EQUITY COMPENSATION PLANNING FOR PARTNERS AND EMPLOYEES OF PASS-THROUGH ENTITIES

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I. SCOPE OF THIS OUTLINE.

A. Pass-Through Entities.

Pass through entities which are the subject of this outline include General and Limited Partnerships, Limited Liability Companies (LLCs) electing to be taxed as partnerships and S Corporations. Not included are business and non-business trusts, sole proprietorships, REITs, RICs, Controlled Foreign Corporations and Passive Foreign Investment Companies or any other pass-through entity not contemplated.

This outline will discuss equity compensation in the context of Partnerships (used generically for all entities taxed as partnerships) and how it differs dramatically from equity compensation in the context of S corporations.

B. Equity Compensation.

Compensation planning generally includes considerations of how and when an employee is paid, what are the income and payroll tax consequences, what types of compensation may be conferred without current tax, what types of compensation may be conferred without tax either currently or deferred, what is the tax consequence to the employer and what are the reporting requirements.

Compensation is often seen as a motivational tool and as such, employers will sometimes structure compensation to tie pay to performance. This can be done where the performance measure is not related to the performance of the company. But, this is also often done with reference to the performance of the company, which is when planners use equity and equity-like compensation vehicles.

Equity compensation is also used when one or more of the owners have their expertise and services to contribute as part or all of their contribution to the venture whereas other owners are contributing property.

Equity compensation is also prevalent in mergers and acquisitions to allow the acquired to participate with the acquirer and to defer taxation on some of the proceeds of the sale.

This outline will discuss the tax aspects to both the entity and the service provider of receipt of equity and equity-like property and agreements in exchange for

services, the unsettled areas and planning to achieve client goals. While equity compensation connotes the payment for services in the form of property other than cash, equity-like compensation may also be paid in cash currently or at a future time.

II. GENERAL GROUND RULES FOR THE INCOME TAXATION OF PROPERTY PAID AND RECEIVED IN EXCHANGE FOR SERVICES

A. TAXATION OF EMPLOYEE/SERVICE PROVIDER.

1. Compensation received is included in gross income under IRC Sec. 61(a)(1) unless otherwise excluded from income by another code section or rule of law. Treas. Reg. Sec. 1.61-2(a).

2. For cash basis recipients, compensation is taxable in the taxable year of the recipient in which the amounts are actually or constructively received. IRC Secs. 446(c)(1), 451(a).

3. For accrual method recipients, compensation is taxable in the taxable year in which all events have occurred which establish the amount and entitlement to the compensation. IRC Sec. 446(c)(2).

4. For compensation paid after June 30, 1969, in the form of property, IRC Sec. 83 applies to determine the amount and timing of taxation of the receipt of such property to the recipient. Treas. Reg. Sec. 1.61-2. Under Sec. 83, property received for services, if it meets the requirements of that section, is included in income, at its fair market value, in the year in which the property becomes substantially vested. Treas. Reg. Sec. 1.83-1(a)(1).

5. IRC Sec. 83 requires three elements in order to apply:

   (a) Property;

   (b) Transferred from an employer (or affiliate); and

   (c) In connection with, the performance of services.

6. Property.

   (a) Defined as any real or personal property, other than money or an unfunded promise to pay money or property in the future. It also may include assets or money set aside in trust or escrow account, out of the reach of creditors, on behalf of an employee or service provider. Treas. Reg. Sec. 1.83-3(e).

   (b) The grant of an option to purchase property is not the receipt of property if the option is itself not trading on an established market. Treas. Reg. Secs. 1.83-3(2) and 1.83-7(a) & (b).

(i) The option does not later become taxable merely because the option becomes traded on an established market. Treas. Reg. Sec. 1.83-7(a).

(ii) But, the exercise of the option at a later date becomes taxable as compensation on the difference between the fair market value of the property received on exercise of the option and the strike price (exercise price), unless the option is a qualified option (Incentive Stock Option governed by IRC Sec. 422. Treas. Reg. Sec. 1.83-7(a).

7. A Transfer.

(a) The transfer of property for purposes of IRC Sec. 83 occurs when the service provider acquires a beneficial interest in property, even if subject to restrictions, if those restrictions are lapse restrictions. Treas. Reg. Sec. 1.83-3(a)(1).

(b) There has been no transfer where:

(i) The property is subject to non-lapse restrictions as described in Treas. Reg. 1.83-3(h) including a permanent right of first refusal in a particular person at a price determined under a formula. But if at fair market value, then it is not a non-lapse restriction.

(ii) The property is required to be returned to the employer upon the happening of an event that will in all events occur. An example is the requirement that the property be returned upon termination of employment. Treas. Reg. Sec. 1.83-3(3).

(iii) If the transfer is substantially similar to an option in operation, no transfer will be deemed to occur. Treas. Reg. Sec. 1.83-3(4).

(iv) If the property will be purchased from the employee for an amount that is well below fair market value. Treas. Reg. Sec. 1.83-3(5).

(v) If the employee does not bear the risk that the value of the property transferred could lose substantial value. Treas. Reg. Sec. 1.83-3(6).

8. In Connection With the Performance of Services.

(a) The performance of services includes past, present and future services and includes payment to refrain from performing services. Treas. Reg. Sec. 1.83-3(f).

(b) The rules on inclusion in income of the service provider apply even if the transferor is not the person for whom the services were provided. Treas. Reg. Sec. 1.83-1(a)(1) flush language.

(c) If a shareholder of a corporation transfers property to an employee of the corporation on account of the performance of services for the corporation, it is considered as if the shareholder contributed the property to the capital of the corporation and the corporation paid the compensation in the form of that property. Treas. Reg. Sec. 1.83-6(d)(1).

(i) In this case, if the shareholder who transferred the stock to the service provider received any money or property for the stock, the amount received is considered as if contributed to the corporation and then distributed to the receiving shareholder as a distribution tested under IRC Sec. 302, and may be treated as a dividend or as amounts received in exchange for stock.

9. While Section 83 requires inclusion of the fair market value of property received in return for services, the timing of taxation is governed by timing of when the property received is substantially vested and is transferable. Until both of those requirements are met, the value of the property is not, absent an election otherwise, includable in income of the employee. Treas. Reg. Sec. 1.83-3(b).

(a) Substantial vesting. Property is substantially vested when it is no longer subject to a substantial risk of forfeiture as defined in Treas. Reg. Sec. 1.83-3(c). A substantial risk of forfeiture is a facts and circumstances test which takes into account not only whether a restriction is substantial but also the likelihood of the employer enforcing the restriction if ultimately violated. The definition is found in Treas. Reg. Sec. 1.83-3(c).

(i) A substantial risk of forfeiture exists where:

(A) Rights in property transferred are conditioned on the future performance of substantial services;

(B) Rights in property transferred are conditioned on refraining from performing future substantial services;

(C) The employee must return the stock if earnings of the employer do not increase;

(D) In certain cases, a restriction prevents an employee from competing with the employer, depending on the employee's age and opportunity.

(ii) A substantial risk of forfeiture does not exist where:

(A) The employer is required to pay the employee the fair market value of the property if the restriction applies and the property must be returned:

(B) The employee is taking a risk that the value of the stock received will go down;

(C) Where the employee must return the stock if he is discharged for cause.

(b) Transferability. Under Treas. Reg. Sec. 1.83-3(d), the property is transferable if the person can transfer the property to another person, not subject to a substantial risk of forfeiture. Merely being able to designate a beneficiary in the event of death is not enough to cause the property to be transferable.

10. Election under IRC Sec. 83(b).

(a) If property is received in exchange for services, the three requirements of IRC Sec. 83 are met, but the value of the property is not includable in income because it is subject to a substantial risk of forfeiture, the employee may elect to include the property in income, at its fair market value, under IRC Sec. 83(b).

(b) To do so, the recipient must make an election within thirty days of receipt of the property by filing the election with the IRS Service Center where he files his return and the employee should provide a copy to the employer for attachment to its tax return for the year of inclusion. Treas. Reg. Sec. 1.83-2(b).

(c) The election must contain the following information:

(i) Name, address and tax identification number of the taxpayer'

(ii) Description of the property received;

(iii) Date on which the property was transferred;

(iv) Nature of the restrictions to which the property is subject;

(v) Fair market value of the property, determined without any lapse restrictions;

(vi) The amount paid for the property;

(vii) A statement to the effect that a copy of the election has been provided to the transferee and the person to whom the services were provided if different.

