that compensation based on appreciation in value of a specified number of shares of service recipient stock are treated as deferred compensation subject to section 409A, unless, (i) the exercise price of the right is equal to the fair market value of the stock on the date of grant, (ii) the right settles only in stock, (iii) the stock is traded on an established securities exchange, and (iv) the right does not contain any additional deferral features.<sup>152</sup> In response to comments criticizing the differing treatment of stock options and stock appreciation rights under the proposed and final 409A regulations, stock appreciation rights are treated in the same manner as stock options, regardless of whether the stock appreciation rights are settled in cash and/or based on service recipient stock that is not traded on an established securities exchange.<sup>153</sup> Accordingly, the treatment of LLC appreciation rights for purposes of section 409A should parallel that of LLC options under the proposed 409A regulations, discussed above.
- For purposes of section 457A, a taxpayer may not treat equity appreciation rights in a non-corporate entity in the same manner as equity appreciation rights in a corporate entity.<sup>154</sup> Rather, any such rights would appear to be subject to section 457A, which is not a surprising result given the express statutory inclusion of the “right to compensation based on the appreciation in value of a specified number of equity units of the service recipient.” By contrast, however, an equity appreciation right of a nonqualified entity that is a foreign corporation

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<sup>152</sup> Notice 2005-1, 2005-1 C.B. 274 (Jan. 10, 2005), Q&A 4(d)(iv).

<sup>153</sup> Prop. Reg. § 1.409A-1(b)(5); Treas. Reg. § 1.409A-1(b)(5).

<sup>154</sup> Notice 2009-8, 2009-4 I.R.B. 347, Q&A 2(b).

would be exempt from section 457A if the section 409A requirements are satisfied.<sup>155</sup>

## **XI. CONCLUSION**

The proposed regulations, if finalized, would substantially change the government's approach to the taxation of compensatory interests, but leave many questions unanswered. In addition, the proposed carried interest legislation, if enacted, could (and likely would) result in significant revisions to the proposed regulations.

Sections 409A and 457A further complicate the taxation of compensatory partnership interests. It is clear that many unresolved issues remain with respect to the application of sections 409A and 457A to transfers of compensatory interests in partnerships and LLCs. While many such transfers generally provide for little, if any, deferral opportunity, they nonetheless may be subject to the deferred compensation regimes of sections 409A and 457A.

Accordingly, partnerships and LLCs should structure their arrangements to either be exempt from, or comply with, the requirements of section 409A, as amplified in Notice 2005-1 and the preambles to the proposed and final 409A regulations, to the greatest extent possible. Similarly, partnerships and LLCs that are nonqualified entities should structure their nonqualified deferred compensation arrangements to be exempt from the requirements of section 457A, as amplified in Notice 2009-8.

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<sup>155</sup> I.R.C. § 457A(d)(3)(A).