A LAYMAN'S GUIDE TO LLC INCENTIVE COMPENSATION©

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A LAYMAN'S GUIDE TO LLC INCENTIVE COMPENSATION*

I. INTRODUCTION

This outline examines the U.S. tax consequences surrounding the use of equity based compensation by partnerships and limited liability companies[1] (each, an "LLC").[2] The grant of compensatory LLC equity interests and the vesting of restricted LLC equity interests raise some of the thorniest issues of Subchapter K, including the necessity of bookups, the occurrence and effect of capital shifts and other hypothetical transactions, and the ancillary tax consequences of a service provider becoming a member.[3]

These issues are discussed in detail in Section II of this outline and are also discussed briefly in subsequent sections with respect to different types of LLC interests. Sections III through VI discuss the federal income tax consequences to service providers, LLCs and other LLC members of granting restricted and unrestricted

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* I am deeply indebted to my colleague Jean M. Bertrand for her collaboration with me on this outline in 2000 and to Sheldon I. Banoff, Shane J. Stroud, Hoon Lee and Alexander F. Anderson for their thoughtful contributions in subsequent years. I'm also very grateful to Jessica W. Seaton, in particular for her organizational suggestions, and to Simon Friedman, for inspiring my interest in this topic with his excellent Partnership Securities article (1 Florida Tax Review 521 (1993)) and for his patience years ago in teaching me enough partnership tax lore to allow me to make sense of the law.

1 Throughout this article LLC is used to refer to both partnerships and LLCs, and member is used to refer to both partners in a partnership and members in an LLC.

2 This article does not discuss the 2005 proposed regulations regarding partnership (and LLC) compensatory interests or the interaction of section 409A and subchapter K. For a discussion of these issues, *see* Swartz, L. Z., *Section 83(b), Section 409A, Section 457A and Subchapter K*, published in the PLI LLC and Corporate Tax Conference materials.

3 Another very important consideration in choosing among types of compensatory LLC interests, which is beyond the scope of this outline, is the accounting treatment accorded each type of interest.

capital and profits interests, options to acquire LLC interests, and virtual options such as equity appreciation rights.

As the following sections make clear, there is no single "best" type of compensatory LLC interest for all parties. Certain types of interests are more favorable for service providers (*e.g.*, interests for which taxation is deferred or for which a section 83(b)[4] election may be made showing a zero value for the interest). Other types of interests may be more favorable for the other LLC members (*e.g.*, fully vested interests that produce an immediate deduction for the LLC). Accordingly, the choice of what type of interest to issue will vary depending on the importance accorded each party's tax position in a given transaction.

The degree of certainty parties require with respect to the tax treatment of the compensatory interest will also be an important factor in choosing among interests, since each type of compensatory interest raises different tax questions. In particular, there are more questions than answers regarding the taxation of restricted profits interests and options. After spending altogether too many hours contemplating these issues, I am sure of only one thing-some element of the tax treatment of each type of LLC compensatory interest is, at best, gray.

II. GENERAL ISSUES REGARDING COMPENSATORY LLC INTERESTS

- The issuance and vesting of LLC compensatory interests raise a host of issues regarding bookups, capital shifts and attendant deemed asset transfers. As a threshold matter, it is well worth considering whether the cost of administering the mark to market regime described below, including bookups, capital shifts and deemed asset transfers, is justified. Granted, bookups (and to a lesser extent, capital shifts) are clearly fundamental to the workings of the section 704(b) safe harbor. Stepping outside those rules, however, it is less clear that any benefit obtained by requiring LLCs to mark to market non-liquid assets and members'

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[4] All references to sections are to sections of the Internal Revenue Code of 1986, as amended, or to Treasury Regulations promulgated thereunder.

interests each time a new compensatory interest is granted or vests (sometimes weekly, at the height of the dot.com boom) is worth the administrative cost of complying with the complex rules and policing those who fail to comply. While this paradigm may have served its original purpose well-policing the sale of tax benefits through real estate tax shelters-the author would submit that it doesn't work nearly as well for the dot.com LLCs and other operating company joint ventures of the new millennium.

A. Revaluations of LLC Assets

- The tax consequences and, more importantly, the quantum of interest transferred to a service provider, will often vary considerably depending on whether the assets are marked to market in connection with the issuance and vesting of compensatory interests. This result can be achieved either through a "bookup" of the LLC's assets or through the issuance of a separate class of LLC units representing an interest in profits/capital created after the date of issuance. As described below, the latter choice often has significant appeal. As discussed below, regulations now permit an LLC to take advantage of the section 704(b) rules to effect a bookup.[5]

- If an LLC's assets are not marked to market, the recipient of a profits interest would also effectively receive an allocable portion of the appreciation in value of the LLC's assets since the date of its last bookup. This transfer may come as quite a surprise to the other members of an LLC who agreed (or so they thought) only to forgo a portion of their interests in future LLC profits. Moreover, this inadvertent issuance of a part-capital, part-profits interest could subject a service provider to tax upon

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[5] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii); Section 704(b) and Capital Account Revaluations, REG-139796-02, 68 F.R. 39498 (July 2, 2003).

receipt of the capital portion of such an interest.[6] To avoid these results, it is important for an LLC to revalue its assets, and to be able to support the fair market values of its assets, on the revaluation date. An artificially low asset value will produce the same issues (albeit of a smaller magnitude) as a failure to revalue assets.[7]

- The IRS has confirmed that the issuance and vesting of a bifurcated profits interest are each non-taxable events under Revenue Procedures 93-27 and 2001-43.[8] The ability of a taxpayer to bifurcate a capital and profits interest and the resulting treatment of the bifurcated interests had been unclear, although IRS officials had informally suggested that such an interest could be bifurcated to permit the unvested profits

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6 *See* Priv. Ltr. Rul. 2003-29-001 (July 21, 2003).

7 As discussed in the text that follows, the valuation of a profits interest granted to a service provider raises several difficult, and perhaps insoluble, issues. For example, the value the parties place on such an interest may differ from the value of the corresponding portion of the LLC's assets. Since Treasury Regulation section 1.704-1(b)(2)(iv)(f) requires that capital accounts be revalued on the basis of the LLC's assets, a bookup will not eliminate any inside-outside value differences. Moreover, it is not clear how, if at all, the value of a service provider's future services affects the value of the LLC's assets. Perhaps only a service provider's interest, and not other members' interests, should have additional value ascribed to it, although the resulting disparity in the values of similar or identical interests may create other equally difficult issues.

8 Priv. Ltr. Rul. 2003-29-001 (July 21, 2003).

In order to satisfy the requirements of Revenue Procedures 93-27 and 2001-43, the partnership represented that (i) it was not a publicly traded partnership, (ii) it was not anticipated that the units would be disposed of within two years, (iii) the partnership would treat the unit holders as partners for all federal income tax purposes, and (iv) the units would not be related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.

interest to qualify for treatment under Revenue Ruling 2001-43.[9]

- The ruling's sensible bifurcation of the part-capital, part-profits interest is particularly welcome since the partnership rules generally contemplate single LLC interests.[10] However, due to its redacted nature, the ruling provides no guidance as to how such partial interests would be valued, either in the aggregate or as a relative matter. Possible bases for valuation would include fair market value or capital account balance, in the latter case with or without a discount to the anticipated distribution date.[11]

- Under the section 704 regulations, an LLC may revalue its assets in connection with the LLC's grant of a compensatory capital or profits interest. The compensatory interest can be granted to an existing partner, or to a new

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[9] *See, e.g.*, "Panel Discusses Guidance on Receipt of Profits Interest", 2001 TNT 197-4.

[10] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(b) (second-to-last sentence provides that each partner has only a single capital account even if multiple interests are held); Rev. Rul. 84-53, 1984-1 C.B. 159 (a partner has only one basis even if multiple interests are held); *Chase v. Commissioner*, 92 T.C. 874 (1989) (redemption of limited partner interest not complete redemption because general partner interest retained); *Hensel Phelps Construction Co. v. Commissioner*, 703 F.2d 485 (10th Cir. 1983) (no bifurcation of limited and general partnership interests); *compare* G.C.M. 37193 (July 13, 1977) (separate capital and profits interests); *United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984) (same); *United States v. Frazell*; 335 F.2d 487 (5th Cir. 1964) (same).

[11] A number of general questions also remain unanswered. For example, the ruling does not address the ability of the service provider to make a valid section 83(b) election, the treatment of a service provider whose services are rendered to a party other than the LLC (such as a member), or the treatment of a service provider holding an unvested profits interest that lapses, is forfeited or is transferred.

partner (acting either in a partner capacity or in anticipation of becoming a partner).[12]

- The IRS appeared to support revaluing LLC assets when compensatory interests are granted in a private ruling on the topic.[13] Although the IRS did not rule specifically on the validity of the bookup, it is fair to assume the bookup affected the values of the profits interests issued for services that were the subject of the ruling.

- Notably, any bookup must take into account the consequences of any reverse section 704(c) allocations required thereafter, which may otherwise negate the effect of the bookup.

  - Treasury Regulation section 1.704-1(b)(2)(iv)(f)(5) describes four circumstances under which an LLC is specifically permitted to revalue or "book up" its property, including its intangible assets such as goodwill: (i) a contribution of money or other property to the LLC as consideration for an LLC interest; (ii) a liquidation of the LLC or a distribution of money or other property by the LLC in consideration for an LLC interest; (iii) when granting a non-de minimis interest to an existing partner, or to a new partner (acting either as a partner or in anticipation of becoming a partner); or (iv) under generally accepted industry accounting practices, provided that substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, or similar instruments that are readily tradable on an established securities market.

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[12] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii).

[13] Priv. Ltr. Rul. 2003-29-001 (July 21, 2003).

- A supplemental rule (the "q" rule) also provides that if the specific bookup rules fail to provide guidance as to how particular adjustments to LLC capital should be made, such adjustments must be made to equalize members' capital accounts with the LLC's capital in a manner consistent with the members' economic arrangement (such adjustments must also be based on Federal tax accounting principles to the extent practicable).[14]

- Even before regulations were issued, two theories justified a bookup when granting compensatory LLC interests. First, if the LLC is treated as issuing an interest in exchange for a deemed cash or property contribution from the service provider, as discussed in Section II.C. below, that deemed contribution may constitute a specifically permitted bookup event.[15] Second, even if such a bookup does not constitute one of the four specifically enumerated events in the regulations, the supplemental "q" rule that permits bookups in circumstances where guidance is lacking should support a bookup.[16]

- Before regulations were issued, the LLC's tax counsel could have also effected a "phantom bookup" by issuing separate classes of LLC interests limited to future profits or capital and/or special allocations of income to a service provider solely with respect to taxable periods after issuance or vesting of restricted interests.[17] Such allocations should have satisfied the

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[14] Treas. Reg. § 1.704-1(b)(2)(iv)(q).

[15] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i).

[16] Treas. Reg. § 1.704-1(b)(2)(iv)(q).

[17] A similar allocation method is also used after a contribution of built-in gain property without a corresponding bookup. Treas. Reg. § 1.704-1(b)(5), Ex. 14(iv).

section 704(b) requirements because they would have been in accordance with the members' interests in the LLC, even though they may have lacked the vaunted substantial economic effect. Presumably, given the final 704 regulations, LLCs that maintain capital accounts no longer need to rely on such valuations (although those that nevertheless choose to effect phantom bookups may be well advised to make such special allocations out of gross income in order to more closely track the parties' business deal).

B. Capital Shifts

- The IRS has a long history of successfully asserting that a shift in capital among partners produces a taxable event both for the member receiving capital[18] and, if an "appreciated" capital interest is transferred, for the transferring members.[19]

- Capital shifts can take many forms, but a capital shift generally occurs when a member with a capital interest agrees to forgo part or all of its right to proceeds on liquidation of the LLC. Accordingly, a shift of unrealized appreciation in the LLC's assets is thought to produce a taxable capital shift.[20]

    - Consistent with this definition, a capital shift could theoretically occur when an unrestricted

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[18] Treas. Reg. § 1.721-1(b)(1) (fair market value of capital shifted to service partner is ordinary income to recipient).

[19] *See, e.g.*, *Lehman v. Commissioner*, 19 T.C. 659 (1953); *Farris v. Commissioner*, 22 T.C. 104 (1954), *rev'd and remanded*, 55-1 USTC ¶ 9411, 222 F.2d 320 (10th Cir. 1955); *U.S. v. Frazell*, 335 F.2d 487 (5th Cir. 1964); *National Oil Company v. Commissioner*, 52 T.C.M. 1223 (1986) (determination of whether capital shift has occurred is based on tax accounting principles).