Treas. Reg. Sec. 1.83-2(d).

(d) If an election is made under IRC Sec. 83(b), the employee must be treated for all tax purposes as being the owner of the interest in the entity and as such, will receive a k-1 annually and include all items of income, loss, deduction and credit in income.

11. The employee required to include amounts in income will take a basis in the property received equal to the income required to be reported, plus the amount the employee was required to pay for the property. The holding period begins with the date of inclusion in income. A later sale or exchange of the stock will generate capital gain or loss.

12. The rules above related to the taxation of an employee or independent contractor in connection with the provision of services to a flow-through entity may sometimes be in conflict with the general treatment of persons who contribute property to a corporation or partnership (or LLC) under IRC Secs. 351 and 721. In some cases, those non-recognition provisions trump the general rules of Sec. 83 and may defer the taxation of property received for services. A complete discussion of this subject in the context of corporate and partnership employers follows later in this outline.

13. Rules related to the taxation of options to purchase property, particularly equity interests in the employer, are also discussed later in this outline.

B. TAXATION OF THE EMPLOYER.

1. The payment of property for services gives rise to a tax deduction to the employer to the extent allowable under IRC Secs. 162 and 212. Treas. Reg. Sec. 1.83-6(a).

2. The amount of the deduction is the same as the amount included in income by the recipient. Treas. Reg. Sec. 1.83-6(a)(1).

3. If there is a compensatory cancellation of a non-lapse restriction, the deduction mirrors the inclusion in income as well. Treas. Reg. Sec. 1.83-6(a)(1).

4. If the payment would otherwise be non-deductible because it exceeds that which would be reasonable compensation for services, it may be recharacterized as a dividend in the case of a corporate payor or as a distribution in the case of a partnership or LLC.

5. If the payment is for services that would otherwise be capitalizable, then the payment will be treated as a capital expenditure by the payor. Treas. Reg. Sec. 1.83-6(a)(4).

6. The timing of the tax deduction is governed by IRC Sec. 83(h) which may create a difference between when the amount is included in income and when it is deductible by the payor/employer. IRC Sec. 83(h) provides that the deduction is taken in the year of the payor with which or in which the taxable year of the recipient ends. Thus, a recipient on the calendar year may receive income in January 2004 and the payor may be a November fiscal year end taxpayer. In that case, the deduction for the employer falls in the November 2005 fiscal year. There is a split in the courts as to whether the year of inclusion for the employer is the year the employee actually included the value of the property in income or the year the income was required to be included in income, regardless of whether the employee actually included the amount in income. The regulations under 1.83-6(a) say it is the year included by the employee and IRC Sec. 83(h) says the same. At least one court says it is the year includable. Where the property is substantially vested on transfer to the employee, IRC Sec. 83(h) does not apply and the deduction to the employer should be taken on the date includable in income of the employee, under general principals in IRC Sec. 162 and 212. See *Robinson v. US*, 335 F.3d 1365 (Fed. Cir. 2003) reversing 2002-2 USTC ¶ 50,524 (Cl.Ct., 2002).

7. The deduction is predicated on the employer complying with the requirements of IRC Sec. 6041 and 6041A related to tax information reporting (i.e. forms W-2 & 1099) to recipients on or before the date for filing the return for the year the employer takes the deduction. Treas. Reg. Sec. 1.83-6(a)(2). This rule applies for taxable years beginning after January 1, 1995. Prior to that, treasury regulations required withholding to be taken out of the income by the employer. That regulation was challenged as being without substance relative to the allowance of a deduction and the IRS modified the regulations.

8. The payor may be required to report taxable income on the distribution of property in exchange for services to the extent the property is appreciated

over its basis in the hands of the employer. Treas. Reg. Sec. 1.83-6(b). To the extent IRC Sec. 1032 prevents the taxation of a corporation if it uses its own stock to pay compensation, then there is no gain or loss recognized. There is no corollary in the partnership area and so the tax result there is not yet settled.

III. EQUITY COMPENSATION IN A PARTNERSHIP/LLC CONTEXT

A. OVERVIEW.

1. The proliferation of LLCs in the last decade coupled with the promulgation of the “check-the-box” regulations in 1997 have helped to increase dramatically the use of LLCs as the entity of choice for many businesses.

2. Practitioners have become most comfortable with the corporate form and the equity based compensation techniques available to those entities. In many cases practitioners attempt to fit corporate equity based techniques to the LLC or partnership form, with varying degrees of success, and with some uncertainty.

3. In addition, the partnership form and its attendant tax rules create some new opportunities not available to corporations but also take away some opportunities only available to corporations.

4. It is to be sure, an ever changing area and the unanswered questions are many. It is also a challenging and interesting area sure to provide opportunities to companies and their employees.

5. This outline discusses the rules related to equity based compensation and does not debate the merits of whether it is ill-advised to pay compensation in this manner. Nor does it discuss the legal rights and obligations created by making an employee an owner, such considerations to be sure, should be explored with clients before embarking on this adventure.

6. In addition, for clients that have audited and reviewed financial statements prepared in accordance with generally accepted accounting principles (GAAP), the reporting consequences of equity based compensation needs to be discussed with the client’s CPA firm before entering into such a program.

7. Finally, equity based compensation may have implications to companies that are looking for venture capital or plan to go public. Such considerations need to be addressed before finalizing any compensatory arrangement.

B. TYPES OF EQUITY AND EQUITY BASED COMPENSATION IN THE PARTNERSHIP/LLC CONTEXT.

1. Equity and Equity based compensation connotes compensation that is either ownership in the entity or an instrument that acts like ownership of the entity.

2. The ownership or ownership-like instrument can be of the entire entity or of some element of the entity. Thus it may be affected by income, performance of the ownership unit, performance of a division or segment of the business or the like.

3. Ownership type interests may be ownership of capital, ownership of income or some hybrid type vehicle.

4. Non-ownership compensatory arrangements can include phantom equity, appreciation rights or options to purchase equity. These are essentially corporate type vehicles applied in a non-corporate environment.

C. NON-OWNERSHIP, EQUITY BASED COMPENSATORY ARRANGEMENTS IN A PARTNERSHIP/LLC CONTEXT.

1. Phantom Equity and Appreciation Rights.

(a) These are merely contractual compensatory arrangements that do not confer ownership on the employee.

(b) The considerations for LLCs and S Corporations are essentially the same. Since LLCs do not have the second class of stock prohibition, this is never an issue for LLCs.

(c) The typical arrangement involves the employer entering into an employment contract with a key individual to provide services in exchange for performance based payment. The employee has a contractual right to receive payment if the "benchmarks" are attained and/or if a triggering event such as death, disability or retirement occurs. Performance can be based on any objective agreeable to the parties. Payment is made when specified in the contract. Payment becomes taxable income in the year of actual or constructive receipt by the employee (or when the all events test is satisfied if the employee happens to be an accrual basis taxpayer).

(d) The payment is ordinary compensation income to the employee subject to reporting on forms W-2 or 1099 as appropriate and federal and state income tax and payroll tax withholding at the source. There is no ability to convert ordinary income into capital

gain to the employee because payment is always in the form of cash or property the value of which will be taxable as ordinary compensation income.

(e) A cash basis employer will deduct the compensation in the year in which it is paid under IRC Sec. 162 or 212. An accrual basis payor will deduct the compensation in the year in which all events have occurred that fix the amount and fact of the liability for the compensation and if the economic performance rules have been met with respect to such services. In addition, any payment of compensation after the year end and more than 2 ½ months thereafter, may be viewed as a plan of deferred compensation and the deduction will be deferred under IRC Sec. 404(b) until the year the employee includes the amount in income. Further, if the employee owns any interest in capital or profits of the partnership/LLC either actually or through constructive receipt because such service provider is related to an owner of an interest in the partnership or LLC under IRC Sec. 267(c) (other than by attribution from another partner of another partnership), then the deduction of the employer is matched to the year of inclusion of the employee under IRC Sec. 267(a)(2).

(f) The transfer of the contract right to the employee in exchange for services is not a transfer of property under IRC Sec. 83.

(g) The deductibility of compensation to an employee are subject to all other limitations to the extent applicable under IRC Sec. 162, 212 etc.

