



Tax Court Ruling Impacts the Treatment of Income Allocations Attributable to Unvested Partnership Capital Interests

12.06.2013

BY: J. Patrick Becker, Jenny H. Connors, J. Conrad Garcia

Crescent Holdings, LLC v. Commissioner. Allocating Income Attributable to Unvested Partnership Capital Interests in accordance with IRC Section 83

The United States Tax Court recently issued its opinion in *Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (12/2/13), a ruling regarding allocations of income attributable to an unvested partnership interest. The Court held that the partnership profits or losses attributable to an unvested partnership capital interest must be allocated solely to those partners holding vested partnership capital interests or profits interests (whether vested or unvested) on a pro rata basis, and should not be allocated to the holder of such an unvested capital interest.

Factual Background

Crescent Holdings (?Holdings?) was a limited liability company formed on September 7, 2006 and was classified as a partnership for federal income tax purposes. On that same date, the ownership of Crescent Resources (?Resources?), another limited liability company, was transferred to Holdings. Also on September 7, 2006, Resources entered into an employment agreement with Arthur Fields (?Fields?) providing a 2% interest in Holdings to Fields if he served as the CEO of Resources for a 3-year period ending on September 7, 2009. During the 2006 and 2007 tax years, Holdings allocated to Fields partnership profits and losses attributable to his 2% interest. Fields included the amounts allocated to him in his gross income for those years. Prior to the conclusion of the 3-year vesting period, however, Fields resigned as CEO of Resources and forfeited his 2% interest in Holdings.

Tax Court Ruling

The issue before the court was whether Fields or the other partners of Holdings should have recognized the partnership income allocations attributable to the unvested 2% partnership interest for the 2006 and 2007 tax years.

Partnership Capital versus Profits Interest Determination

Rev. Proc. 93-27 and Rev. Proc. 2001-43, which apply to partnership profits interests, require a partner to bear the tax liability associated with his, her or its share of partnership profits. Thus, the first step in the Court's analysis hinged on whether the 2% partnership interest granted to Fields was a partnership capital interest or a partnership profits interest.

A partnership profits interest is defined in Rev. Proc. 93-27 as "a partnership interest other than a capital interest." A capital interest, on the other hand, is defined as an interest that would grant the holder a share of proceeds in the event that the partnership was liquidated and its assets were sold for their respective fair market values. Pursuant to Rev. Proc. 2001-43, the determination of whether a partnership interest is a capital or profits interest is made at the time the interest is granted, regardless of whether the interest is substantially unvested. Under the terms of the Limited Liability Company Agreement of Holdings, Fields would have received a 2% share of the liquidation proceeds if Holdings had liquidated on September 7, 2006. As a result, the Court determined that Fields held a partnership capital interest, and Rev. Proc. 93-27 and Rev. Proc. 2001-43 did not apply to this situation.

Application of IRC Section 83

Fields and the IRS asserted that Treas. Reg. Sec. 1.83-1(a)(1) applied, contending that Fields was not the owner of the partnership capital interest for income recognition purposes. Alternatively, the other Holdings partners argued that Treas. Reg. Sec. 1.721-1(b)(1) provided that Fields was the owner. Prior opinions from both the Tax Court and the Court of Appeals for the Eighth Circuit ruled that IRC Sec. 83 applied to partnership capital interests. IRC Sec. 83 provides for income recognition deferral until a transferee's interest is transferrable and no longer subject to a substantial risk of forfeiture. Thus, under IRC Sec. 83, the holder of an unvested partnership capital interest would not be deemed the owner of such interest until it vested or was no longer substantially at risk of being forfeited.

Income Recognition by Transferor

Treas. Reg. Sec. 1.83-1(a)(1) provides that income attributable to unvested property actually received by a transferee is included in the transferee's gross income in the tax year that it is received. The Regulations, however, do not address the treatment of

partnership income allocations attributable to an unvested partnership interest.

In evaluating this issue of first impression, the Court noted that the purpose of IRC Sec. 83 is income recognition deferral where the underlying property is subject to a substantial forfeiture risk. The Court held that, when Fields resigned, he forfeited his 2% partnership interest and any rights he had to the income allocations attributable to that interest. As a result, the undistributed income of Holdings was subject to the same substantial risk of forfeiture as the 2% partnership interest itself. In addition, Fields never received any economic benefit from the partnership income allocations, and he should not have been required to recognize them in his income. Instead, the other Holdings partners became entitled to the economic benefits attributable to those partnership income allocations upon the resignation of Fields. Consequently, the Court determined that the partnership income allocations attributable to the 2% partnership interest of Fields should have been recognized in the gross income of the other Holdings partners.

Conclusion

Pursuant to the Court's ruling in *Crescent Holdings*, partnership income attributable to an unvested partnership capital interest should be allocated to those partners holding vested capital interests or profits interests (whether vested or unvested). This decision largely will affect those tax partnerships with outstanding unvested partnership capital interests. Not only could it affect the manner in which partnership income is allocated among the partners in the future, but also prior allocations of partnership income to holders of such interests. To the extent that the Court's decision stands and is not otherwise challenged on appeal, practitioners and business owners should be aware of potential economic changes among partners and exercise caution in drafting partnership agreements and interest award agreements to account for such changes.

Related People

- Jenny H. Connors ? 804.420.6582 ? jconnors@williamsmullen.com
- J. Conrad Garcia ? 804.420.6910 ? cgarcia@williamsmullen.com

Related Services

- Tax Law