[20] *See McDougal v. Commissioner*, 62 T.C. 720 (1974), *acq.* 1975-2 C.B. 2; *Edgar v. Commissioner*, 56 T.C. 717, 747 (1971); *Johnston v. Commissioner*, T.C. Memo. 1995-140; *see also* S. Rep. No. 86-1616, at 117-19 (1960) (1960 proposed legislation that was never enacted would have confirmed this position).

interest is issued, when a restricted interest vests, and when a preferred interest is converted into a common interest.[21] The amount of the capital shift is typically thought to equal the service provider's undivided interest in the LLC's assets. As Shelley Banoff astutely points out, however, the value of the assets deemed transferred in the capital shift will generally exceed the value of the service provider's LLC interest once liquidity and minority discounts are applied to his or her interest. As a result, the LLC's books won't balance, and I shudder to think of the section 704(b) machinations necessary to force that result.

- In connection with the issuance or vesting of a compensatory interest, it may also be argued that the services performed for the LLC have increased the value of the LLC's assets (and so its aggregate capital), theoretically permitting the LLC to avoid a capital shift whenever the increase in capital equals or exceeds the value of the compensatory interest. Not surprisingly, the IRS has yet to adopt this view.

C. Hypothetical LLC Transfers When Compensatory Interests Are Issued

- The quantum of interest received and the resulting tax consequences to the service provider and the LLC's other members each generally depend on whether some type of consideration, *e.g.*, cash or an undivided interest in the LLC's assets, is deemed to be received by a service provider and then used to acquire the LLC interest.[22]

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[21] *See* 1996 FSA LEXIS 246 (June 25, 1996) (profits interest may subsequently be transformed into a capital interest by virtue of a taxable capital shift).

[22] An additional consequence of issuing new LLC interests that this outline does not analyze in detail is the effect of re-allocating liabilities under section 752 when a new member is admitted. The minimum gain chargeback rules would generally govern reallocations of nonrecourse debt, but reallocations of recourse or

- One of two hypothetical transactions may be deemed to occur. Each transaction can be theoretically supported, and in the absence of controlling authority, an LLC will presumably choose to adopt the more favorable approach based on its particular facts and circumstances. The IRS may of course counter with another, less taxpayer favorable recast.

1. Deemed Asset Transfer

    - Under this theory, the LLC is deemed to transfer an undivided interest in each of its assets, or the LLC's members are deemed to transfer LLC interests, to the service provider, which the service provider is treated as immediately re-contributing to the LLC in exchange for an LLC interest.

    - If an LLC holds appreciated assets, including, notably, goodwill, and the members hold appreciated LLC interests, the LLC or its members may be treated as recognizing gain upon the deemed asset/LLC interest transfer. The IRS may assert this theory based on the general principle that gain is generally imposed when appreciated property is transferred as compensation for services.[23] Note that the LLC or its members may also recognize loss with respect to deemed transfers of its depreciated assets subject to section 267. LLC gain or loss may be allocable only to the old members under section 706(d) principles, in a manner consistent with section 704(c), since the gain or loss would

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guaranteed debt may produce taxable deemed distributions and should be carefully analyzed.

[23] *See* Treas. Reg. § 1.83-6(b) ("Except as provided in section 1032, at the time of a transfer of property in connection with the performance of services the transferor recognizes gain to the extent that the transferor receives an amount that exceeds the transferor's basis in the property."); *see also*, *e.g.*, *General Shoe Corp. v. U.S.*, 60-2 USTC ¶ 9678, 282 F.2d 9 (6th Cir. 1960); *Riley v. Commissioner*, 64-1 USTC ¶ 9254, 328 F.2d 428 (5th Cir. 1964).

be recognized immediately before the service provider receives his or her LLC interest.

- Because only a small portion of the LLC's assets would generally be deemed transferred in any hypothetical transaction, any interest "purchased" with the assets would still constitute a part-capital interest unless the LLC's assets are booked up. It is not clear whether a bookup avoids a capital shift entirely under these circumstances, since the capital account received by the service provider will exceed any amount paid for the interest and may exceed any amount deemed paid for the interest. In any event, a bookup immediately before the issuance of the interest would minimize the value of the interest received, and the amount of any capital shift.

2. Deemed Cash Transfer

- Alternatively, the LLC could be deemed to transfer cash (rather than an interest in the LLC's assets) to the service provider in exchange for his or her services. If so, the service provider would be deemed to immediately re-contribute the cash to the LLC in exchange for his or her LLC interest.

- Under this analysis, the other LLC members would not recognize gain in connection with a deemed transfer of appreciated LLC assets. This analysis can be supported by analogy to the section 1032 rules that sanction deemed cash transfers for corporations. Given the identical purpose of section 721 (and its virtually identical language), a different result should not properly obtain for LLCs.

    - Unfortunately, no controlling authority in the partnership area compels a deemed cash payment. In the absence of an analog to the section 1032 regulations (which explicitly treat a corporation's issuance of its stock for services as a transfer of cash to its employee

that is re-contributed in exchange for stock), the IRS may not feel compelled to extend this beneficial (and proper) treatment generally to LLCs.[24]

- As in the case of a deemed asset transfer, a capital shift may occur regardless of whether assets are booked up, if the capital account received by the service provider exceeds the amount paid (or deemed paid) for the interest. However, a bookup immediately before the issuance of the interest would minimize the amount of any capital shift.

3. Actual Loan and Cash Purchase of LLC Interest

- To avoid the possibility that the IRS may deem a transfer of assets or cash to have occurred, an LLC may wish to actually borrow and loan to the service provider funds sufficient to purchase the LLC interest.

    - These transactions may limit the negative consequences to the other members of the LLC, but they are nonetheless vulnerable to be recast by the IRS. For example, the IRS may seek to disregard the circular flow of cash between the LLC and the service provider, and instead either treat one of the deemed transactions described above as having occurred, or treat the service provider as having not actually acquired the LLC interest at all (*e.g.*, as having acquired only an option to acquire the interest).

- Alternatively, the service provider could be treated as receiving ordinary income in the amount of the cash received and then purchasing the LLC interest. In that case, although the IRS could raise the same capital shift issues discussed above with respect to deemed transfers, a strong argument can be

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[24] *See* Treas. Reg. §§ 1.1032-1(a), 1.721-1.

made that no capital shift occurred because the interest was paid for with new borrowed capital.

D. Employee vs. Member Status for Service Providers

- The IRS has consistently ruled that LLC members may not properly be treated as employees, and has announced that it will not follow case law to the contrary.[25] In essence, the issue of when an employee is transformed into a member is one of timing and character of income. A service provider who is an employee generally will recognize ordinary income, but only when paid. On the other hand, a service provider who is a member of an LLC recognizes his or her allocable share of the LLC's ordinary income or capital gain as and when it is realized by the LLC.

- It is generally unclear whether, and if so, when, a service provider becomes a member as a result of receiving a compensatory LLC interest. The following lines of authority all bear directly or indirectly on this question:

  - Revenue Procedure 93-27 The receipt of a profits interest in exchange for services is generally not a taxable event to a service provider acting in a member capacity or in anticipation of being a member.[26] Treating the service provider as an employee for non-income tax purposes should not affect the applicability of Revenue Procedure 93-27, or Revenue Procedure 2001-43 (discussed below), although this result is not certain.

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[25] *See* Rev. Rul. 69-184, 1969-1 C.B. 256 (members cannot be employees for FICA, FUTA and withholding purposes); GCM 34001 (Dec. 23, 1969); GCM 34173 (July 25, 1969); *compare Armstrong v. Phinney*, 68-1 USTC ¶ 9355, 394 F.2d 661 (5th Cir. 1968) (partnership member permitted to exclude meals and lodging expenses from gross income because section 707(a) permits a member to have both member and employee status). The IRS has announced that it will not follow *Armstrong*.

[26] *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

- Revenue Procedure 2001-43 A service provider who is granted a restricted (substantially nonvested) profits interest will be treated as receiving the interest in a non-taxable transaction on the date of its grant, provided, among other requirements, that the service provider is treated as the owner of the LLC interest from the date of the grant (including for purposes of allocating distributive shares of income, gain, loss, deduction and credit associated with the interest).[27] Notably, the Revenue Procedure does not provide that a service provider actually becomes a member, and does not make clear whether the individual will be treated as a member for all tax purposes, or merely for purposes of recognizing his or her allocable share of the LLC's income.

- Section 83 Section 83 likely imposes tax on the receipt of an LLC interest by an employee or an independent contractor (if the interest has an ascertainable fair market value). However, this result is not clearly mandated and commentators have long questioned the applicability of section 83 to service providers who become members of the LLC as a result of the receipt of an LLC interest. As discussed below, even if section 83 does not apply to the receipt of such an interest, section 707(a) may separately impose tax on a service provider receiving a capital interest.

- Section 707 Section 707(a) provides that if a member engages in a transaction with an LLC other than in his or her capacity as a member, the transaction will be treated as occurring between the LLC and a party who is not a member. Although Treasury is authorized to promulgate regulations to determine when allocations and distributions should be treated as payments to a member not acting in his or her

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[27] *See* Rev. Proc. 2001-43, 2001-2 C.B. 191.

capacity as a member,[28] no regulations have been issued.

- The 1984 Committee Report to section 707, which sets out factors to be considered in promulgating the regulations, still represents the only guidance on this issue.[29] Entrepreneurial risk appears to be the determining factor under section 707 as to when and under what circumstances a service provider should be treated as a member.[30] Accordingly, perhaps a service provider should be treated as a member if and when the distributions he or she is entitled to receive with respect to a compensatory interest depend on the LLC's profits.

- Even if the receipt of a particular LLC interest transforms a service provider into a member, and section 83 did not apply to the transaction as a result of the service provider's new member status, section 707(a) may treat the service provider as receiving the interest in a non-member transaction, resulting in the imposition of tax.

- Consistent with Revenue Procedure 2001-43, the author suggests that a service provider should be treated as a member only if and when his or her income depends on the profits of the LLC, *i.e.*,

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[28] *See* I.R.C. § 707(a)(2)(A).

[29] *See* S. Rep. No. 98-169, at 223-32 (1984).

[30] For an excellent discussion of this issue *see* Sowell, James B., *Partners as Employees: A Proposal for Analyzing Partner Compensation*, Tax Notes, Jan. 15, 2001, p. 375; Karch, Gary C., *Equity Compensation By Partnership Operating Businesses*, 74 Taxes 722 (1996); *compare* Priv. Ltr. Rul. 95-33-008 (May 9, 1995) (service provider who was entitled to a share of general partner's profits but had no right to participate in partnership affairs was not considered a partner).

whenever the service provider bears the entrepreneurial risk of the LLC's business. Under this test, the point at which a service provider becomes a member would vary depending on the form of compensatory interest issued. Until Revenue Procedure 2001-43 was issued, it was not clear in many cases (other than perhaps the receipt of an unrestricted capital interest) when a service provider would be considered a member, and we welcome its clarity regarding member treatment, at least for purposes of distributive share allocations. However, the IRS should clarify the open question of whether a service provider will be treated as a member for all tax purposes, including those discussed below.

1. Ancillary Tax Consequences of Employee vs. Member Status

   a. Tax Consequences of Employee Status

      - All amounts paid to an employee or independent contractor constitute ordinary income when paid. The income is reported on a Form W-2 for employees and on Form 1099 for independent contractors. LLCs are required to satisfy wage withholding tax requirements with respect to payments made by the LLC to an employee.[31]

      - LLC employers and their employees are liable for specified employment tax payments (*e.g.*, FICA: 6.2% for employees and 6.2% for employers on the first $118,500 of wages paid to the employee in 2015). The employer and employee must each also pay a Medicare hospital tax equal

[31] I.R.C. § 3402; Treas. Reg. § 31.3402(g)-1(a)(2).

to 1.45% of the total (uncapped) amount of wages paid to the employee.[32]

b. Tax Consequences of Member Status

- A member is subject to tax on his or her share of the LLC's income (other than guaranteed payments) when such income is realized by the LLC consistent with the LLC's method of accounting, regardless of when (or if) the income is distributed to the member. Accordingly, service providers may fairly be expected to negotiate for mandatory tax distributions from LLCs when they are (or fear they may be) treated as LLC members.

- Each member's allocable share of LLC income and loss is reported to the member on a Schedule K-1 to Form 1065. Guaranteed payments produce ordinary income for members receiving the payments in the year in which the payment is paid or accrued under the LLC's method of accounting.[33]

    - The character of a member's distributive share of LLC income is determined at the LLC level, and each member's allocable share of the income retains that character in the member's hands. However, guaranteed payments always give rise to ordinary income that is non-

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[32] The Affordable Care Act imposes an additional Medicare tax of 0.9% on the employee-paid portion of the Medicare hospital tax for amounts in excess of the applicable statutory threshold. The threshold annual compensation amounts for imposition of this additional Medicare tax are (1) $250,000 for married taxpayers who file jointly; (2) $125,000 for married taxpayers who file separately; and (3) $200,000 for single and all other taxpayers.