2. Options to purchase an ownership interest in a partnership or LLC.

(a) Options to purchase an interest in the employer or related entity are of two types, in the context of a corporation: qualified (otherwise known as incentive stock options governed by IRC Sec. 422) and non-qualified stock options, the taxation of which are governed by Section 83.

(b) In the context of partnerships and LLCs, the incentive stock option is not available. This leaves only non-qualified compensatory options.

(c) There are essentially two types of equity interests in which one could be granted an option to purchase, a capital interest and a profits interest. An option to purchase a profits interest seems to be irrelevant. An option to purchase an interest in the capital of an LLC or partnership looks very much like a non-qualified stock option in the corporate context.

(d) As stated above in the outline at Section II. A. 6. b., the grant of an option to purchase property, including an interest in capital of a partnership or LLC, is not a taxable event unless the option itself has a readily ascertainable fair market value. In order to have a readily ascertainable fair market value, the option would have to be traded on an established exchange. Treas. Reg. Sec. 1.83-3(2) and 1.83-7(a) and (b) and IRC Sec. 83(e)(3). The code and regulations do not seem to limit this treatment to stock of a corporation. IRS may conclude otherwise in forthcoming guidance but preliminary indications are that they will not. Since the grant of an option is not subject to Section 83, the employee may not make a Section 83(b) election with regard to the option at the time of grant.

(e) The exercise of an option to purchase a capital interest in an LLC or partnership is taxable under general principles set out in IRC Sec. 83 and the regulations thereunder. The employee recognizes taxable ordinary income to the extent the fair market value of the interest in the partnership exceeds the "strike price" (the price at which the employee must purchase the interest). The basis of the partnership interest to the employee is the price paid plus the income recognized as a result of the exercise of the option. The holding period begins on the day after the date of exercise of the option. Treas. Reg. Sec. 1.83-4(a) and (b).

(f) Under IRC Sec. 83(h), the employer is entitled to a deduction equal to the income reportable by the employee and under Treas. Reg. Sec. 1.83-6, the deduction is predicated on the employer meeting the reporting requirements for the employee to the federal government with regard to the compensation. Presumably the reporting requirement would be a form W-2 for an employee but if the employee becomes a partner, query whether the K-1 will satisfy this requirement. The likely answer is that as with an individual whose status changes from employee to partner in the middle of a year, that partner is likely to get both a form W-2 for his compensation before becoming a partner and a form K-1 for income after that date.

(g) At this point, the exercise of the option and the compensatory element should be treated under Section 704(c) as if a capital interest in the partnership is received in exchange for services. Questions remain as to how this exactly will play out. There are two generally accepted theories, discussed in detail later in the outline. However, the accepted view as it relates to the exercise of an option to acquire a capital interest in a partnership or LLC, the deduction is allocable to the partners in existence on the day before

the exercise of the option based on their relative interests in the partnership. The result is potentially different than the same transaction in an S corporation where income and deductions may be allocated to shareholders for periods before they were shareholders.

(h) As with any transaction where the substance differs from the form, if there is an attempt to circumvent the rules of taxation by the use of an option, through what is known as a "deep in the money option," IRS may regard the transaction as merely the issuance of an interest in capital in exchange for services and cause taxation at the date of grant rather than at date of exercise. If this occurs and the employer does not follow the rules on reporting of income on forms W-2 or 1099 out of a belief that the grant of the option is not taxable, the deduction may be lost.

D. ACTUAL OWNERSHIP EQUITY COMPENSATION IN PARTNERSHIPS AND LLC TAXED AS PARTNERSHIPS.

1. Interests in a partnership generally are either an interest in profits or an interest in capital. However, some interests may be hybrids and some partners may receive both capital and profits interests in exchange for services. This area is full of ambiguities and ancillary issues, many of which are yet to be resolved. This outline will attempt to further cloud the issue until IRS publishes long anticipated guidance.

2. Capital Interest – A capital interest in a partnership is one where the partner would receive value if the partnership was liquidated immediately after the grant of the interest in the partnership. See Rev. Proc. 93-27, 1993-2 CB 343 and Treas. Reg. Sec. 1.704-1(e)(1)(v).

(a) Receipt of a Capital Interest in Exchange for Services.

(i) Section 83 applies. A capital interest in a partnership or LLC is property for purposes of Section 83. If the interest is not subject to a substantial risk of forfeiture, then the fair market value of the interest received is includable in income of the employee in the year received.

(ii) If there is a substantial risk of forfeiture (see analysis above in this outline), the taxation of the receipt of the property may be delayed unless the employee files a timely Section 83(b) election. If a Section 83(b) election is not made, when the substantial risk of forfeiture lapses, taxation occurs.

(iii) If the receipt of a capital interest in exchange for services occurs at the time of formation or at a later time simultaneous with the contribution of property to the partnership/LLC, IRC Sec. 721 will generally shield the contributor of property other than services from income despite the fact that some portion of the interests in the partnership/LLC are going to a partner who does not contribute property. This result differs from corporations because IRC Sec. 721 does not have a similar requirement to IRC Sec. 351 requiring 80% control after the contribution to allow tax free treatment to those contributing appreciated property to the entity.

(b) Taxation of the Partnership/LLC.

(i) The partnership/LLC is entitled to a compensation deduction equal to the amount included in income of the employee. IRC Sec. 83(h), Treas. Reg. Sec. 1.83-6(a).

(ii) The deduction is taken in the year in which or with which the tax year of the employee ends, regardless of the method of accounting of the employer. IRC Sec. 83(h).

(iii) The deduction is allocated to the partners in accordance with their interests in the partnership on the day before the receipt of the interest.

(iv) Does the partnership recognize income as if it transferred an interest in each of its assets to the service partner? This is an open question but the likely answer is no. In the context of a corporation, the regulations shield the corporation from income in this situation (see discussion under S corporations later). There is no corollary in the partnership/LLC area. This raises the specter of two alternative theories of taxation of the partnership: (1) the Circular Cash Flow theory; and (2) the Deemed Exchange or Circle of Assets theory.

(A) Under the Circular Cash Flow theory, the partnership is deemed to have paid cash to the service partner followed by a contribution of cash to the partnership by the partner in exchange for the interest in the partnership. There is no gain or loss on the assets of the partnership and no change in tax basis. The capital accounts of the non-service partners are "booked up" to fair market value and

allocated to the non-service partners. See Treas. Reg. Secs. 1.704-1(b)(2)(iv)(f) and 1.704-3(a)(6)(i) for the "book up" and allocation provisions. This is the theory that is likely to be the result under pending guidance from IRS.

(B) Under the Deemed Exchange Theory, the service provider is deemed to receive cash which he/she uses to purchase an interest in each of the assets of the partnership, which the service partner in turn is deemed to contribute to the partnership in exchange for the partnership interest. The partnership recognizes gain on the deemed sale which is allocable to the non-service partners and the deduction is also allocated to the non-service partners. The capital accounts are booked up and the tax basis of the assets is stepped up under IRC Sec. 723, but the existing partners also recognize gain flow through.

3. Profits Interest – A profits interest in a partnership or LLC is defined as a partnership interest other than an interest in capital. Rev. Proc. 93-27, 1993-2 CB 343.

(a) Receipt of a Profits Interest in Exchange for Services.

(i) A profits interest is tantamount to a mere promise to pay income in the future. In that regard, it is roughly equivalent to phantom stock or a stock appreciation right in the context of a corporation. The interest is not capable of valuation unless it represents a steady flow of income and it confers no rights to anything of value if the partnership is liquidated immediately after the grant of the interest. As such it should not give rise to a taxable event upon grant in exchange for services. See *Campbell v. Commissioner,* 943 F 2d. 815 (8th Cir., 1991) and *Sol Diamond v. Commissioner,* 942 F 2d. 286 (7th Cir., 1974).

(ii) After the *Campbell* case, in which IRS conceded that a mere profits interest in exchange for services did not give rise to taxable income to the service provider, IRS issued guidance in the form of Rev. Proc. 93-27, 1993-2 CB 343, later clarified by Rev. Proc. 2001-43, 2001-34 IRB 199. In those rulings, IRS announced that a profits interest (vested or non-vested), received in exchange for services would not give rise to taxable income to a service partner performing

services for or on behalf of a partnership in a partner capacity or in anticipation of becoming a partner, if the following conditions are met:

(A) The income of the partnership must not be from a substantially certain and predictable stream of income from partnership assets such as a high quality portfolio of debt securities or a high quality net lease;

(B) The service partner must not dispose of the interest within two years of receipt; and

(C) The interest must not be a limited partner interest in a publicly traded partnership.

