JO Knows Tax Reporting Issues for Partnership Interest as Non-Cash Compensation and 83(b) Elections

JANUARY 23, 2023 | BY: THE REAL ESTATE TEAM

Non-cash compensation is a popular way for businesses to incentivize and retain employees. Non-cash compensation is often used by businesses that need to conserve cash flow such as start-ups or businesses that want to reward employees in a promote vehicle like real estate investment companies or as means to bring in a new owner. If the business is organized as a partnership, compensation can be in the form of a profits or capital interest in the partnership. A profits interest entitles the partner only to a share of the future profits, so it typically has zero value at the time it is awarded. A capital interest gives the partner an interest in both the current assets of the partnership and future profits. It is important that partners know which type of interest they are receiving as any amount of capital received is taxable.

Non-cash compensation can be awarded with or without vesting. Awards without vesting are immediately taxable. Awards with vesting, where the award is earned over time (which can be done evenly over the vesting period or all at the end), are taxed as they vest, based on the fair market value at the time of vesting. If the awardee leaves before the end of the vesting period, non-vested amounts are forfeited. Since the expectation is that these awards will increase in value, recognizing income as the award vests can create more income than an award without vesting.

The Internal Revenue Code Section 83(b) allows the recipient of an award to elect to recognize the total fair market value of the award immediately rather than as it vests. For a profits interest, an 83(b) election is protective, ensuring that the IRS treats it as having a zero value and starts the holding period. For a capital interest, in addition to starting the holding period, the 83(b) election will recognize the value of the capital that was transferred as income immediately. It's important to note that the recognition of income means there is tax to be paid on that income that will have to come from another source. The 83(b) election is permanent, so one cannot get a refund of tax paid if some of the award is subsequently forfeited or if it goes down in value, but a capital loss for forfeited interests would be created. The signed 83(b) election must be filed with the IRS within 30 days after the award.

An 83(b) election is not something that should be made lightly, especially if there is value in the award at inception, as would be the case with a capital interest. Consulting with your tax advisor as soon as possible will ensure that you understand what type of award you are receiving, its tax implications and, if an 83(b) election makes sense for you. The window for filing that election is extremely tight, but you do NOT want to sign anything without a discussion with your advisor. We are here to help so if you have received these interests in the past or may receive them in the future, or if you provide these interests to your employees, please reach out so we can help you and/or your employees understand the implications of these beneficial awards.

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