[33] Treas. Reg. § 1.707-1(c).

passive, non-portfolio income for section 469 purposes.[34]

- No withholding is required with respect to members' LLC income, including income from capital shifts.[35] Instead, LLC members are subject to estimated tax with respect to their allocable shares of LLC income.[36]

- A general member's distributive share of ordinary income from an LLC's trade or business (other than dividends, interest and real estate rental income) constitutes "net earnings from self-employment" ("NESE"), which is subject to self-employment tax.[37] By contrast, a "limited partner's" share of income or loss, except with respect to guaranteed payments for services, is not considered NESE.[38]

  - Widely criticized 1997 proposed regulations would subject most LLC members to tax on their NESE due to the extremely narrow definition of "limited members," who are the only members exempt from tax on NESE.[39]

    - Generally, an individual is <u>not</u> treated as a limited member under the proposed regulations if he or she (i) is personally liable for debts or claims against the LLC; (ii) has authority to contract on behalf of the LLC; or (iii) participates in the

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[34] *See* Rev. Rul. 69-184, 1969-1 C.B. 256.

[35] *See* Rev. Rul. 69-184, 1969-1 C.B. 256.

[36] I.R.C. § 6654; *see also* Treas. Reg. § 1.707-1(c).

[37] I.R.C. § 1402(a).

[38] I.R.C. § 1402(a)(13).

[39] Prop. Treas. Reg. § 1.1402(a)-2(h).

LLC's trade or business for more than 500 hours during the year. Service members cannot be limited.[40]

- Congress, which viewed the regulations as a "stealth tax" designed to usurp its legislative role by extending the scope of self-employment tax, responded to the proposed regulations by enacting legislation to preclude the issuance of final NESE regulations through July 1, 1998. Although that date has long since passed, the proposed regulations have not been finalized or withdrawn. In the absence of final regulations, LLC service providers did not embrace the view that they were subject to tax on their NESE.[41]

- In 2011, the Tax Court held that the exclusion from NESE for "limited partners" was intended to ensure that individuals who merely invest in a partnership and who are not actively

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[40] Prop. Treas. Reg. § 1.1402(a)-2(h). Individuals not described in the enumerated qualifications may also be considered limited members if they satisfy one of two exceptions provided by the proposed regulations. The first exception is for certain individuals holding more than one class of interests and the second is for holders of only one class of interest who do not meet the qualifications of limited member status solely by reason of participating in the LLC's trade or business for more than 500 hours during the year. *See* Prop. Treas. Reg. § 1.1402(a)-2(h)(3)-(4); *NYSBA Comments on Self-Employment Regs*., 97 TNT 59-24 (March 17, 1997) (suggesting that participation in an LLC's business should be the only measure of whether an owner is a limited member); *New York City Bar Suggested Modification on Limited Partnership Regs*., 97 TNT 113-33 (June 12, 1997) (suggesting that individuals lacking personal liability for LLC obligations and not participating more than 500 hours per year in the LLC's trade or business should be treated as limited members).

[41] One exception may be individuals seeking to maximize their qualified compensation to take advantage of increased contribution limits for qualified retirement plans under the 2001 tax act.

participating in the partnership's business operations would not receive credit toward Social Security coverage.[42] Accordingly, the court held that the "limited partner" exclusion applied only to individuals who passively invest in a partnership and did not apply to partners of a law firm operating as an LLP (acting in the manner of self-employed persons).

- In brief, *Renkemeyer* further limits the exception from NESE to only passive limited partners rather than all limited partners, or even the subset of limited partners that the 1997 proposed regulations excepted. IRS officials have been quoted as saying that the holding in *Renkemeyer* is consistent with what the statute intended,[43] but have also said that the IRS will not challenge pass-through entities that rely on the more generous 1997 proposed regulations to structure transactions.[44]

    - As Shelley Banoff foreshadowed, the Court's analysis in *Renkemeyer* may be a harbinger of the characterization of general and limited partners under other Code sections and Treasury Regulations.[45] In 2012, a Federal

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42 *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).

43 *See* Elliott, Amy S., *Renkemeyer Rationale Consistent With Statute, IRS Official Says*, Tax Notes, May 30, 2011, p. 903.

44 *See* Trivedi, Shamik, *After Renkemeyer, Passthroughs Can Still Rely on Proposed Regs*, Tax Notes, May 16, 2011, p. 675.

45 Banoff, Sheldon I., *Renkemeyer Compounds the Confusion in Characterizing Limited and General Partners – Parts 1 and 2*, 115 J. Tax'n 306 (Dec. 2011) and 116 J. Tax'n 300 (June 2012); *see Howell v. Commissioner*, TCM 2012-303 (guaranteed payments to

district court cited *Renkemeyer* and held that an individual cannot be an employee and a partner of the same partnership.[46] In May 2014, an IRS official confirmed the IRS's intent to provide guidance on the issue.[47] Shortly thereafter, the IRS Office of Chief Counsel issued Chief Counsel Advice (CCA) 201436049, which held that service provider members of an investment management company organized as an LLC were not "limited partners" within the meaning of section 1402(a)(13), and thus were subject to self-employment tax on their distributive shares from the LLC. While a CCA cannot be used or cited as precedent, CCA 201436049 provides some additional insight into the views of the IRS on the scope of section 1402(a)(13) and what parameters IRS guidance on the issue may take once it is ultimately issued.

- The government's 2014-2015 Priority Guidance Plan lists guidance on the application of section 1402(a)(13) to limited liability companies as a priority project.[48]

- LLC members also forfeit several non-income tax subsidies available to employees.

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limited partner found to be attributable to services and so subject to self-employment tax).

46 *Riether v. United States*, 919 F. Supp.2d 1140 (D.N.M. 2012).

47 *See* Elliott, Amy, *IRS Guidance Expected on Dual Partner/Employee Status*, Tax Notes, May 26, 2014, p. 889.

48 This project continued to be listed as a priority project in each of the first, second and third quarter updates issued by the Treasury and IRS.

- Members do not qualify for tax-free employer subsidized health insurance.[49] Instead, health insurance premiums paid by LLCs are treated as guaranteed payments, taxable as ordinary income to members and deductible by the LLC.[50] Members are also permitted to deduct 100% of such premiums.[51]

- Members may not participate in cafeteria plans.[52]

- No portion of group-term life insurance funded by the LLC may be excluded from a member's income.[53]

- Somewhat less favorable rules regarding overtime meals and lodging and other fringe benefits apply to members.[54]

2. Planning Strategies to Reduce Self-Employment Tax

   - LLC members seeking to avoid the unfavorable self-employment tax treatment associated with member status may consider holding their membership interests through a separate entity or arranging employment by a separate entity.[55] While these and other structures may yield

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49 I.R.C. § 105.

50 Rev. Rul. 91-26, 1991-1 C.B. 184.

51 I.R.C. § 162(l)(1). Such deductions are limited to the taxpayer's earned income from the LLC's trade or business, and are not allowed for self-employment tax purposes.

52 I.R.C. § 125(d)(1).

53 I.R.C. § 79.

54 I.R.C. § 132(e); Treas. Reg. §§ 1.132-1(b)(4), 1.132-6(d)(1).

55 For an excellent discussion of the employment tax and related issues resulting from partnership employee classification, *see* Sowell, James B., *Partners as Employees: A Proposal for Analyzing Partner Compensation*, Tax Notes, Jan. 15, 2001, p. 375.

favorable employment tax treatment, it is also important to weigh the other less favorable income tax consequences that could result if the IRS recasts the transactions.

- In one increasingly popular structure, LLC service providers contribute their options or membership interests to a separate S corporation. Since the S corporation is a member of the LLC rather than the service providers, the service providers should not be treated as LLC members for self-employment tax purposes. It should be possible to structure the S corporation in such a manner that it will be respected, although the IRS may seek to recast the arrangement as a disguised sale.[56]

- An LLC can also create a separate service corporation to directly employ its service providers and lease their services to the LLC. This structure could allow service providers to hold direct interests in an LLC while being treated as S corporation employees for employment tax purposes. However, such a structure may entail substantial recast risk; taxpayers should carefully consider the statutory and common law principles under which the IRS and courts would determine whether the LLC or the affiliated corporation controls the activities of the employee, including in particular the payment of the employee's wages.[57]

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[56] *See, e.g.*, *Commissioner v. Bollinger*, 485 U.S. 340 (1988); *but see* ABA Tax Section, *Questions and Answers Relating to Section 707(a) of the Internal Revenue Code*, 87 TNT 63-57, Q & A 41 (indicating that an S corporation held by a single shareholder providing services to a partnership by the individual may be recast in a manner causing section 707(a)(2)(A) to apply).

[57] *See generally*, Sowell, James B., *A Road Map for Employment Tax Audits*, Tax Notes, May 20, 1996, p. 1091 at 1096-1097. *See* I.R.C. § 3401(d) (applicable to federal withholding taxes); Treas. Reg.

- LLCs may also wish to compensate LLC service providers with stock and options in an affiliated corporate member in lieu of LLC interests. As discussed below in Section V.D., the recent section 1.1032-3 regulations make the issuance of options and stock in a corporate member a viable strategy. However, this structure could also be recast by the IRS as a direct LLC interest,[58] and the use of an affiliated corporation would impose a second level of tax on LLC earnings distributed to shareholders of the corporation.

III. LLC CAPITAL INTERESTS

A. Definition

- A capital interest entitles the holder to a distribution of his or her allocable share of the proceeds if and when the LLC's assets are sold at fair market value in connection with a complete liquidation of the LLC.[59] A restricted capital interest is a capital interest that is non-transferable or is subject to a substantial risk of forfeiture.[60]

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§ 31.3401(c)-1(b); Treas. Reg. § 31.3121(d)-1(c)(2); Rev. Rul. 87-41, 1987-1 C.B. 296 (providing a list of 20 factors relied upon to characterize an employees status). Under section 3401(d), the term "employer" applies to the person who controls the payment of an employee's wages. *See also Otte v. U.S.*, 419 U.S. 43, 51 (1974); *In re Armadillo Corp.*, 561 F.2d 1382, 1386 (10th Cir. 1977); *General Motors Corp. v. U.S.*, 67 AFTR2d 520 (E.D. Mich. 1990) (all expanding the applicability of section 3401(d) to include FICA and FUTA taxes).

[58] In particular, this structure may involve additional risk when membership interests in the LLC are transferred for less than their fair market value.

[59] Rev. Proc. 93-27, 1993-2 C.B. 343; *see also Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171, 1176 (1990), *aff'd*, 969 F.2d 669, 674 (8th Cir. 1992).

[60] A person's rights in property are subject to a substantial risk of forfeiture if his or her rights to full enjoyment of the underlying

B. Unrestricted Capital Interests

1. Service Provider Consequences

- The transfer of an unrestricted capital interest (*i.e.*, a fully vested capital interest issued in exchange for services) is a taxable event.[61] The individual receiving the interest will immediately recognize income equal to the fair market value of the capital interest, reduced by the amount, if any, that the employee pays for the interest.[62] This income will be ordinary compensation income, subject to wage withholding and payroll taxes if the recipient has been an employee.[63]

- Upon receipt of an LLC capital interest (which, by definition, includes a profits interest), the IRS would likely treat the recipient as a member of the LLC.[64] As discussed in Section II.E. above, significant income and non-income tax consequences obtain when a service provider becomes a member of an LLC. As a member, the service provider would be entitled to a share of the LLC's profits and losses and would be subject to tax, as and when the LLC realizes

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property at issue are conditioned upon the future performance of substantial services by any individual. I.R.C. § 83(c)(1).

61 *See Mark IV Pictures, Inc.*, 60 T.C.M. 1171 (1990), *aff'd*, 969 F.2d 669 (8th Cir. 1992) (applying section 83); *see also* Treas. Reg. § 1.721-1(b)(1) (providing, like section 83, that issuance of capital interests to service providers is taxable in the year in which the interests are no longer contingent on the service provider's performance of services).

62 I.R.C. § 83(a); Treas. Reg. § 1.721-1(b)(1).

For an excellent discussion of the nuances and methods of valuing a capital interest, *see* Banoff, Sheldon I., *What's the Value of a Capital Interest Received for Services?*, 96 J. Tax'n 57 (2002).

63 *See* Treas. Reg. § 1.721-1(b)(1).

64 *See Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd,* 703 F.2d 485 (10th Cir. 1983); *Mark IV Pictures, Inc.*, 969 F.2d 669 (8th Cir. 1992), *aff'g* 60 T.C.M. 1171 (1990).

taxable income. Even after becoming a member, however, subsequent guaranteed payments made to the service provider regardless of the LLC's income would continue to produce ordinary compensation income.[65]

2. LLC Consequences

- The tax consequences for the LLC and its other members upon the issuance of a capital interest for services will depend on whether some type of hypothetical transaction is deemed to occur in connection with the issuance. If the LLC or its members were deemed to have transferred appreciated assets, the other LLC members (or transferring members in a deemed transfer of LLC interests among members) would be subject to tax on their allocable shares of gain on the deemed transfer.

- If the LLC does not (or cannot) revalue its assets in connection with the transfer of the interest, the other LLC members may recognize gain (or loss, subject to section 267) as a result of a capital shift in favor of the service provider, as discussed above in Sections II.A. and B.

- In general, however, the LLC should be entitled to a deduction equal to the amount of income recognized by the service provider when the interest is issued, as well as subsequent deductions when any future guaranteed payments are made, in each case subject to section 263 and other capitalization provisions.[66] At least the initial deduction could (and would) presumably be allocated to the old members in the same proportion as any income

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[65] *See* I.R.C. § 707(c).