(iii) Under Rev. Proc. 2001-43, the receipt of a non-vested income interest will not be as taxable at either the time of receipt or when the interested is vested if the interest meets the requirements above under Rev. Proc. 93-27 and: A. the partnership and the service partner treat the recipient as the owner of the partnership interest for all tax purposes from date of grant; and B. Neither the partnership nor any of the partners may take a deduction for the grant of the interest or the vesting of the interest.

Rev. Proc. 2001-43 presumably eliminates the need to make a Section 83(b) election on the grant of a non-vested income interest but many practitioners advise making the election anyway.

(b) Taxation of the Partnership/LLC when a service partner receives an income interest in exchange for services

(i) The payment of a profits interest for services that qualifies under Rev. Proc. 93-27 is not a taxable event to the partnership. No tax deduction is allowable to the partnership and no income is taxable to the employee/service partner.

(ii) If the profits interest fails to qualify under Rev. Proc. 93-27, IRS' view is that the receipt of the interest is taxable compensation to the employee/service partner and thus, a compensation deduction under IRC Sec. 83(h) should be allowed under the rules set out above.

4. Interests in Both Capital and Profits.

(a) What happens if a service partner receives two types of interests, an interest in capital and an interest in profits. Or in the alternative, what if an interest can be characterized as both an interest in capital and profits. Or, what if a service partner simultaneously contributes property to a partnership and receives both an interest in capital and profits.

(b) The IRS could take the approach that the entire interest is currently taxable and unless a Section. 83(b) election is made, any interest that is not vested would become taxable when vested at its then fair market value. This may, or may not, be the preferred result. However, a reading of PLR 200329001 and GCM 37193 (1977), indicate that the capital and income interests may be able to be treated separately and differently.

E. REVALUATIONS ON ISSUANCE OF PROFITS INTERESTS UNDER THE PROPOSED REGULATIONS.

1. Substantial Economic Effect – Under IRC Sec. 704(b), a partnership's allocation of income, loss, deduction and credit to its partners must have substantial economic effect. If it does not, the IRS may re-allocate in a way that meets the substantial economic effect rules. If there is no partnership agreement, the allocations must have substantial economic effect taking into account all of the facts and circumstances. If there is a partnership agreement, the regulations at Treas. Reg. Sec. 1.704-1 provide that there are three ways to meet the substantial economic effect rules:

(a) The allocation can meet the test for substantial economic effect under Treas. Reg. Sec. 1.704-1(b)(2); or

(b) The allocation can be made in accordance with the partner's interest in the partnership taking into account factors such as a partner's relative contributions, his interest in economic profits and losses, rights to cash flow distributions and rights to liquidating distributions, set out in Treas. Reg. Sec. 1.704-1(b)(3); or

(c) The allocations can meet one of the special rules under Treas. Reg. Sec. 1.704-1(b)(4).

2. The substantial economic effect test under Treas. Reg. Sec. 1.704-1(b)(2) involves a two-part analysis. This analysis is made at the end of the tax year of the partnership/LLC to which the allocation relates. At that time, the allocation must have both economic effect and the economic effect must be substantial.

(a) Economic effect – Treas. Reg. Sec. 1.704-1(b)(2)(ii) describes the economic effect of an allocation. If a partner receives an allocation, he/she must bear the economic benefit or burden of such allocation. Probably the most prevalent way to meet this test is to meet the three-pronged requirements of Treas. Reg. Sec. 1.704-1(b)(2)(ii)(b). Those three requirements are:

(i) Determine and maintain capital accounts for partners in accordance with the rules in the regulations; and

(ii) Upon liquidation, liquidating distributions must be made in accordance with positive capital accounts taking into account all adjustments through the tax year of liquidation or if later, ninety days after the liquidation; and

(iii) A partner that has a deficit capital account must be unconditionally required to restore the deficit capital account unless an alternate test is used to meet this requirement.

(b) Substantial – under Treas. Reg. Sec. 1.704-1(b)(2)(iii), an allocation must have a reasonable possibility that it will impact the economic benefits and burdens of the partner, and is not merely a temporary shifting of tax benefits with little or no overall economic effect on the partners.

3. Capital Account Maintenance Rules.

(a) It is likely that the vast majority of partnerships and LLCs maintain capital accounts in accordance with the above rules to meet the substantial economic effect test. Capital accounts are maintained on a tax basis for purposes of determining the tax consequences of transactions to the partners. Capital accounts for purposes of the substantial economic effect test are kept on a "book" basis in order to reflect the economic deal among the partners.

(b) Treas. Reg. Sec. 1.704-1(b)(2)(iv)(f) sets out the rules when capital accounts may be revalued for purposes of determining if an allocation has substantial economic effect and thus reflecting the real deal as contemplated by the parties. A book revaluation can have significant effect on the tax allocations in a partnership. The current rules allow revaluations in three situations:

(i) When a new or existing partner contributes money or other property in exchange for an interest in the partnership;

(ii) When the partnership is liquidated or a continuing; or retiring partner receives money or other property in exchange for an interest in the partnership; and

(iii) In the case of certain investment companies, (like hedge funds), in accordance with industry accounting practices (usually, marked to market on a regular basis).

4. Effect of Revaluation – the partnership revalues its assets by determining the fair market value of each asset it owns, which in turn reflects how unrealized income, gain, loss and deduction would be allocated to the partners if all of the assets were disposed of on that date. Capital accounts of the partners are adjusted accordingly and then going forward, under IRC Sec. 704(c), allocations of tax attributes in accordance with book capital accounts are made. This should have the effect of preventing a change in partnership interest from altering the economic deal.

5. Application of the revaluation rules to the issuance of a profits interest under Prop. Reg. Sec. 1.704-1(b)(2)(iv)(f)(5)(iii), issued July 2, 2003. The proposed regulation adds a fourth situation where capital accounts may be revalued in order to reflect the economic deal of the partners. This situation occurs upon the issuance of a profits interest in a partnership in exchange for services. While the wording of the regulation does not speak specifically to interests in profits, the wording is the same as in Rev. Proc. 93-27 and so it is thought that Treasury intended these regulations to apply only to an interest in profits issued to a new partner acting in his capacity as a partner or in anticipation of becoming a partner. These "book up" rules would apply after publication of the final regulations in the federal register and are seen as a welcome change.

6. Practical impact of revaluation and what to do until it is available.

(a) EXAMPLE 1 – A & B are the original members of AB LLC which owns a residential apartment building. The building has a depreciated cost basis of $1,500,000 and a fair market value of $3,000,000. Member C is brought on to manage the building and is given a 1/3 profits interest in the LLC. Absent a revaluation, and absent any other action, if the LLC was liquidated the next day, C would receive $1,000,000, and this interest would fail to qualify as a profits interest under Rev. Procs. 93-27 and 2001-43..

(b) Under the Proposed Regulations, a revaluation occurs on the day before the profits interest is granted. The value of the building is restated to $3,000,000 and the book capital accounts of A & B are booked up to $1,500,000 each. C then starts with a zero book capital account and the revenue procedures are complied with.

(c) Until the proposed regulations are effective, there are three alternative ways to deal with the issue that the author can think of, there are likely to be more:

(i) Use the proposed regulations anyway. Will this work? Not known;

(ii) Have at least one other partner contribute cash or other property to the partnership simultaneously with the issuance of the profits interest, thus putting you within the current treasury regulations allowing a revaluation (see Letter Ruling 200329001); or

(iii) Fashion the income interest in your operating agreement or partnership document to exclude appreciation in assets prior to the issuance of the profits interest, from the capital of the profits partner.

F. FINANCIAL ACCOUNTING ISSUES.

1. Most LLCs and Partnerships do not issue financial statements prepared in accordance with GAAP but some do. The treatment of a profits interest for financial statement purposes may have a big impact on current earnings. And in the case of entities that may go public, the proper reporting of the compensatory element can be a sensitive issue in this era of restated earnings on the part of public companies and public mistrust of financial accounting data.