[66] I.R.C. § 83(h). If an LLC interest is granted in exchange for services that will benefit the LLC beyond the current year, the LLC may be required to capitalize the otherwise deductible cost of the interest, and amortize it over the period for which the services are to benefit the LLC.

recognized on a deemed sale of LLC assets and/or a capital shift.

C. Restricted Capital Interests

1. Service Provider Consequences

- The receipt of a restricted capital interest (*i.e.*, an interest subject to a substantial risk of forfeiture) should generally not be taxable to the service provider until the interest vests (*i.e.*, until the risk of forfeiture has lapsed), consistent with open transaction principles.[67] The single exception to such deferred taxation occurs if the service provider can and does timely elect under section 83(b) to treat the receipt of the interest as immediately taxable (such election, a "section 83(b) election").[68]

- A valid section 83(b) election can only be made with respect to "property" governed by section 83. It is not crystal clear (although it is clearly the IRS's view) that section 83 applies to restricted capital interests, since they do not clearly constitute such property.[69] This ongoing theoretical debate aside, there is certainly ample support to enable service providers to make section 83(b) elections.

a. Section 83(b) Election Made

- Under section 83(b), a person performing services in exchange for property may immediately elect to include in gross income the excess of the fair market value of the property received (reduced by non-lapse

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[67] *See* I.R.C. § 83(a).

[68] I.R.C. § 83.

[69] *See* 1996 FSA LEXIS 246 (June 25, 1996).

restrictions) over the amount, if any, paid for the property.[70]

- Although a restricted capital interest will remain subject to a substantial risk of forfeiture after a section 83(b) election is filed, it is certainly possible that making the election will transform the service provider into a member of the LLC.[71] If so, the service provider would be allocated his or her undivided interest in future LLC gains and losses as a member of the LLC. Any guaranteed payments owed to the service provider member that are not dependent on LLC income would continue to constitute ordinary compensation income to the recipient.

- Future vesting of a capital interest for which a valid section 83(b) election is made should have no tax consequences for the service provider.

    - It is worth noting that this conclusion is premised on the assumptions that (i) making a section 83(b) election turns an employee into a member (which is far from certain), and (ii) the member's right to a specified percentage of the LLC's capital is determined as of the date the interest is granted (as opposed to the date the interest vests).

    - If these assumptions are correct, query what the consequences would be if the interest is forfeited before vesting, including, specifically, whether the

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[70] A section 83(b) election with respect to any transfer of property must be made within 30 days after the date of transfer and may not be revoked without the consent of the Secretary. I.R.C. § 83(b)(2).

[71] *See* Treas. Reg. § 1.83-2(a).

service provider would be entitled to a loss.[72]

b. Section 83(b) Election Not Made

- In the first taxable year in which the service provider's rights in the capital interest vest (*i.e.*, the interest becomes transferable or no longer subject to a substantial risk of forfeiture), he or she will recognize ordinary compensation income equal to the then fair market value of the capital interest, less any amount paid for the interest.[73] The amount of the service provider's taxable income at that time may be substantial if the LLC's assets associated with the capital interest have appreciated between issuance and vesting of the interest.

- The holder of a restricted capital interest who does not file a section 83(b) election should not properly be considered a member of the LLC until the capital interest vests, consistent with the general principle that the service provider does not "own" the interest until it vests. If so, the service provider would not be allocated any LLC income or loss prior to vesting, and would recognize ordinary compensation income only when and to the extent he or she receives distributions from the LLC.[74]

- The service provider would presumably become a member of the LLC when his or her capital interest vests. After the service provider becomes a member, the character of his or her allocable share of LLC profits and losses (*i.e.*, capital or ordinary) will be determined at the LLC level. Guaranteed

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[72] *See* Section IV.D.3. for a detailed discussion of this issue.

[73] I.R.C. § 83(a); Treas. Reg. § 1.721-1.

[74] *See* Treas. Reg. § 1.83-1(a)(1).

payments owed to the service provider that are not dependent on LLC income would continue to produce ordinary income for the service provider after the interest is vested.

2. LLC Consequences

- The issuance of a restricted capital interest in exchange for services would entitle the LLC to a deduction equal to the income of a service provider making a section 83(b) election, subject to the capitalization rules.[75]

- If a valid section 83(b) election is not made, a bookup would not be required to avoid a capital shift or the LLC's recognition of gain or loss at issuance, since the issuance of a restricted capital interest is treated as a non-event. A capital shift may occur upon vesting whether or not a bookup occurs, but a bookup would minimize the size of any capital shift.

- In addition, if a section 83(b) election is not timely made and the service provider is not treated as a member prior to vesting, distributions with respect to the unvested LLC interest would be treated as deductible compensation paid by the LLC, subject to the capitalization rules. Similarly, the LLC would be entitled to a deduction (subject to the capitalization rules) when the interest vests to the extent of the income the service provider recognizes at that time. Note that if a service provider is treated as an employee with respect to the receipt of the vested interest, the LLC would be liable for withholding taxes with respect to the "payment" of the interest.

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[75] I.R.C. § 83(h).

D. Special Issues Raised by Transfers from LLC Members to Service Providers

- Although it is more typical for an LLC to directly issue interests to service providers and so dilute the existing members *pro rata*, interests may also be transferred to service providers directly by other LLC members. The appeal of this structure may be limited, however, by the fact that the member transferor will generally recognize gain equal to the fair market value of the interest transferred, less the member's basis in such interest.[76]

  - A service provider receiving an LLC capital interest from a member will recognize ordinary income equal to the fair market value of the interest; the service provider may also receive a basis step-up with respect to its share of the LLC's assets if the form of the transfer is respected and the LLC has made or makes a section 754 election in connection with the transfer.[77]

  - It is also possible, although unfortunately not clear under current law, that this transaction could be recast as a contribution of the capital interest by the transferring member to the LLC, followed by a transfer to the service provider.[78] If so, the transferring member should not recognize gain on any appreciation of the LLC's assets in connection with the deemed contribution under section 721. Instead, the transferring member should receive an increase in the basis of its LLC interest. The LLC may recognize gain, either in connection with the

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[76] *See* I.R.C. § 1001; *see also* Treas. Reg. § 1.83-6(b); *McDougal v. Commissioner*, 62 T.C. 720 (1974).

[77] Note, however, that no basis step-up would be available if the transaction is recast as a transfer by the LLC rather than the transferring member.

[78] *See* Treas. Reg. § 1.83-6(d) (similarly recasting transfers of stock from corporate shareholders to corporate employees).

disposition of low (or zero) basis property in the LLC's hands, or in connection with a deemed transfer of other LLC assets.

- It is not completely clear whether the transferring member or the LLC should be entitled to claim any corresponding deductions. Because the service provider will be providing services to the LLC, the compensation deduction could (and perhaps should) be taken by the LLC by analogy to the section 721 regulations.[79] In that case, the compensation deduction could and would generally be allocated solely to the transferring member that bore the cost of compensating the service provider. In that case, any deduction treated as an investment expense may be subject to additional limitations under section 212 (*e.g.*, 2% floor on miscellaneous itemized deductions).

IV. LLC PROFITS INTERESTS

A. Definition

- A profits interest is an interest that does not entitle the holder to receive a share of the proceeds distributed following a hypothetical sale of the LLC's assets in connection with a complete liquidation of the LLC.[80] A restricted profits interest is a profits interest that is non-transferable or is subject to a substantial risk of forfeiture.[81]

B. Taxation (or Not) of Profits Interests

- In the absence of clear authority, commentators have debated for some time whether section 83 governs Subchapter K transactions, and if so,

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[79] *See* Treas. Reg. § 1.721-1(b)(2).

[80] Rev. Proc. 93-27, 1993-2 C.B. 343 (defining a profits interest as an interest other than a capital interest).

[81] *See* I.R.C. § 83(c).

whether an LLC profits interest constitutes property for purposes of section 83.[82] Section 83 generally applies to the transfer of property in connection with the performance of services.[83] The section 83 regulations define property to include real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future, and impose immediate tax on the receipt of property with a readily ascertainable fair market value.[84]

- Under Treasury Regulations proposed in 1971, section 83 would have applied to the issuance of partnership interests (although less clearly to profits interests), but those regulations were never finalized.[85]

- This ongoing debate as to whether a partnership profits interest constitutes property for section 83 purposes heated up after the Seventh Circuit held in *Diamond v. Commissioner* that the receipt of a partnership profits interest was a taxable event because the interest constituted property, and the interest had a readily ascertainable fair market value at the date of receipt.[86]

    - A few years after the *Diamond* decision, the IRS issued General Counsel Memorandum 36346.[87]

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[82] *See, e.g.*, Schmolke, 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).

[83] I.R.C. § 83(a).

[84] I.R.C. § 83(a); Treas. Reg. § 1.83-3(e).

[85] Prop. Reg. § 1.721-1(b)(1)-(2).

[86] *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd,* 492 F.2d. 286 (7th Cir. 1974).

[87] G.C.M. 36346 (July 23, 1975).

The GCM analyzed a proposed Revenue Ruling that would have disavowed the Seventh Circuit's holding in *Diamond*. The GCM took a limited view of *Diamond*, holding that the receipt of a profits interest was not taxable to the service provider, because a profits interest should properly be treated as a mere unfunded promise to pay that would not constitute section 83 "property".[88] Although the proposed Revenue Ruling was never published, the General Counsel's Memorandum has never been withdrawn.

- The subsequent enactment of section 707 is another curious development. If the government clearly believed that section 83 applied to all transfers of LLC interests for services, there would have been no need to enact section 707 in 1984, which applies when section 83 would not.[89] It does not seem possible to reconcile these mutually exclusive sections in any principled manner.

- A long series of subsequent cases continued the debate over whether a partnership profits interest constitutes property.[90] Several of these cases

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[88] *See* G.C.M. 36346 (July 23, 1975). More specifically, the proposed Revenue Ruling stated that "the Service will not follow Diamond to the extent that it holds that the receipt of an interest in future partnership profits as compensation for services results in taxable income" and further provided that the "renderer of services must be a partner rather than an employee or independent contractor."

[89] *Campbell v. Commissioner*, 59 T.C.M. 236 (1990), *aff'd in part and rev'd in part*, 943 F.2d. 815 (8th Cir. 1991) (Eighth Circuit concluded that if partnership interests received for services were per se taxable, it would not be necessary to recast such an interest as a fee under section 707(a)(2)).

[90] *See, e.g.*, *Campbell v. Commissioner*, 59 T.C.M. 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.

equated a profits interest with an unfunded, contingent right to future compensation, due to its purely speculative nature. The Eighth Circuit neatly sidestepped the issue in *Campbell*, although it did mention in dictum "we doubt that the tax court correctly held that Campbell's profits interests were taxable upon receipt."[91]

- This lengthy saga culminated in the publication of Revenue Procedures 93-27 and 2001-43. Read together, they provide merely that transfers of partnership profits interests (including certain transfers of nonvested profits interests) are not taxable to either the service provider or the partnership upon receipt or vesting. The Revenue Procedures do not specify whether this result obtains because (i) section 83 does not govern Subchapter K transactions, (ii) a profits interest is not property that is subject to tax when received under section 83, or (iii) a profits interest is property governed by section 83, but lacks a readily ascertainable fair market value and therefore is not subject to tax.[92]

    - Revenue Procedure 2001-43 hints that section 83 may not apply, stating that the taxpayers it covers "need not file an election under section 83(b) of the Code," but makes no explicit statement regarding the (non) application of section 83 to the issuance or vesting of restricted profits interests. Taxpayers

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1983) (without discussion, the court assumed partnership profits interests to be property for section 83 purposes, but found taxpayer's interest was not subject to tax since it had no value); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. 1749 (1984) (all partnership interests are property within the meaning of section 83); *Kobor v. U.S.* 88-2 USTC ¶ 9477 (C.D. Cal. 1987); *U.S. v. Pacheco*, 912 F.2d 297 (9th Cir. 1990).

91 *Campbell v. Commissioner*, 59 T.C.M. 236 (1990), *aff'd in part and rev'd in part*, 943 F.2d. 815 (8th Cir. 1991) (Eighth Circuit considered but failed to rule as to whether partnership profits interests are property).

92 Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.

have viewed this statement with skepticism and many have continued to make protective section 83(b) elections.[93]

C. Unrestricted Profits Interests

1. Service Provider Consequences

- The threshold issue regarding the tax consequences of a profits interest is whether the issuance of a given profits interest qualifies for the Revenue Procedure 93-27 safe harbor from taxation. If so, the issuance would not result in taxable income to the service provider or to the LLC.[94] As discussed below, even under the limited circumstances where the safe harbor may not apply, taxpayers can find support for deferred taxation in the case law and the 1984 legislative history.