2. The accounting industry still relies on APB 25 "Accounting for Stock Issued to Employees" to govern how awards of equity participation to employees is treated for financial purposes. Although it speaks in terms of stock, compensation arrangements in LLCs that are substantially similar are accorded similar accounting treatment. The APB categorizes such awards into two basic categories: fixed awards and variable awards.

3. If an award is treated as a fixed award, the compensation expense is booked on a level basis over the vesting period of the award.

4. If the award is treated as a variable award, the compensation expense is determined each period by calculating the intrinsic value of the award until it either vests or in the case of an option, is exercised.

5. Generally speaking, structuring equity participation to meet the fixed accounting rules will have a favorable impact on current earnings and in the realm of larger acquisitions and startups expected to go public, it is expected that entities will attempt to structure to meet these rules. A basic profits interest should meet the fixed accounting rules. Adding special

features such as special allocations and conversion features may push the award into the variable accounting rules and may be ill-advised.

6. On the other hand, financial reporting of stock options, particularly for public companies, has become the subject of much discussion and scrutiny. On March 31, 2004, the Financial Accounting Standards Board issued an exposure draft that would treat all forms of compensation paid to employees that are based on shares, including stock options, as if it was any other compensatory arrangement and the related cost would be required to be recognized currently as an expense.

7. At the current time, FAS 123 requires companies issuing stock options to estimate the value of the options and show the fair value as a cost over the years related to their vesting. The cost can either be shown on the income statement or can be footnoted.

8. Stock options are the subject of several bills pending in the 108th Congress as of April 15, 2004.

G. PLANNING.

1. Conversion of ordinary income to capital gain – while a profits interest is tantamount to an unsecured promise to pay compensation in the future, a profits interest in a partnership has the potential to shift ordinary income to capital gain. Compare the profits interest to phantom stock in a corporate setting. A phantom stock arrangement, as will be discussed later, is pure compensation. Usually upon a triggering event such as a sale of the business or a change in control, the employee under a phantom stock arrangement receives cash compensation measured by just about anything but usually based on his/her share of the difference between the fair market value of the company and the benchmark value used to value the company at the time of the arrangement. The employee receives a W-2 and the payment is made after federal, state and payroll tax withholdings. It is usually at this point that the employee who was ecstatic when the phantom stock award was made is now appalled at the size of the tax bite. The employer on the other hand receives a valuable deduction for the amount paid to the employee and even the employer's half of the FICA and Medicare tax is tax deductible. Had the employee received a profits interest in the entity, the post grant appreciation in the entity allocated to the profits interest is taxed as capital gain to the extent not allocable to Section 751 "hot assets." That capital gain retains the character of the underlying assets under IRC Sec. 1(h) and so the gain may be taxed at 28% in the case of collectibles, 25% to the extent of prior depreciation on real estate and 15% on everything else, at least until 2008. In addition, there would be no FICA or Medicare tax on this amount. And, some states and localities do not tax capital gains whereas they may tax

compensatory payments. On the other side, some states may tax a profits interest in an LLC or partnership as an intangible whereas a compensatory arrangement may not be taxed. All things must be considered.

2. Shifting of value to family members – in the context of family businesses, a profits interest has the ability to shift value to a lower generation family member without income or transfer tax cost. As can be seen in the prior paragraph related to shifting ordinary income to capital gain, the profits interest also has the ability to shift value to the lower generation family member. Arguably, this is not really a shift as the increase in value of the entity is presumably tied to the efforts of the lower generation family member. And it makes sense that the matriarch or patriarch (founder) should not be transfer taxed on value increases attributable to the efforts of an heir to the estate. This would certainly not be the case if the founder had gifted his or her interest in the entity to the next generation, in which case the appreciation in value would attach to the interest now owned by the next generation. However, the problem of moving the interest to the next generation without transfer tax cost or shifting appreciation to the next generation is easily dealt with using a profits interest where the family member really performs services for the family business. Otherwise, other freeze transactions are necessary to accomplish the same result. And sometimes, this cannot be done without giving up some measure of control, which may be easier dealt with using a profits interest.

3. Potentially superior to stock bonus arrangements for S corporations – many taxpayers will want to give stock to employees but for various reasons, delay the taxation of the stock reward. Where this is the case, the ultimate award of stock, or the lapse of a restriction absent a Section 83(b) election may give rise to a very large compensation item to the employee and a very large paper deduction to the company. If the company is an S corporation and there is not enough basis in the S stock to absorb the deduction, the overall tax paid by both parties on the transaction may be far too high. S corporations need to be wary of the trap but the profits interest avoids the problem by matching the income to the event triggering the receipt of assets necessary to pay the tax and converting part of the income to capital gain, thereby ameliorating the tax bite.

IV. EQUITY COMPENSATION IN THE CONTEXT OF "S" CORPORATIONS

A. OVERVIEW.

1. S corporations are the "other" pass-through entity. While they operate much like partnerships and LLCs electing to be taxed as partnerships, there are important differences. In the context of equity based compensation, the differences include the following:

(a) Except to the extent otherwise provided in Subchapter S of the Code, S corporations are corporations subject to the rules on taxation of corporations. IRC Sec. 1363. Non-compensatory distributions to owners are tested under IRC Secs. 301 and 302 to determine if they are treated as dividends or redemptions. If a dividend, they run the gamut of the IRC Sec. 1368 rules to determine whether the distribution is deemed to come out of accumulated adjustments, C corporation earnings and profits if any, or applied against basis.

(b) Only citizen or resident alien individuals, estates and certain qualifying trusts may be owners. IRC Sec. 1361(b)(1).

(c) There may be no more than 75 shareholders counting husband and wife as one and each potential current income beneficiary of an Electing Small Business Trust as one. IRC Sec. 1361(b)(1), (c)(1) and (c)(2)(B)(v).

(d) Certain entities such as financial institutions using the reserve method of account for bad debts, certain insurance companies and a few other special entities may not be S corporations. IRC Sec. 1361(b)(2).

(e) A subsidiary corporation may not be an S corporation and grant equity to another shareholder since a subsidiary corporation must be wholly owned by an S corporation to qualify to be an S corporation. IRC Sec. 1361(b)(3).

(f) An S corporation is prohibited from having more than one class of stock. The two class of stock rule is important in the context of equity compensation. The only permitted difference between types of stock is voting rights. Thus, an S corporation may have both voting and non-voting common stock but may not have common and preferred stock. IRC Sec. 1361(b)(1)(D) and Treas. Reg. Sec. 1.1361-1(b)(1)(iv). All outstanding shares must confer identical rights to distribution and liquidation proceeds. Treas. Reg. Sec. 1.1361-1(l).

(i) Unlike partnerships and LLCs, equity compensation may not give different classes of stock (other than voting and non-voting) to service shareholders versus capital shareholders. These types of arrangements must be taken care of through compensation agreements. Treas. Reg. Sec. 1.1361-1(b)(4).

(ii) Buy-sell agreements are typically ignored in determining if a class of stock differs from another class of stock, except where the purpose of the agreement is to circumvent the second class of stock rules. Treas. Reg. Sec. 1.1361-1(l)(2)(iii).

(iii) Restricted stock issued in connection with the performance of services for the corporation and which is substantially non-vested is treated as not being outstanding unless a Section 83(b) election is made. Treas. Reg. Sec. 1.1361-1(b)(3).

(iv) A compensatory arrangement that does not convey the right to vote, is an unfunded unsecured promise to pay money or property in the future, is issued in connections with the performance of services and is under an arrangement where the recipient is not taxed currently, will not be treated as outstanding stock, even if there is a current payment feature that mirrors a supposed dividend with respect to stock to be received in the future. Treas. Reg. Sec. 1.1361-1(b)(4).

(g) Unlike a partnership or LLC where IRC Sec. 721 provides a shield to those contributing property who do not control the partnership after the transfer, the tax free incorporation rules of IRC Sec. 351 do not shield a contributor of appreciated property from recognizing income on the receipt of stock in exchange where a service provider receives a significant enough stake in the company to fail the 80% control test. And if a service shareholder contributes services and property to the corporation in exchange for stock, and if the services are substantial enough to acquire more than 20% of the stock, the contribution of property will not be shielded from recognition of gain by IRC Sec. 351. See Treas. Reg. Sec. 1.351-1(a)(1)(ii). Services are themselves not property and the receipt of stock (unless otherwise restricted) will give rise to compensation income to the recipient of the stock, taxable under IRC Sec. 83, and will not be shielded by the non-recognition provisions of IRC Sec. 351.