  - Revenue Procedure 93-27 generally provides that the receipt of a profits interest for the provision of services to, or for the benefit of, an LLC in a member capacity or in anticipation of being a member will not be a taxable event for either the member or the LLC. Unfortunately, the Revenue Procedure does not elaborate on the meaning of this phrase.[95] Fortunately, however, the same phrase appears in the 1984 legislative history to section 707(a)(2)(B), which provides that "persons who become partners after performing services for, or transferring property to, the partnership are to be treated

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93 *See* Section IV.D. for a more detailed discussion of this issue.

94 Rev. Proc. 93-27, 1993-2 C.B. 343.

95 The author believes that this phrase can best be read as the IRS conceding its alternative argument in *Campbell* that the services at issue were performed for a corporate partner (the services were, in fact, provided pursuant to a written employment agreement with the partner), rather than the partnership.

as partners."[96] This treatment is solidly supported under an aggregate approach to taxing profits interests, since a sole proprietor would not be subject to tax merely because his or her services create the possibility of future value.

- In general, courts apply a facts and circumstances analysis in determining whether a service provider is, or anticipates becoming, an LLC member for tax purposes.[97] Accordingly, while there may be an issue as to whether the Revenue Procedure would apply if services are directly performed pursuant to a contract with a separate entity, the Revenue Procedure should clearly apply as long as services are provided for an existing LLC, albeit as an employee.

- The Revenue Procedure explicitly carves out three exceptions to the above-described tax-free treatment: (i) profits interests relating to a substantially certain and predictable stream of income from LLC assets, (ii) profits interests disposed of within two years of receipt,[98] and (iii) profits interests that are limited LLC interests in a "publicly traded" LLC.

- While it is generally possible for the recipient of an interest to avoid an outright sale for two years, other quasi dispositions may be more difficult to avoid. For example, interests are often revalued, and the LLC may even be incorporated (often in anticipation of an IPO) within two years

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96 *See* S. Rep. No. 98-169, at 232 (1984).

97 *See*, *e.g.*, *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Luna v. Commissioner*, 42 T.C. 1067 (1964).

98 Note that this exception may be called into question by subsequent LLC transactions outside the control of the service provider.

after the issuance of a profits interest. While the author believes that neither of these events should be treated as a disposition, the IRS could take a different view.[99]

- As discussed in Section II.A. above, a bookup at issuance is required to ensure that an intended profits interest is not partly a capital interest that would be outside the scope of the Revenue Procedure. It is not clear whether such a part-capital, part-profits interest may be bifurcated. However, the IRS has stated that bifurcation will be permitted, and the Revenue Procedure will apply to the pure profits interest, as long as the capital interest carries rights to equal percentages of LLC capital and profits.

- Even if the Revenue Procedure's non-taxation safe harbor does not apply, and the receipt of the unrestricted profits interest in an LLC is a taxable event under section 83(a), the fair market value of the interest should presumably be zero whenever the LLC's profits are speculative.[100]

- Tax consequences of future LLC income allocations and distributions to the service provider (other than guaranteed payments not dependent on LLC income) would depend upon whether he or she is treated as a member for tax purposes after the issuance of an unrestricted profits interest. The author believes that the service provider would likely be treated as a member upon issuance, although this result is uncertain. It is interesting that this uncertainty remains, given the fact that Revenue Procedure 2001-43 not only permits, but requires that a

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[99] A bookup shortly after (but not before) the issuance of a profits interest may also raise issues as to the part-capital nature of the interest.

[100] For an excellent discussion of this issue, see Maxfield, John R., *Equity Based Compensation for Partnerships and LLCs*, Q287 A.L.I.-A.B.A. 145, 160 (1999).

partner receiving a restricted profits interest be treated as the "owner" of the interest for income tax purposes and take into account his or her share of the LLC's net income or loss.

2. LLC Consequences

- The tax consequences for the LLC and its other members of issuing a profits interest for services will depend in part on whether a hypothetical transaction is deemed to occur in connection with the issuance. If the LLC is deemed to have transferred an undivided interest in its appreciated assets to the service provider, the other LLC members would recognize their allocable shares of the LLC's gain (or loss, subject to section 267) on the deemed transfer.

- As discussed in detail in Section II.A. above, a profits interest that entitles the service provider to a share of the LLC's appreciated assets may constitute a part-profits, part-capital interest. Accordingly, in order to minimize any gain (or loss, subject to section 267) to the other LLC members as a result of the capital shift in favor of the service provider, as discussed in Section II.B., an LLC must revalue its assets to reflect their fair market values, and book up its members' capital accounts accordingly, immediately prior to the issuance of a profits interest.

- In general, if the service provider were regarded as a member of the LLC, the LLC would allocate to the service provider his or her share of future LLC gains and losses and no deduction would be permitted for the LLC. Any guaranteed payments owed to the service provider that are not dependent on LLC income would continue to constitute ordinary compensation income to the recipient and would be deductible by the LLC, subject to the capitalization rules. However, during any period of time the service provider is not regarded as a member of the LLC, the LLC

generally would receive a deduction, subject to capitalization rules, for distributions to the service provider.[101]

D. Restricted Profits Interests

- Prior to the issuance of Revenue Procedure 2001-43, it was not completely clear whether Revenue Procedure 93-27 applied to the receipt of a restricted profits interest, since its safe harbor only applies generally to exempt a service provider from tax upon receipt of a profits interest, leading to concern that a profits interest might not be treated as received until it fully vests.[102] Thankfully, this issue has now been resolved by Revenue Procedure 2001-43.

1. Service Provider Consequences Upon Issuance

- Clarifying Revenue Procedure 93-27, Revenue Procedure 2001-43 provides that whether a restricted partnership interest granted to a service provider is a capital or profits interest will be determined on the date it is issued (rather than on the vesting date).[103]

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[101] *See* Treas. Reg. § 1.83-1(a)(1)(ii).

[102] As the Los Angeles County Bar Association Taxation Section aptly noted, "many practitioners believe that, in the absence of a valid section 83(b) election, an unvested profits interest may not initially constitute a partnership interest" treated as received for purposes of Revenue Procedure 93-27. The safe harbor of the Revenue Procedure only applies by its terms to a service provider's receipt of a profits interest, and since Treasury Regulations section 1.83-1(a) provides that, "[u]ntil such property becomes substantially vested the transferor shall be regarded as the owner of such property," it is not clear that Revenue Procedure 93-27 applies to the transfer of an unvested profits interest, because the transferee (the service provider) has not received the LLC interest on the date of issuance. *See* Los Angeles County Bar Association Taxation Section Pass-Through Entities Committee, *Federal Income Taxation of Unvested Partnership Profits Interests* (June 22, 1999) (copy on file with the author).

[103] Rev. Proc. 2001-43, 2001-2 C.B. 191.

Accordingly, neither the grant nor the vesting of a restricted profits interest will be treated as a taxable event to the service provider or the LLC as long as (i) the service provider is treated as owning the interest from the date of the grant (including for purposes of allocating distributive shares of LLC income, gain, loss, deduction and credit associated with the interest), (ii) the LLC does not deduct the fair market value of the interest when it is granted or when it vests, and (iii) all other conditions of Revenue Procedure 93-27 are satisfied.[104]

- Like Revenue Procedure 93-27, Revenue Procedure 2001-43 assumes that a bookup occurs immediately before a restricted profits interest is issued. Thus, neither Revenue Procedure resolves the question of how to characterize a "profits" interest issued at a time when part or all of the appreciation inherent in the LLC assets is not reflected in the existing members' capital accounts, or whether an LLC would be permitted to avail itself of a bookup to solve the problem. Moreover, even a bookup may not be dispositive in the event the IRS successfully challenges the LLC's valuation of profits vs. capital interests. However, the IRS has now approved the bifurcation of part-capital, part-profits interests, and will apply the Revenue Procedure to the bifurcated profits interest.[105] Query, however, whether the part-capital interest in the ruling carried rights to equal percentages of LLC capital and profits, as might be expected.

- Note that the Revenue Procedure does not state that issuance and vesting are not taxable events—it merely states that they

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[104] Rev. Proc. 2001-43, 2001-2 C.B. 191.

[105] Priv. Ltr. Rul. 2003-29-001 (Feb. 21, 2003).

will not be so treated. As Terry Cuff and others have observed, this raises the interesting question of whether a court would view the Revenue Procedure as a safe harbor, or more. For example, how would a court's decision be affected if the IRS revoked one or both of the Revenue Procedures, or merely took an inconsistent litigating position? Under these circumstances, a service provider who made a section 83(b) election upon receipt may fare better.

- Another interesting question is whether Revenue Procedure 93-27 would apply upon the vesting of an interest outside the scope of Revenue Procedure 2001-43 on the theory that an unrestricted profits interest is received at that time.

- Regardless of whether Revenue Procedure 2001-43 applies, it is highly unlikely that the receipt of a restricted profits interest will be a taxable event to the service provider. Even if Revenue Procedure 2001-43 does not apply and section 83(a) does, no tax should be imposed due to the fact that the profits interest is subject to a substantial risk of forfeiture prior to vesting, except perhaps when the interest includes an embedded capital interest. In that (worst) case, the amount of taxable income should be negligible in most cases.[106]

- Can (and Should) an Employee Make a Section 83(b) Election?

  - Revenue Procedure 2001-43 explicitly provides that taxpayers need not file section 83(b) elections when a restricted profits interest is issued, but it does not state that section 83 does not apply to such an interest. Interestingly, the author

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[106] *See* Treas. Reg. § 1.83-1(a).

understands that the number of section 83(b) elections filed with the IRS did not decrease significantly after the Revenue Procedure was published. The continued use of the election may reflect practitioners' nagging uncertainty as to whether some profits interests may include an embedded capital interest either in the absence of a bookup or due to valuation uncertainties.

- Since it is not clear whether section 83(a) would apply to a restricted profits interest upon issuance or vesting if any of the requirements of Revenue Procedure 2001-43 are not (or may not be) satisfied, the service provider may want to make a prophylactic section 83(b) election with respect to the transferred profits interest showing a zero value.

- If the requirements of Revenue Procedure 2001-43 are not satisfied, and section 83 also does not apply to the issuance of a restricted profits interest (and thus the service provider cannot make a valid section 83(b) election), any payment from the LLC received by the service provider prior to vesting of the interest should be taxable as compensation at ordinary income rates.

- Technically, a service provider can only make a section 83(b) election upon receipt of a restricted profits interest if the interest constitutes property for purposes of section 83, a conclusion that is far from clear.[107] Nonetheless, until authority

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[107] *See* G.C.M. 36346 (July 25, 1977) (profits interest analogized to an unfunded promise to pay); Treas. Reg. § 1.83-3(e) ("the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future").

addresses this issue, the author, like most other practitioners, advocates consideration of a protective section 83(b) election when there is any issue as to whether the Revenue Procedures apply (and when the parties have taken affirmative action to avoid application of Revenue Procedure 2001-43). In doing so, however, taxpayers should also consider the effect of a section 83(b) election on the amount of the service provider's loss if the interest is forfeited.[108]

- Service providers may also wish to consider making a non-*de minimis* capital contribution to the LLC when the restricted profits interest is issued, in order to convert the profits interest into a combined profits and capital interest, and so increase the probability that the interest received would be considered property with respect to which a section 83(b) election could be made. This approach may be more popular now that the IRS has sanctioned the bifurcation of such a combined interest into its component parts.[109]

    - If Revenue Procedure 2001-43 does not apply and a valid section 83(b) election is made upon receipt of a restricted profits interest, the service provider would be subject to tax on the current fair market value of the interest received (reduced by non-lapse restrictions), less any amount paid for the interest.[110] Presumably a service provider could generally demonstrate that a restricted profits interest has limited or no value.

    - Although the profits interest would remain subject to a substantial risk of forfeiture after the section 83(b) election is filed, making the

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[108] *See* Section IV.D.3. for a discussion of these issues.

[109] Priv. Ltr. Rul. 2003-29-001 (Feb. 21, 2003). *See* Section II.A. for a more detailed discussion of this issue.

[110] I.R.C. § 83(b).

election may transform the service provider into a member of the LLC if Revenue Procedure 2001-43 does not apply.[111] If a valid section 83(b) election is not made upon receipt of a restricted profits interest (or such an election is made but not accepted as valid) and Revenue Procedure 2001-43 does not apply, the service provider should not be considered a member prior to vesting. Thus, in such a case, any payment received by the service provider prior to vesting of the interest should be taxable as compensation at ordinary income rates.

2. Service Provider Consequences Upon Vesting

- If Revenue Procedure 2001-43 applies to the grant of a restricted profits interest, the vesting of the interest will not be a taxable event. In addition, assuming the LLC revalues its assets before the interest is granted and before it vests, the vesting of a restricted profits interest for which a valid section 83(b) election was made should have no tax consequences to the service provider under section 83 even if Revenue Procedure 2001-43 does not apply.

  - Note, however, that vesting may constitute a taxable event if Revenue Procedure 2001-43 does not apply and the LLC does not book up its assets at that time. In the absence of a bookup by an LLC with appreciated assets, the service provider would receive a part-capital LLC interest, which could theoretically produce a capital shift, subjecting all members to tax upon vesting.[112] (If so, query whether a valid section 83(b) election should therefore be permitted for such an interest at issuance.)

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[111] I.R.C. § 83(b).

[112] *See* 1996 FSA LEXIS 246 (June 25, 1996).

3. Service Provider Consequences Upon Forfeiture

- Somewhat curiously, Revenue Procedure 2001-43 does not address a forfeiture of an unvested profits interest, perhaps because of an IRS concern that forfeiture raises capital shift issues they are not yet prepared to definitively address.

- If Revenue Procedure 2001-43 applies and the profits interest is forfeited prior to vesting, the author believes that the service provider should be entitled to recognize a loss equal to his or her basis in the restricted interest (as increased by any LLC income or gain allocated with respect to the service provider's interest). It is likely, although not clear in the absence of a sale or exchange, that the loss would be capital rather than ordinary.[113] It is possible that a service provider who is not allocated any share of the LLC's nonrecourse debt under section 752 could abandon his or her interest and so claim an ordinary loss under section 165.[114]

    - It should be noted that Treasury regulations under section 83 limit a service provider's loss upon the forfeiture of property following a section 83(b) election to the excess of the amount (if any) paid for the property over any amount realized on forfeiture.[115] This regulation, like much of section 83, is difficult to apply sensibly to partnerships, since section 83 was designed to apply to stock with a fixed basis. It was not crafted to apply to LLC interests with bases that are continually adjusted to reflect items of income, gain, loss and deductions allocated to each member. Accordingly,

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[113] *See* Rev. Rul. 93-80, 1993-2 C.B. 239 (deemed cash distribution to a partner relieved of LLC debt renders abandonment loss capital).

[114] *See Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991); *Citron v. Commissioner*, 97 T.C. 200 (1991).

[115] *See* Treas. Reg. § 1.83-2(a).

applying this regulation strictly to the forfeiture of restricted LLC interests would improperly deny a loss for basis attributable to allocations of LLC taxable income and gain.

- Thus, the author believes that a service provider's loss should not be limited to the amount he or she paid for the interest in excess of any amounts realized on forfeiture, even if a valid section 83(b) election was previously made. However, if the IRS is not persuaded by this argument, it may seek to apply the literal language of the section 83 regulations to limit the amount of loss deductible by the service provider upon forfeiture to the amount (if any) paid for the interest, whether or not Revenue Procedure 2001-43 applies. Service providers should therefore carefully consider this uncertainty regarding a loss on forfeiture when deciding whether to make a protective section 83(b) election.

4. LLC Consequences

- Except as discussed below, neither the issuance nor the vesting of a restricted profits interest should constitute a taxable event for the LLC if the LLC's interests are marked to market on each date, as discussed in the text above, so that only a pure profits interest is issued and vests. If Revenue Procedure 2001-43 applies, no bookup should be required at vesting, since vesting is a non-event under the theory of Revenue Procedure 2001-43. Note that Revenue Procedure 2001-43 applies only if the LLC and its members forgo any deduction upon issuance and vesting of the interest.[116]

    - If a service provider makes a valid section 83(b) election when he or she receives a restricted profits interest, and

[116] Rev. Proc. 2001-43, 2001-2 C.B. 191.

Revenue Procedure 2001-43 does not apply, the LLC should be entitled to a deduction to the extent of the service provider's income, subject to the capitalization rules. (The fact that claiming such a deduction renders the Revenue Procedure inapplicable provides an interesting planning tool for taxpayers wishing to avoid the Revenue Procedure.) However, the service provider will presumably assert that his or her interest has little, if any, value, which would limit the size of the LLC's corresponding deduction.

- Notably, the Revenue Procedures do not explicitly address capital shifts. However, the issuance of a profits interest within the scope of the Revenue Procedure does not (and should not) trigger a deemed capital shift since no share of current appreciation in LLC assets is transferred to the service provider when a pure profits interest is issued. It is important to note, however, that the Revenue Procedures seem to contemplate that a bookup occurs immediately before a profits interest is issued, which is assuming a lot.

- A hypothetical transfer of appreciated assets to the service provider at issuance could subject the other LLC members to tax on their allocable shares of the LLC's gain on the deemed transfer, since Revenue Procedure 2001-43 only states that the issuance will not be a taxable event for the recipient or the LLC, and does not address the tax treatment of the other LLC members. However, the better view is that no deemed asset transfer occurs because a restricted profits interest does not have an ascertainable fair market value.[117] If not, the value of the interest, and so the value of the assets deemed transferred, should be quite low.

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[117] Section 707 would not impose tax unless the service provider is treated as a member of the LLC before vesting.

- If Revenue Procedure 2001-43 applies, the vesting of a pure profits interest is not a taxable event to the LLC. Accordingly, no bookup should be required at vesting.

    - Under certain circumstances a service provider may wish to retain an option to cause the LLC to claim a compensation deduction upon vesting, affirmatively rendering the Revenue Procedure invalid, in the event an interest does not significantly increase in value before vesting. In that case, the LLC must book up when the interest is issued and when it vests.

E. Special Issues Raised by Transfers from Members to Service Providers

- It is also possible for a service provider to be compensated with a profits interest transferred by a member, rather than by the LLC. However, as in the case of a transfer of a capital interest, the transferring member may recognize income.

    - If a profits interest a member transfers to a service provider is not related to a substantially certain and predictable stream of LLC income, and the interest is not disposed of within two years of its receipt, the service provider should not be required to recognize income on receipt of the interest.[118]

    - It is unclear whether section 83 governs such transfers of profits interests. If section 83 applies, the transferring member should not recognize income as long as (i) the transferor receives no value for transferring the interest, and (ii) no income is recognized by the service

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[118] *See* Rev. Proc. 93-27, 1993-2 C.B. 343. Notably, the Revenue Procedure is not restricted to transfers by the LLC, although it only states that the LLC and the recipient of an interest will be protected from gain recognition.

provider.[119] If section 83 does not apply, however, the transferor should recognize income equal to the fair market value of the profits interest, reduced by the transferor's basis in its LLC interest.

- No compensation deduction would be available to either the transferring member or the LLC, assuming the service provider does not recognize income upon receipt of the interest.

    - It is unlikely that the IRS would seek to recast the transaction as a contribution of the profits interest by the member transferor to the LLC followed by a transfer to the service provider since such a recast could result in a more favorable outcome for the LLC members, *e.g.*, the transferring member would not be subject to tax on the contribution of the interest to the LLC and neither the LLC nor the service provider would recognize income on the subsequent transfer and receipt of the interest, respectively.[120]

F. Management Fee Waivers

- The IRS has sharpened its focus on a common practice in the private equity industry whereby a fund manager waives all or a portion of its fee for managing invested assets in exchange for an additional profits interest.

    - For example, a fund manager otherwise entitled to a management fee equal to 2% of invested assets and 20% of a fund's future profits (a typical "carried interest"), waives (either upfront or on a periodic basis) all or a part of the 2% management fee taxable as ordinary income in exchange for a priority allocation of an equal

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[119] *See* Treas. Reg. § 1.83-6(b).

[120] *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

amount of the fund's future profits, potentially taxable as long-term capital gain.

- As noted previously, section 707(a) provides that if a member engages in a transaction with an LLC other than in his or her capacity as a member, the transaction will be treated as occurring between the LLC and a party who is not a member.

  - The legislative history of section 707(a)(2) notes that the allocation of an LLC's capital gains to a service-providing partner in lieu of a fee is a type of transaction section 707(a)(2) is intended to cover, particularly when the service-providing partner's share of profit is "assured without regard to the success or failure" of the LLC.[121]

  - The government views the text and intent of section 707(a)(2) as sufficient authority to challenge at least some fee waivers, and guidance on management fee waivers is listed as a priority project on the Treasury-IRS 2014-2015 Priority Guidance Plan. In May 2015, an IRS official was quoted as saying that such guidance was likely to be issued in "three to six months."[122]

V. OPTIONS TO ACQUIRE LLC INTERESTS

A. The Tangled Theory of LLC Option Taxation

- LLCs may wish to issue options to acquire capital or profits interests in the LLC to valued employees in a variety of circumstances.[123] Such options are

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[121] *See* S. Rep. No. 98-169, at 224, 226 (1984).

[122] Herzfeld, John, *Proposal on Management Fee Waivers Expected Soon, IRS Attorney Says*, Daily Tax Rep. (BNA), May 14, 2015, at G-3.

[123] LLCs are limited to issuing "nonqualified" options since the issuance of "qualified stock options" is restricted to corporations. *See* I.R.C. §§ 421-424. Note that the preamble to the final section 409A

generally exercised only when the LLC interest to be received is more valuable than the sum of (i) any consideration previously transferred to the LLC in exchange for the option grant, *i.e.*, the option premium, and (ii) any consideration transferred to the LLC upon exercise of the option, *i.e.*, the strike price.

- The principles of section 83 governing the treatment of stock options granted to corporate employees should also apply to the issuance of options in the LLC context.[124] Under these or similar rules, the receipt of options to acquire LLC interests would benefit from open transaction treatment and recipients would therefore not be subject to tax upon receipt.[125] As discussed below, this is a hotly debated issue. The newly proposed noncompensatory option regulations (discussed below) generally adopt this approach, and hopefully this sensible result will also prevail in the area of compensatory options.

- Assuming an option holder is not treated as holding an LLC interest until the option is exercised, and the holder receives a capital account on exercise equal to the option exercise price, booking up prior to exercise would permit

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regulations provides, consistent with Notice 2005-1, that the principles applicable to a grant of stock options or stock appreciation rights under the final section 409A regulations also apply by analogy to equivalent rights with respect to partnership interests.

[124] *See* Treas. Reg. § 1.83-3(a)(2) (option to acquire property may be subject to section 83, even though the underlying property is not; thus, if a partnership interest is subject to section 83, an option to acquire same is also subject to section 83); Treas. Reg. § 1.83-7 (referring to nonqualified stock options in the heading, yet referring to the underlying property that is the subject of the option more broadly as property); *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); *see also* Maxfield, *supra* note 100, at 164.

[125] *See generally* Rev. Rul. 58-234, 1958-1 C.B. 279, *clarified by* Rev. Rul. 68-151, 1968-1 C.B. 363; Rev. Rul. 78-182, 1978-1 C.B. 265.

the historic members to retain all the pre-exercise LLC value. However, as a result of the bookup, an exercising option holder paying a strike price less than the fair market value of the interest would acquire a much less valuable asset than a corporate employee exercising an option to acquire stock of an equally valuable corporation.

- In other words, if the LLC's assets are booked up to insure that no capital shift occurs, the exercising holder's capital account balance will be less than the holder's proportionate interest in the LLC. On the other hand, equalizing capital accounts raises the spectre of another potentially taxable shift of capital from the old holders to the exercising holders, even though a bookup just occurred.[126] As Simon Friedman has astutely pointed out, taxing this discount element of a compensatory option makes little sense when the exercising holder can receive a profits interest tax free, and the other LLC members have had no accretion of wealth.[127]

- As in the case of direct issuances of LLC interests, parties could transfer additional value to an exercising option holder through special allocations of income and losses to effect their business deal, but doing so raises other issues under section 704(c) (*e.g.*, whether the new member should properly be allocated some share of the built-in gain on LLC assets accrued between option grant and exercise).

- The issuance of options to acquire interests in a single member LLC ("SM-LLC") raises a host of additional issues. These options raise the basic philosophical question of whether an option with

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[126] *See* Treas. Reg. § 1.721-1(b)(1).

[127] Friedman, Simon, *A Better Tax Treatment of Compensatory Options*, 90 Tax Notes 1107 (Feb. 19, 2001).

respect to a disregarded entity should itself be disregarded. Assuming the answer is that such an option exists for tax purposes (even if not in any other metaphorical sense), query whether the issuance of such an option can transform a SM-LLC into an entity taxable as a partnership. The author believes that options that are out of the money or are exercisable for LLC interests that are subject to a substantial risk of forfeiture certainly should not be treated as exercised and so should not yield this result.

- Options issued at a deep discount pose more interesting questions, and should only be deemed exercised, creating a new entity, consistent with the principles generally governing corporate option taxation.[128]

- Under the final section 409A regulations, a stock option with an exercise price less than the fair market value of the stock underlying the option is subject to section 409A (which means the option could only be exercised on a fixed date or upon the occurrence of a section 409A-compliant payment event). Because the section 409A rules applicable to stock options also

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[128] *See Commissioner v. LoBue*, 351 U.S. 243 (1956) (option subject to taxation on exercise date, not grant date, where strike price represented 25% of the fair market value of the underlying shares on the date of grant); *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964), *aff'g* T.C.M. 1962-231 (99.8% in-the-money option taxable in year of exercise); *Simmons v. Commissioner*, T.C.M. 1964-237 (option to purchase stock worth $1 per share for $.001 not considered grant of the underlying stock); *cf.* Rev. Rul. 82-150, 1982-2 C.B. 110 (non-compensatory option recharacterized to purchase of underlying stock where option premium represented 70% of the fair market value of the shares on the grant date); *Morrison v. Commissioner*, 59 T.C. 248 (1972), *acq.* 1973-2 C.B. 3 (option to acquire stock worth $300 at grant for $1 was the substantial equivalent of the stock itself); *see* NYSBA Tax Section, *Report on the Taxation of Partnership Options and Convertible Securities*, 2002 TNT 21-24 (Jan. 29, 2002) (NYSBA recommends that general option taxation principles be used to determine when partnership options should be treated as equity).

apply by analogy to equivalent rights with respect to partnership interests, the grant of a discounted option to purchase a partnership interest would also be subject to section 409A (and so could only be exercised on a fixed date or 409A-compliant payment event).