2. Types of equity compensation generally available to employees of S corporations include the following:

(a) Stock Bonus plans, qualified and non-qualified;

(b) Restricted stock;

(c) Stock options, qualified and non-qualified; and

(d) Stock appreciation rights and phantom stock.

B. Discussion of the different types of Equity Compensation.

1. Stock Bonus Plans – Non-Qualified.

(a) Although paying an employee in stock, absent restrictions on the stock, is not actually “deferred” compensation, it is sometimes advantageous from a tax standpoint to do so.

(b) A bonus paid in employer stock (or that of a subsidiary corporation) is taxable to the employee as compensation and is taxable for income as well as FICA tax purposes. The amount of taxable income is the fair market value of the stock on the date of the transfer to the employee.

(c) The employer receives a tax deduction for the payment as long as it includes the compensation on the W-2 of the employee or otherwise complies with the reporting requirements for such compensation. [Treas. Reg. Section 1.83-6(a)(2)]. Thus, the employer receives a tax deduction without a cash outlay.

(d) Sometimes, the employer will agree to do this and take the refund of tax it receives from the government by virtue of the tax deduction and pay additional compensation to the employee to pay his/her tax. This is often “rolled” forward each year until the additional compensation to the employee is *deminimus*.

(e) Since the employee becomes an owner, there are several additional considerations:

(i) The employer should be careful and make the shares subject to buy/sell agreements generally applicable to other owners. There may even be special provisions vis-à-vis the employee.

(ii) Under Ohio law [*Crosby vs. Beam,* 47 Ohio St 3d 105 (1989)], the employee may acquire additional rights including not only those of any other minority shareholder, but also no longer being employed “at will.”

(iii) If the corporation is an S corporation, be sure the employee is a qualified S shareholder and is restricted from doing anything that would jeopardize the S election.

2. Restricted Stock.

(a) Restricted stock is the same as a stock bonus plan except the stock received by the employee is subject to restrictions that create a “substantial risk of forfeiture.”

(b) The restriction, if substantial, will prevent current taxation for FICA and federal income tax purposes. It also prevents a current tax deduction to the employer.

(c) Substantial risk of forfeiture is a facts and circumstances test which takes into account not only whether a restriction is substantial but also the likelihood of the employer enforcing the restriction if ultimately violated. The definition is found in Treas. Reg. Sec. 1.83-3(c).

(i) A substantial risk of forfeiture exists where:

(A) Rights in property transferred are conditioned on the future performance of substantial services;

(B) Rights in property transferred are conditioned on refraining from performing future substantial services;

(C) The employee must return the stock if earnings of the employer do not increase; and

(D) In certain cases, a restriction that prevents an employee from competing with the employer, depending on the employee's age and opportunity.

(ii) A substantial risk of forfeiture does not exist where:

(A) The employer is required to pay the employee the fair market value of the property if the restriction applies and the property must be returned;

(B) The employee is taking a risk that the value of the stock received will go down; and

(C) Where the employee must return the stock if he is discharged for cause.

(iii) The above are provided from the regulations by way of example. Other situations will be determined based on facts and circumstances.

(d) If there is a substantial risk of forfeiture, the employee is not required to be taxed currently. However, especially in the case of startups, the employee may be better off if taxed currently rather than later if the company stock value goes up. In this case, the employee may wish to make a Section 83(b) election. If made, the employee agrees to be taxed on the value of the stock received as if not restricted. The income is compensation income subject to

federal income tax and FICA and Medicare tax withholding. The employer receives a corresponding tax deduction. The employee then has a basis in the stock equal to the amount included in income and the holding period for purposes of determining whether later gain or loss is long term or short term capital gain begins on the date of the election. The Section 83(b) election must be made within 30 days of the transfer of the restricted stock to the employee.

(e) If a Section 83(b) election is made for an employee of an S corporation, the two class of stock rules of IRC Section 1361(b)(1)(d) will not be violated. [Treas. Reg. 1361-1(l)(3)]. However, once an 83(b) election is made with respect to S corporation stock, the electing shareholder is treated as the shareholder for purposes of subchapter S. This means that he/she will receive the k-1 and have to report the income and receive distributions with respect to that stock. [Treas. Reg. Section 1.1361(b)(3)].

3. Incentive Stock Options (ISO). [Qualified Stock Options under IRC Section 422].

(a) Typically used by publicly traded corporations although they may be used in larger closely held corporations.

(b) As with most options, the receipt of the ISO is not currently taxable to the employee.

(c) ISOs are an exception to the general rule of taxation of non-restricted property received as compensation by an employee. Ordinarily, the exercise of an option, particularly in a public company, would be taxable compensation in the amount of the fair market value of the option at date of issuance less the “strike price,” the amount which the employee must pay to exercise the option.

(d) In addition, but for this exception to the general rule, the taxable amount would be taxed at ordinary income tax rates and would be subject to payroll tax withholding.

(e) However, if the employee exercises an ISO within the rules of IRC Section 421, the tax consequences will be as follows:

(i) No tax to the employee upon grant of the option.

(ii) No tax to the employee upon exercise of the option. The employee merely pays the strike price and holds the stock

(iii) No tax deduction to the employer at that time of grant of the option, no tax deduction at the time of exercise of the option and no tax deduction to the employer at any time if the employee does not make a disqualifying disposition of the stock after exercise of the option.

(iv) Upon later sale of the stock, if after two years from the date the option was granted and one year from the date it was exercised, the employee will have long-term capital gain income on the difference between the strike price and the sale price of the stock.

(v) In order to get this treatment, the employee must exercise the option not later than three months after termination of employment with the employer or affiliated company.

(vi) The employee will have an alternative minimum tax preference item for the amount, which is the difference between the strike price and the fair market value of the stock on the date of exercise, in the year of exercise. This amount is creditable and will be returned to the employee in a later year when the AMT credit may be used. The AMT preference item is the biggest source of surprise and dismay for employees exercising ISOs if not adequately apprised of the issue or if they don't pay attention to the paperwork provided by the employer.

(f) If the employee disposes of the stock before the date which is both two years after the grant of the option and one year before the date of exercise of the option (a disqualifying disposition), the option will be treated as a non-qualified stock option and the difference between the strike price and the fair market value of the stock will be treated as compensation. The employer and employee will treat it as such.

(g) Per IRC Section 422(d)(1), "To the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to this subsection) are exercisable for the 1st time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, such options shall be treated as options which are not incentive stock options."

4. Non-Qualified Stock Options (NSOs).

(a) Used by both publicly traded and closely held companies. Closely held companies are more likely to use these types of options than ISOs if options are to be used as compensation.

(b) The tax consequences are different if used by closely held companies and public companies whose stock options are not traded on a public market than if used by a company whose stock options are publicly traded. The tax consequences for those without publicly traded options are as follows:

(i) No tax consequence to the employee on grant of the option because the option has no readily ascertainable value.

(ii) No tax deduction to the employer on grant of the option.

(iii) Upon exercise of the option, the employee has immediate compensation income in the amount of the difference between the strike price and the fair market value of the stock on date of exercise. There is no alternative minimum tax preference with NSOs.

(iv) The employer receives a compensation deduction in the amount the employee is required to pick up in income on the date of exercise. The compensation income is also subject to federal income tax and FICA and Medicare tax withholding.

(c) No Section 83(b) election is available on the grant of NSOs.

5. Stock Appreciation Rights and Phantom Stock..

(a) Stock Appreciation Rights (SARs) and Phantom Stock are two names for what is in essence the same thing.

(b) SARs and Phantom Stock are deferred compensation arrangements, which usually call for the payment of cash bonuses to a management employee, based on certain financial benchmarks.

(c) Payment can be triggered by any of a number of events including death, retirement, sale of the business, change in control of the business, disability, etc.

(d) The amount of payment can be tied to any of a number of items including the financial results of the company or a segment of the company, increases in sales or fee income, increases in gross profit or net profit or meeting any other goal that the company can think of.

(e) Payment may be made whenever required under the contract.