- The transformation of a disregarded SM-LLC into an LLC upon the exercise of an option may also raise other issues; for example, assets transferred out of a consolidated group would trigger deferred gain, and LLC level elections, *e.g.*, section 754, would also need to be made once options are (or are deemed) exercised.

- The significant uncertainty surrounding the consequences of using LLC compensatory options prompted the Treasury Department to request public comment on the federal income tax treatment of the exercise of options to acquire LLC interests in Notice 2000-29.[129]

- After receiving numerous comments, Treasury and the IRS issued proposed regulations with respect to the issuance and exercise of noncompensatory options issued by LLCs.[130]

  - The proposed regulations generally would not subject the LLC or the option holder to tax upon either issuance or exercise of a noncompensatory option.

  - The proposed regulations generally do not treat the issuance of a noncompensatory option as a section 721 transaction.[131] Instead, the preamble to the proposed regulations provides that the issuance is an open transaction for the issuer until the lapse, exercise, repurchase, or other termination of the option, and the purchase

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[129] *See* Notice 2000-29, 2000-1 C.B. 1241.

[130] 68 Fed. Reg. 2930 (Jan. 22, 2003).

[131] *Id*.

of an option is a capital expenditure for the holder that is neither taxable nor deductible to the holder, unless the holder uses non-cash property (in which case section 1001 would govern the holder's treatment).[132]

- The proposed regulations also clarify that section 721 does not apply to the lapse of a noncompensatory option,[133] which generally results in income to the LLC and loss to the former option holder.[134]

- Consistent with commentators' general view that the exercise of an option should not be treated as a taxable capital shift, the proposed regulations generally treat the exercise of a noncompensatory option as tax-free to both the LLC and the option holder under section 721.[135]

    - An exercising member's initial capital account will equal the consideration paid to the LLC at issuance together with the fair market value of any property (other than the option) contributed to the LLC at the time of exercise.[136] Because this initial capital account would often not reflect the exercising member's bargained-for interest in the LLC, the proposed regulations require the LLC in such cases to bookup its assets immediately following the exercise of the noncompensatory option, and to allocate any resulting items of built-in gain or loss first to the exercising member to the extent necessary to reflect that partner's right to share in LLC capital under the LLC agreement, and then remaining items to the

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132 *Id*.; Prop. Treas. Reg. § 1.721-2(b).

133 Prop. Treas. Reg. § 1.721-2(c).

134 68 Fed. Reg. 2930 (Jan. 22, 2003).

135 Prop. Treas. Reg. § 1.721-2(a).

136 Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(4).

existing members in accordance with the LLC agreement.[137] If the allocations following the bookup are not sufficient to reflect the exercising member's right to share in LLC capital under the LLC agreement, the LLC must reallocate capital between the existing members and the exercising member to properly reflect the exercising member's share of LLC capital.[138] If capital accounts are so reallocated, the LLC would be required to make corrective allocations of income and gain, or loss and deductions, to take into account the capital account reallocation (*i.e.*, eliminate as quickly as possible the differences between reallocated capital accounts and the members' bases in their LLC interests).[139]

- Requiring allocations of items resulting from the revaluation first to the exercising member effectively "substitute[s] built-in gain or loss in the [LLC's] assets for the built-in gain or loss in the option."[140]

- The proposed regulations generally recharacterize a noncompensatory option as an LLC equity interest if the option (together with any associated rights) provides the holder with rights that are substantially similar to the rights afforded to a member, taking into account all facts and circumstances, including whether the option is reasonably certain to be exercised and whether the option holder possesses other LLC

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137 Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s)(2).

138 Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3).

139 Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s)(4), (b)(4)(x); *see* Prop. Treas. Reg. § 1.704-1(b)(5) Ex. 21.

140 68 Fed. Reg. 2930 (Jan. 22, 2003).

member attributes.[141] However, this rule would apply only if, as of the date that the option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities.[142]

- While these proposed regulations provide useful insight into the government's thoughts on LLC options, the preamble to the proposed regulations confirms that nothing in the proposed regulations should be construed as creating any inference regarding the proper treatment of compensatory LLC options.[143]

- Treasury and the IRS have requested comments on (i) the application of section 83 to the issuance of compensatory options and partnership capital interests in connection with the performance of services,[144] and (ii) how to coordinate the tax treatment of partnership profits interests issued in connection with the performance of services (Revenue Procedures 93-27 and 2001-43) with the tax treatment of options to acquire partnership capital interests issued in connection with the performance of services.

B. Options to Acquire LLC Capital Interests

1. Definition

- An option to acquire an LLC capital interest is a contract that allows the service provider to

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141 Prop. Treas. Reg. § 1.761-3(a), (c).

142 Prop. Treas. Reg. § 1.761-3(a).

143 68 Fed. Reg. 2930 (Jan. 22, 2003).

144 In this context, the preamble refers to the 1971 proposed amendment to Treasury Regulation section 1.721-1(b)(1), which would have treated the transfer of a partnership capital interest after June 30, 1969 as a transfer of property to which section 83 applies. *See* discussion above at note 85.

purchase an interest defined by a percentage or a fixed dollar amount of the LLC's capital for a fixed price. Such options are typically exercisable over a limited period of time and expire if not exercised on or before the last day of the exercise period.

2. Service Provider Consequences

a. Upon Receipt of the Option

- Generally, a service provider should not be subject to tax upon the grant of an option to acquire a capital interest, as the open transaction treatment generally accorded to options should govern.[145] Thus, the issuance of an option to acquire a capital interest in an LLC should not result in tax to the recipient as long as the option does not have a readily ascertainable fair market value at the time of grant.[146]

  - In general, section 83 (which may or may not apply to LLC options) provides that a compensatory option that is not actively traded on an established market has a readily ascertainable fair market value, when: (i) the option is transferable by the holder, (ii) the option is exercisable immediately in full by the holder, (iii) the option or the property subject to the option is not subject to any restrictions or conditions significantly affecting the fair market value of the option, and (iv) the fair market value of the holder's ability to benefit from appreciation in the underlying property

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[145] *See generally* Rev. Rul. 58-234, 1958-1, C.B. 279, *clarified by* Rev. Rul. 68-151, 1968-1 C.B. 363; Rev. Rul. 78-182, 1978-1 C.B. 265.

[146] Treas. Reg. § 1.83-7.

without risking any of his or her capital is readily ascertainable.[147]

- The IRS may attempt to characterize a "deep in the money" option[148] as ownership of the actual underlying LLC interest for tax purposes.[149] There is no hard and fast rule under section 83 as to when an option is so deep in the money as to cause the option holder to be treated as the owner of the underlying equity interest. However, the IRS and several courts have ruled on when an option should be deemed exercised and/or constructive receipt of the underlying LLC interest should be presumed.[150] This

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[147] Treas. Reg. § 1.83-7(b); *Schulman v. Commissioner*, 93 T.C. 623 (1989). If section 83(a) does not apply to an option grant because the option does not have a readily ascertainable fair market value, sections 83(a) and 83(b) will not apply until the time the option is exercised or otherwise disposed of, even if the fair market value of the option becomes ascertainable prior to the exercise date. Treas. Reg. § 1.83-7(a).

A service provider cannot make a section 83(b) election with respect to the option grant since the option does not constitute "property" for these purposes at this point in time.

[148] Generally, an option is "deep in the money" if the option strike price is significantly less than the fair market value of the underlying interest on the date of grant.

[149] *See* Rev. Rul. 82-150, 1982-2 C.B. 110.

[150] *See Commissioner v. LoBue*, 351 U.S. 243 (1956) (option subject to taxation on exercise date, not grant date, where strike price represented 25% of the fair market value of the underlying shares on the date of grant); *Victorson v. Commissioner*, 326 F.2d 264 (2d Cir. 1964), *aff'g* T.C.M. 1962-231 (99.8% in-the-money option taxable in year of exercise); *Simmons v. Commissioner*, T.C.M. 1964-237 (option to purchase stock worth $1 per share for $.001 not considered grant of the underlying stock); *cf.* Rev. Rul. 82-150, 1982-2 C.B. 110 (non-compensatory option recharacterized to purchase of underlying stock where option premium represented 70% of the fair market value of the shares on the grant date); *Morrison v. Commissioner*, 59 T.C. 248 (1972), *acq.* 1973-2 C.B. 3 (option to acquire stock worth $300 at grant for $1 was the substantial equivalent of the stock itself).

issue will undoubtedly continue to receive increasing scrutiny as more LLCs grant compensatory options.[151]

- Presumably a service provider who is treated as owning the LLC interest underlying a deep in the money option would be treated as a member for all purposes, including allocations of LLC income consistent with section 704(b), although this result is not confirmed by any authority and would have nightmarish capital account implications.

    - Query whether the virtual allocations attendant to treating an option holder as a constructive LLC member could be the straw that breaks the back of the capital accounts camel.

- Unless a service provider is treated as owning the LLC interest underlying a deep in the money option at issuance, he or she should not be treated as becoming a partner until the option is exercised, even if the option becomes extremely valuable between issuance and exercise.[152]

b. Upon Exercise of the Option

- If section 83 principles prevail, the service provider would recognize ordinary income equal to the excess of the fair market value of the LLC capital interest received over the exercise price of the option, if any.[153] The

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[151] *See* NYSBA Tax Section, *Report on the Taxation of Partnership Options and Convertible Securities*, 2002 TNT 21-24 (Jan. 29, 2002) (NYSBA recommends that general option taxation principles be used to determine when partnership options should be treated as equity).

[152] Treas. Reg. § 1.83-7(a); *Schulman v. Commissioner*, 93 T.C. 623 (1989); *Bagley v. Commissioner*, 85 T.C. 663 (1985), *aff'd*, 806 F.2d 169 (8th Cir. 1986).

[153] Treas. Reg. § 1.83-1(a).

New York State Bar Association report on partnership options (the "NYSBA Report") recommends that the amount paid for the LLC interest also include the service provider's section 752 share of the LLC's liabilities.[154] It is not clear whether the value of the capital interest would be its fair market value assuming a willing buyer, or assuming an immediate liquidation, as the NYSBA report recommends.[155] Note that if the value of the interest includes the value of the new member's services, the member would curiously be subject to tax on his or her own value.

- It is not clear whether this result (should or) will prevail; it is substantially less favorable to the service partner than the general tax-free receipt of an economically equivalent profits interest.

3. LLC Consequences

   a. Upon Grant of the Option

      - An LLC generally will not be entitled to a deduction upon the grant of an option to acquire a capital interest.[156]

   b. Upon Exercise of the Option

      - Assuming section 263 does not apply upon exercise of the option, the LLC would

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[154] *See* NYSBA Tax Section, *Report on the Taxation of Partnership Options and Convertible Securities*, 2002 TNT 21-24 (Jan. 29, 2002).

[155] *See* NYSBA Tax Section, *Report on the Taxation of Partnership Options and Convertible Securities*, 2002 TNT 21-24 (Jan. 29, 2002).

[156] In the rare case where an option has a readily ascertainable fair market value, the LLC may be entitled to a deduction corresponding to the amount included in income by the service provider, subject to the capitalization rules.

properly be entitled to a deduction equal to the amount of ordinary income (if any) recognized by the service provider, assuming section 83 principles govern. Any deduction would be available for the same taxable year in which the service provider recognizes the corresponding income.[157] In general, the service provider, by then a new member of the LLC, may be entitled to part (or all) of the deduction, although the IRS may be expected to question the substantial economic effect of such an allocation. Moreover, in some cases the new member may not have sufficient basis to utilize the deduction.

4. Consequences to Other LLC Members

- There is no consensus regarding the effect on other LLC members of the exercise of a compensatory option to acquire a capital interest.[158] It is reasonably clear that the regulations under section 721 providing for tax-free treatment may not apply.[159] What is not clear, however, is whether the exercise triggers a deemed transfer of cash or LLC assets, or another shift in capital.[160] No authority applies

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[157] I.R.C. § 83(h). An LLC may lose its deduction, however, if it fails to withhold any applicable employment taxes. Treas. Reg. § 1.83-6(a)(2).

[158] *See* NYSBA Tax Section, *Report on the Taxation of Partnership Options and Convertible Securities,* 2002 TNT 21-24 (Jan. 29, 2002).

[159] Treas. Reg. § 1.721-1(b)(1) generally provides that section 721 does not apply to the extent that any member gives up any part of the right to be repaid his or her contributions (as distinguished from a share in LLC profits) in favor of another member for compensation for services.