(f) The employee has merely a contractual right to receive payment. The payment is generally not secured and is usually not funded. The payment is subject to the employer's ability to pay.

(g) Payment when received is ordinary compensation income to the employee and deductible compensation to the employer.

C. ISSUES ON ALLOCATION OF TAX DEDUCTIONS – IRC SECTIONS 1377 AND 1368.

1. Income recognition to corporation.

(a) Generally, a corporation that uses appreciated property to pay compensation will be treated as having sold the property at fair market value and then having paid the compensation in cash.

(i) Gain or loss is generally recognized.

(ii) Loss may not be recognized if the recipient is related to the corporation.

(b) If a corporation uses its stock or the stock of an affiliated company gain or loss is not recognized. IRC Sec. 1032; Treas. Reg. Sec. 1.1032-3.

2. When the corporation is deemed to have paid the compensation, the deduction falls in the corporation's tax year and is allocated to the shareholders on a per-share, per-day basis under the general rule of IRC Sec. 1366 and 1377(a)(1).

(a) Thus, a person becoming a shareholder during the tax year may share in the allocation of the tax deduction; whereas in a partnership, the service partner generally would not.

3. Under certain circumstances, the corporation may actually close the books and allocate the deduction to one or another part of the tax year.

(a) IRC Sec. 1377(a)(2) allows an actual close of the books if all affected shareholders consent and if any shareholder terminates his or her entire interest in the corporation.

(i) If it is desired to allocate the deduction more to or away from the service provider, a shareholder may be able to cause an actual close of the books by agreeing to terminate an interest at an opportune time.

(ii) If the property received in exchange for services is subject to Section 83, the tax deduction will fall on the last day of the recipient's tax year and therefore may fall at the end of the year instead of earlier.

(b) IRC Sec. 1368 and Treas. Reg. Sec. 1.1368-1(g) also allows an election to close the tax year if there is a qualifying disposition which includes any of the following three types of dispositions:

(i) A disposition of 20% or more of the outstanding stock of the corporation by a shareholder within a thirty-day period in one tax year;

(ii) A redemption treated as a sale or exchange under IRC Secs. 302(a) or 303(a) of 20% of the stock of the corporation within a thirty-day period during one tax year; and

(iii) The issuance of 25% or more of the previously outstanding stock to one or more new shareholders during a thirty-day period during one tax year.

D. INCOME TAX VERSUS FICA AND MEDICARE TAX ISSUES.

1. It is possible to have amounts which represent deferred compensation be deferred for income tax purposes but taxable currently for FICA and Medicare tax purposes.

2. In order to avoid current income taxation, the employee must not be in constructive receipt of the compensation and must not have received an economic benefit there from. [Treas. Reg. Section 1.451-2].

(a) Constructive receipt occurs if the employee has earned the payment and decides not to take payment. If the payment was not made available to the employee, or if the payor was not able to make the payment, or there were substantial restrictions on the employee's ability to take payment, or if the employee had no control over the right to take payment, then the amount will not be considered to be constructively received.

(b) If however, the employee elects to defer income before he is entitled to receive it, particularly before the services are rendered, and if the employee's right to the payment is merely an unsecured promise to pay by the employer, the deferred income taxation will be recognized. [Rev. Rul. 60-31, 1960-1 CB 174, as modified by Rev. Rul. 64-279, 1964-2 CB 121, and Rev. Rul. 70-435, 1970-2 CB 100].

3. FICA and Medicare tax is payable at the moment when the amounts are no longer subject to a substantial risk of forfeiture. This will be discussed in greater detail below. The question of whether to defer FICA and Medicare tax or pay it up front depends on the facts of each situation. In some cases, it will be better to pay up front.

4. Deferred compensation does not have to be an amount deferred from the pay to be received by the employee. It can also be a deferred payment of an amount over and above normal salary. Sometimes this is the incentive payment under a phantom stock arrangement or SAR. Sometimes it is pay for past services that the employer now recognizes as contributing to the success of the company or for longevity or loyalty. Or it can be payment that an employer promises to make later in order to keep the employee with the company, such as a golden handcuff.

E. PLAN DESIGN AND CONSTRUCTIVE RECEIPT

1. The employee and the IRS have competing interests. The employee wants as much security and control over the deferred compensation as he can get. The IRS feels that when the employee receives too much control, he has either constructively received the payment or received an economic benefit that causes taxation.

2. Plans can be structured using an account balance/defined contribution type concept or a defined benefit type concept. Regardless of how designed, employees generally want the plan to have certain features if it can be accomplished.

3. The employee ideally wants the plan to include the following features, often in contravention of IRS thoughts on the subject:

   (a) The payment or money to fund the benefit should be set aside and not be touched by the employer for any purpose other than to provide benefits to the employee.

   (b) If there is more than one employee under the deferred compensation plan, usually the employee will want his own fund.

   (c) The employee would like to have some say-so as to how the funds are invested.

   (d) The employee would like to have the funds not be subject to claims of company creditors.

   (e) The employee would like to be able to receive the funds in all events.

4. If the employee had all of his wishes come true, he would be taxed immediately for income and FICA and Medicare tax purposes. But, the employer would receive a current tax deduction. Plans are sometimes designed this way [via secular trusts] although the benefit is less significant.

5. In order to prevent current income taxation, the plan should have the following features:

   (a) Either no funding at all or if funded, the fund should be subject to the claims of the creditors of the company.

   (b) The ability to currently receive the funds should be subject to a restriction, which is substantial, such as retirement or separation from service or severe financial loss.

   (c) The payment of the funds should not be secured.

   (d) The employee should not control the investment of any funds set aside.

V. FUNDED AND UNFUNDED PLANS

A. UNFUNDED PLANS

1. The typical non-qualified deferred compensation plan is an unfunded and unsecured promise by the employer to pay compensation in the future. The plan need not be in writing.

2. The employee (assuming it is a cash basis employee) will have income in the year of payment and the employer will have a deduction in the year paid or accrued depending on the method of accounting of the payor. If the payment is accrued by an accrual basis payor, the amount will be deductible in the year accrued if paid within 2½ months after the end of the tax year unless the payee is a related party. A related party in a C corporation is anyone who is a more than 50% owner including attribution. For an S corporation and partnership as well as an LLC electing to be taxed as a partnership, any owner (including attribution) is considered a related party. [IRC Section 404(a)(5) and 267(a)(2)]. In the case of a payment to a related party, payment is deductible in the year made regardless of the accounting method of the payor company.

3. If the plan is a deferral of income that the employee would otherwise receive as current compensation, it will be deferred for income tax purposes as long as the election to defer is made prior to the year in which the services are performed.

B. FUNDED PLANS.

1. In order to get closer to the desires of most employees, particularly those who are not owners or related to owners, many plans are "funded" insofar as money or property is set aside for the employee.

2. The typical way this is done is through trusts although escrow arrangements may also be used. There are essentially two types of trusts that an employer may use to hold the assets used to fund the deferred compensation:

   (a) Rabbi Trusts.

   (b) Secular Trusts.

3. Rabbi Trusts. These are the most common. Properly done, they achieve the income tax results desired by the employee. IRS has prepared and published a model Rabbi trust and if a taxpayer uses the model trust, they are deemed to meet the constructive receipt and economic benefit rules without an advanced ruling. The trust can be found at Rev. Proc. 92-64, 1992-2 CB 422. The original ruling that sanctioned the technique is PLR 8113017.

   (a) The trust provides that it may be used only to pay promised benefits.

   (b) The trust is a grantor trust with respect to the employer.

   (c) The employer maintains administrative and investment powers over the trust.

   (d) The trust assets are subject to the general creditors of the company although the amounts held in the trust are safer than if it was merely an unsecured promise to pay.

4. Secular Trusts. The main difference between Rabbi and Secular trusts is that while a Rabbi trust provides for deferral of taxation, the secular trust does not. The employee gets greater protection but is currently taxed. The employer usually helps the employee pay the tax on an as you go basis.

   (a) There is some uncertainty regarding the taxation of secular trusts. The trust may be considered an employer grantor trust under IRC Section 677 or it may be taxed as a Section 402(b) trust.

   (b) IRS may also contend that distributions to the employee prior to age 59½ is subject to a 10% excise tax on distribution under IRC Section 72(q).

(c) IRS analysis of the issues is found in PLR 9502030 and 9417013.

(a) This excerpt from PLR 9502030 illustrates the uncertainty in the taxation of these arrangements: …"The tax consequences to highly compensated employee Plan participants of amounts actually distributed or made available from the Trust are unclear. Section 402(b)(4)(A) of the Code in its current form does not apply section 402(b)(2) to trigger application of Section 72 to amounts actually distributed or made available to a highly compensated employee from a nonexempt trust to which Section 402(b)(4)(A) applies. However, under the technical correction described above contained in H.R. 11, 102d Cong., 2d Sess. Section 6102(j)(1)(A) (1992), amounts actually distributed or made available to a highly compensated employee from a nonexempt employees' trust to which Section 402(b)(4)(A) applies would be taxed under Section 72 (relating to annuities). From this proposed technical correction, it appears that Congress intended to tax amounts actually distributed or made available to highly compensated employees from nonexempt employees' trusts in accordance with the rules of Section 72. Accordingly, this ruling does not address the tax consequences to highly compensated employee Plan participants of amounts actually distributed or made available from the Trust. In the event that Section 402(b)(4) is amended in accordance with the proposed technical correction, the 10% additional tax imposed under Section 72(q) will not apply to amounts actually distributed or made available from the Trust."

VI. FICA TAX ISSUES

A. BACKGROUND ISSUES AFFECTING THE FICA TREATMENT OF DEFERRED COMPENSATION.

1. Pre-1984 treatment of deferred compensation.

(a) Non-qualified deferred compensation included in FICA and Medicare wages at the earlier of when actually or constructively received by the employee.

(b) Except, certain non-qualified plans that qualified as special retirement-type plans were entirely excluded from FICA and Medicare tax.

2. Post-1983 Amendments in the Deficit Reduction Act of 1984.

(a) Added IRC Section 3121(v)(2) to the Internal Revenue Code applicable to deferred compensation attributable to services performed after 1983. Transition rules apply to deferrals attributable to services performed before 1984 which include a

binding contract exception. If you have such a situation, see Section 2662(f)(2) of the Deficit Reduction Act of 1984.

(b) Under IRC Section 3121(v)(2)(A), FICA and Medicare tax now attaches to amounts in a deferred compensation plan at the later of when the services are performed or when there is no longer a substantial risk of forfeiture of the right to the deferred compensation amounts.

(c) Under IRC Section 3121(v)(2)(B), amounts that are subject to FICA and Medicare tax at a point earlier than when they are actually paid, will not be subject to FICA and Medicare tax again when actually paid. In addition, any income attributable to amounts taxed for FICA and Medicare tax purposes prior to actual payment, will also be exempt from FICA and Medicare tax.

3. 1991 Changes to the FICA and Medicare tax limits.

(a) Prior to 1991, the Medicare tax applied only up to the Social Security Wage base, which is $87,900 for 2004 and will continue to rise with inflation thereafter.

(b) For 1991 through and including 1993, the Medicare tax was applied to wages up to $125,000 as adjusted for cost of living increases.

(c) For 1994 and later, there is no cap on the wages or self-employment income subject to the Medicare portion of the FICA tax.

4. Components of the FICA and Medicare tax.

(a) Technically, FICA tax is made up of two components:

(i) Old-Age, Survivors and Disability Insurance (OASDI) tax which is 6.2% of wages up to the social security wage base for each of the employer and employee, and

(ii) The Hospital Insurance tax which is 1.45% for each of the employer and employee, which since 1994 applies to all FICA wages.

(iii) For purposes of this outline, the OASDI portion is referred to as the FICA tax and the Hospital Insurance portion is referred to as the Medicare tax, since most CPAs refer to these with these labels.

5. IRS Regulatory action in this area.

   (a) Notice 94-96, 1994-2 CB 564, IRS announced its intent to publish proposed regulations under IRC Section 3121(v)(2) effective not earlier than January 1, 1995 and that it would not challenge good faith determinations of the FICA and Medicare tax liability of employees and that as long as the tax withholding was applied at least annually, it didn't matter at what intervals the employer withheld and paid over the tax.

   (b) Proposed regulations under IRC Section 3121(v)(2) were published January 25, 1996 and Final Regulations were published on January 29, 1999.

B. FICA AND MEDICARE TAX RULES UNDER TREASURY REGULATIONS AT SECTION 31.3121(v)(2).

1. The Final Regulations are generally effective January 1, 2000. For prior periods, employers can rely on a reasonable good faith interpretation of the Code. Certain situations qualify for transition rules.

2. The regulations deal with the amount and timing of FICA and Medicare tax withholding. They apply only to "non-qualified deferred compensation plans" as that term is defined in the regulations. This includes a formal plan or may include a clause in an employment contract. It may even be an informal arrangement that provides for the deferral of the payment of compensation for services of an employee.

   (a) It may cover as few as one employee.

   (b) It may be a negotiated arrangement or may be an arrangement that is adopted unilaterally by the employer.

   (c) It need not be a plan subject to ERISA and it need not be deferred compensation for purposes of the income tax provisions of the Internal Revenue Code, specifically the rules found in IRC Sec. 267 or 404.

3. The following plans or arrangements are however exempt from the timing rules in the regulations under IRC Sec. 3121(v)(2) although they may be subject to FICA and Medicare tax under other such rules in other sections of IRC Sec. 3121.

   (a) Qualified retirement plans under IRC Sections 401(a), 403(a) and (b).

   (b) Payment after year end for pay periods beginning before year end.

(c) The grant or exercise of a stock option, SAR or similar arrangement if the proceeds of the exercise are actually or constructively received in the year of exercise.

(d) The receipt of property subject to restrictions pursuant to Section 83.

(e) Vacation, sick pay, disability pay, severance pay and death benefits.

(f) Payment for current services.

(g) Certain early retirement benefits, benefits paid after termination of employment of the employee other than cost of living increases and parachute payments under IRC Section 280G.

4. The regulations provide for the payment of FICA and Medicare tax when the services are performed or if later, when there is no longer a substantial risk of forfeiture of the amounts. The timing of the payment is often well before the amounts are received. Therefore, the meat of the rules centers on how much FICA and Medicare tax must be paid when it becomes due. Once the tax is paid, the amounts and earnings thereon are forever exempt from tax. To determine how much tax is to be paid, you must first calculate the amount deferred. The calculation depends on whether this is an Account Balance plan or a Nonaccount Balance Plan.

   (a) Account Balance Plan. Treas. Reg. Section 31.3121(v)(2)-1(c)(1)(ii)(A) defines an Account Balance Plan to be "…a nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account."

   (b) Nonaccount Balance Plan. By implication the same regulation defines a Nonaccount Balance Plan as any plan which is not within the definition of an Account Balance Plan.

5. The amount includable as FICA and Medicare wages for Account Balance Plans is generally the principal amount credited to the employee's account for the period, increased or decreased by the income attributable to that amount through the date it is required to be taken into account as wages. This is essentially a defined contribution concept (in the vernacular of qualified plans).

6. Treas. Reg. Section 31.3121(v)(2)-2(i) provides in the case of Nonaccount Balance Plans, that "…if benefits for an employee are provided under a

nonqualified deferred compensation plan that is not an account balance plan (a nonaccount balance plan), the amount deferred for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right (as described in paragraph (b)(3)(i) of this section) under the plan during that period.

(a) Amounts deferred under Nonaccount Balance Plans may be taken into account when the amount is reasonably ascertainable or earlier if the employer so elects.

7. Deferred amounts may be estimated and corrected later if done within three months. The corrected FICA and Medicare tax would then be payable with interest. Deferred amounts may be taken into account any time during the calendar year, even if they become taxable at an earlier date.

VII. IRS ADVANCED RULING POSITIONS

A. The IRS will not rule on whether a restriction constitutes a substantial risk of forfeiture, if the employee is a controlling shareholder. [Rev. Proc. 2004-3, IRB 2004-1.]

B. The IRS will not rule on whether a transfer has occurred if the amount paid for property includes a non-recourse obligation. [Rev. Proc. 2004-3, IRB 2004-1.]

C. The IRS will not rule on which corporations entitled to the deduction under Section 83(h) in cases where a corporation undergoes a corporate division if the facts are not similar to those described in Rev. Rul. 2002-1. [Rev. Rul. 2004-3, IRB 2004-1.]