[160] The deemed asset sale and deemed cash transfer theories are discussed in Section II.C. above. For an exhaustive analysis comparing the arguments for and against the two theories, *see*

capital shift principles to the exercise of an option, and as discussed above, the author believes that such principles should not be applied.

- In order to avoid overstating the capital interest that the service provider receives and to minimize any unintended capital shift, the LLC should book up its assets whenever an option is exercised. (Of course, as discussed above, the value retained by the old members as a result of the bookup will correspondingly reduce the value of the interest received on exercise.) In the case of a cashless option exercise, a bookup may not be specifically permitted, but should nonetheless be respected as necessary to correctly reflect the members' interests in the LLC. If there is a risk of the service provider being treated as a "virtual partner" before exercise, a bookup when the option is issued would also be advisable.

C. Options to Acquire LLC Profits Interests

1. Definition

- An option to acquire an LLC profits interest allows the service provider to purchase an LLC interest that provides for the right to receive a specified percentage (or fixed dollar amount) of profits and asset appreciation after the exercise date for a fixed price. Such options are typically exercisable over a limited period of time and expire if unexercised on or before the last day of the exercise period.

2. Service Provider Consequences

a. Upon Receipt of the Option

- Like the issuance of an option to acquire a capital interest, the issuance of an option to acquire a profits interest should not require the service provider to recognize income (although this result may be less certain if a deep in the money option is deemed exercised).[161]

b. Upon Exercise of the Option

- The exercise of an option to acquire a pure profits interest generally should have the same tax consequences as the grant of such a profits interest on the date of exercise. Accordingly, the exercise of such an option generally should not constitute a taxable event for the service provider.[162] However, as discussed above, this result may not obtain if section 83 principles are applied. Consequently, the use of these types of options is best avoided.

    - Moreover, as discussed in Section II.A. above, a taxable capital shift may occur upon exercise because the capital account received by the service provider will exceed any amount paid, and may exceed any amount deemed paid, for the interest. A bookup immediately before the exercise of the option would, however, minimize the amount of such a capital shift.

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[161] *See generally* Rev. Rul. 58-234, 1958-1, C.B. 279, *clarified by* Rev. Rul. 68-151, 1968-1 C.B. 363; Rev. Rul. 78-182, 1978-1 C.B. 266.

[162] *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

3. LLC Consequences

   a. Upon Grant of the Option

      - Like the grant of an option to acquire a capital interest, the grant of an option to acquire a profits interest generally would not entitle the LLC to a deduction.

      - If the service provider could be treated as a "virtual partner" before exercise, a bookup when the option is issued would be advisable.

   b. Upon Exercise of the Option

      - Assuming no capitalization requirement applies, the LLC would only be entitled to a deduction if and to the extent the service provider recognizes ordinary compensation income upon exercise of the option. Since the receipt of a pure profits interest on exercise of an option should not constitute a taxable event, the service provider should recognize income (and so the LLC should be entitled to any otherwise allowable deduction) only if the service provider is subject to tax on exercise because the interest received represents a combined profits and capital interest, *e.g.*, in the absence of a bookup.

4. Consequences to Other LLC Members

   - It is not clear whether the regulations under section 721 providing for tax-free treatment apply,[163] and more generally, the tax consequences to the other members as a result

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[163] Treasury Regulation section 1.721-1(b)(1) generally provides that section 721 does not apply to the extent that any member gives up any part of the right to be repaid his or her contributions (as distinguished from a share in LLC profits) in favor of another member as compensation for services.

of a deemed transfer of cash or LLC assets or other shift in capital when the option is exercised are not clear.

- In order to avoid overstating the interest that the service provider receives, and to protect against an unintended capital shift, the LLC should book up its assets at the time of exercise. (Of course, as discussed above, value retained by the old members as a result of such a bookup will correspondingly reduce the value of the interest received on exercise.) In the case of a cashless option exercise, a bookup may not be specifically permitted but should be respected nonetheless as necessary to correctly reflect the members' interests in the LLC. If the service provider could be treated as a "virtual partner" before exercise, a bookup when the option is issued may also be advisable.

D. Virtual Options: LLC Equity Appreciation Rights

1. Definition

- An LLC may adopt a phantom "LLC unit" plan and grant "LLC units" that replicate the periodic profit interests distributed by the LLC to members. Although the treatment of stock appreciation rights is well-settled for corporations, the treatment of similar interests issued by LLCs is less clear.

- All phantom equity plans entail the risk that, like a deep in the money option, the equity appreciation right will be treated as an interest in the underlying partnership. Thus, to avoid constructive receipt of income, the phantom LLC unit plan must be designed to be an "unfunded, unsecured promise to pay" deferred compensation arrangement that complies with section 409A.

2. Service Provider Consequences

   - The service provider is not taxed upon the grant of equity appreciation rights ("EARs").

   - A grant of EARs should not cause the holder to be treated as a member, because no LLC interest has been issued, although a "virtual LLC interest" could of course be deemed issued in the case of deep in the money EARs.

   - Upon exercise of the EARs, the service provider should recognize ordinary income equal to the compensation payment on settlement.[164]

     - If the upside on the EARs are limited by a ceiling, the service provider may recognize ordinary income prior to settlement if the ceiling is reached at a time the EARs are currently exercisable.[165]

3. LLC Consequences

   - The LLC should not recognize income or gain upon its issuance of EARs.

   - The LLC would not be entitled to a deduction until compensation is paid to the service provider in connection with settlement of the EARs.

E. Use of Corporate Member Options

- The IRS extended the benefits of section 1032 to LLCs using the stock of a corporate member to compensate LLC service providers in Revenue Ruling 99-57. The ruling treats an LLC as having a zero basis in contributed stock of a corporate member, and so the LLC recognizes gain upon the transfer of that stock to a service provider. However, all the built-in gain on the contribution

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[164] *See* Rev. Rul. 80-300, 1980-2 C.B. 165.

[165] *See* Rev. Rul. 82-121, 1982-1 C.B. 79.

date is allocated to the contributing corporate member under section 704(c), and the ruling holds that section 1032 protects the corporate member from tax on the gain and on its allocable share of any post-contribution appreciation in the stock.[166] Notably, the corporate member receives an increase in the basis of its LLC interest equal to its gain, even though the corporation is not subject to tax on the gain under section 1032.[167]

- More recently, the IRS issued regulations under section 705 to prevent a corporation from relying on Revenue Ruling 99-57 to increase its basis in its LLC interest where the corporation acquires an LLC interest during a year in which the LLC does not have a section 754 election in effect, the LLC already owns the corporation's stock, and subsequently disposes of the stock.[168] The increase in the corporation's adjusted basis in its LLC interest would equal the gain the corporation would have recognized on the LLC's sale of its appreciated stock absent section 1032, had a section 754 election been in effect when the corporation acquired the LLC interest.[169]

- The IRS has also issued regulations eliminating the "zero basis" problem associated with using corporate member options to compensate LLC service providers.[170] Under prior law, it appeared that a transfer of stock or options by a corporate member to a service provider of the LLC could be characterized as transfer of such stock or options to the LLC with a carryover basis (presumably zero)

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166 Rev. Rul. 99-57, 1999-2 C.B. 678.

167 Rev. Rul. 99-57, 1999-2 C.B. 678.

168 T.D. 8986 (Mar. 29, 2002).

169 Treas. Reg. § 1.705-2(b)(1).

170 T.D. 8883 (May 16, 2000). For a excellent comprehensive discussion of the section 1.1032-3 regulations, *see* Banoff, Sheldon I., *Partnership Use of Corporate Stock and Options as Compensation Easier Under the 1032 Regs*., 93 J. Tax'n 81 (2000).

and subsequent transfer to the service provider, resulting in taxable gain to the LLC and allocation of gain to the corporate member, both equal to the fair market value of the stock or options. It was not clear whether section 1032 applied to eliminate the tax on the gain allocated to the corporate member, and while the IRS did not mechanically apply such an unfavorable result, the lack of consistency in its rulings was troubling.[171]

- Under the section 1.1032-3 regulations, an LLC that compensates service providers with corporate member options is treated as purchasing the stock of the corporate member for the option's fair market value at the time of exercise, using cash deemed contributed by the service provider (equal to the option exercise price) and by the corporate member (equal to the option spread).[172] Immediately thereafter the LLC is deemed to transfer the stock to the service provider,[173] who recognizes ordinary income equal to the option spread upon exercise.[174] The corporate member will be protected from gain recognition by section 1032 and will receive a step-up in the basis of its LLC membership interest equal to the amount of cash deemed contributed to the LLC.[175]

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171 *See* Rev. Rul. 99-57, 1999-2 C.B. 678 (applying an aggregate approach); T.A.M. 98-22-002 (Oct. 23, 1997) (applying an aggregate approach); Rev. Rul. 80-76, 1980-1 C.B. 15 (applying a zero-basis approach without gain recognition); P.L.R. 98-22-012 (Feb. 5, 1998) (same); P.L.R. 98-53-038 (Oct. 1, 1998) (same). *See also* Treas. Reg. §§ 1.83-3(b), 1.83-6(d) and Treas. Reg.§ 1.1032-3(b) (nonrecognition applies to disposition of issuing corporation's stock by acquiring entity, in which cash is deemed contributed by issuing corporation, stock is deemed purchased by acquiring entity, then deemed sold immediately after).

172 Treas. Reg. § 1.1032-3(e), Ex. 8(ii).

173 Treas. Reg. § 1.1032-3(e), Ex. 8(ii).

174 I.R.C. § 83(a); Treas. Reg. § 1.83-7.

175 I.R.C. § 722.

- If the option exercise price is payable to the LLC and is not remitted to the corporate member, the LLC will be treated as purchasing the stock for its fair market value and the corporate member will increase its basis in its membership interest by the full fair market value of its stock without reduction for the option exercise price.

- The same favorable outcome should result under the section 1.1032-3 regulations in the case of an option to purchase stock of the corporate member's parent corporation, with the parent corporation also obtaining a stepped-up basis in the subsidiary stock (option to purchase stock of a direct corporate member).[176] Deemed cash purchase treatment is available to transfers of options through a chain of corporate subsidiaries to corporate service providers. By analogy, the same outcome should result when the recipient of options on stock of an upper-tier corporation provides services to a lower-tier subsidiary.[177]

- In the case of an option to purchase the corporate member's stock that is exercisable directly against the LLC, if the corporate member transfers the underlying stock to the LLC in advance of the option's exercise, the section 1.1032-3 regulations may not apply because the stock is not immediately transferred to the service provider.[178] Despite commentators' requests for clarification, the section 1.1032-3 regulations do not address whether the transfer would be governed by the regulations if the issuing corporation retains the stock until the option is exercised.[179] In any event, however, a

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[176] *See* Treas. Reg. § 1.1032-3(e), Ex. 8(ii) (option to purchase stock of a direct corporate member).

[177] Treas. Reg. § 1.1032-3(b)(1).

[178] *See* Treas. Reg. § 1.1032-3(c)(2) (requiring the transfer of stock to be immediate).

[179] *See* ABA Section of Taxation "Comments on Proposed Regulations § 1.1032-3" (Jan. 14, 1998) (requesting clarification from the IRS on

corporate member may be able to gain comfort from Revenue Ruling 99-57 (discussed above) that no tax should be imposed on the transfer.

F. Conversion and Forfeiture of Options

- An existing LLC may wish to convert to a C corporation under certain circumstances, *e.g.*, to facilitate a public offering of the company's stock. The effect of such a conversion on outstanding LLC options is unclear. Two theories appear to dominate: The C corporation option could be viewed as a mere continuation of the LLC option which, presumably, would not result in a taxable event. Alternatively, the transaction could be viewed as a surrender of the LLC options in exchange for newly issued C corporation options, which would only constitute a taxable event to the option holder if the LLC option had a readily ascertainable fair market value when it was exchanged.[180]

    - The conversion should not result in current income to the holder under either theory since it is highly unlikely that the C corporation options will have a readily ascertainable fair market value. In fact, the IRS recently ruled privately that an option holder would not recognize gain or loss when its LLC option was exchanged for a C corporation option.[181] Notably, however, the ruling does not specify how deep in the money the options were at the time of the exchange. Therefore, theoretical arguments

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Treasury Regulation section 1.1032-3(d), adopted verbatim, regarding whether an option must be exercisable for stock held by the issuing corporation in order to qualify for tax-free treatment).

[180] *See* I.R.C. § 1001.

[181] *See* Priv. Ltr. Rul. 98-01-016 (Sept. 30, 1997). The IRS has also issued similar rulings in the corporate arena where in the context of a reorganization a C corporation exchanged its options for options in a different C corporation. *See also* Priv. Ltr. Rul. 2000-04-026 (Oct. 29, 1999); Priv. Ltr. Rul. 97-38-009 (June 17, 1997); and Priv. Ltr. Rul. 90-31-009 (May 3, 1990).

regarding constructive receipt and substance over form may also apply to LLCs for corporate option exchanges.

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