***Crescent Holdings, LLC v. Commissioner, 141 T. C. No. 15 (2013)***

In a landmark decision, the U. S. Tax Court ruled that undistributed partnership income allocations attributable to a nonvested partnership capital interest must be recognized by the transferor, not the transferee. This ruling clarified the application of Section 83 to partnership interests received in exchange for services, impacting how income is allocated when such interests are subject to forfeiture. The case involved Crescent Holdings, LLC, and the allocation of partnership income to a 2% interest granted to Arthur W. Fields, which he forfeited before it vested. The decision ensures that income is not recognized until the interest vests, aligning with the policy of Section 83 to defer income recognition until property rights are secured.

**Parties**

Crescent Holdings, LLC, Arthur W. Fields, and Joleen H. Fields, as petitioners, filed against the Commissioner of Internal Revenue as respondent. Duke Ventures, LLC, intervened as the tax matters partner for Crescent Holdings.

**Facts**

Crescent Holdings, LLC, was formed on September 7, 2006, and classified as a partnership for federal income tax purposes. On the same day, Crescent Resources, LLC, was transferred to Crescent Holdings, and Arthur W. Fields, the president and CEO of Crescent Resources, entered into an employment agreement. This agreement stipulated that Fields would receive a 2% interest in Crescent Holdings if he remained CEO for three years until September 7, 2009. This interest was subject to a substantial risk of forfeiture and was nontransferable. For the taxable years 2006 and 2007, Crescent Holdings allocated partnership profits and losses attributable to the 2% interest to Fields, which he included in his gross income. However, Fields resigned as CEO before the interest vested, forfeiting his right to the 2% interest.

**Procedural History**

The Commissioner of Internal Revenue issued a Final Partnership Administrative Adjustment (FPAA) for the taxable years 2006 and 2007, determining that Fields should be treated as a partner for allocating partnership items. Fields, as a partner other than the tax matters partner, filed petitions for readjustment of partnership items under Section 6226. The cases were consolidated for trial, briefing, and opinion. The Tax Court had jurisdiction to determine all partnership items and their proper allocation among the partners.

**Issue(s)**

Whether the undistributed partnership income allocations attributable to the nonvested 2% interest in Crescent Holdings should be recognized in the income of

 

Arthur W. Fields or allocated to the other partners?

**Rule(s) of Law**

Section 83(a) of the Internal Revenue Code provides that property transferred in connection with the performance of services must be included in the gross income of the transferee in the first taxable year in which the rights in the property are transferable or not subject to a substantial risk of forfeiture. Section 1. 83-1(a)(1) of the Income Tax Regulations states that until such property becomes substantially vested, the transferor is regarded as the owner of the property. A partnership capital interest is considered property for the purposes of Section 83.

**Holding**

The Tax Court held that the undistributed partnership income allocations attributable to the nonvested 2% partnership capital interest should be recognized in the income of the transferor, Crescent Holdings, LLC, and allocated on a pro rata basis to Duke Ventures, LLC, and MSREF, the remaining partners.

**Reasoning**

The court reasoned that the 2% interest in Crescent Holdings was a partnership capital interest, not a profits interest, and thus subject to Section 83. The court applied the legal test from Section 83, which defers income recognition until the property rights become vested. The court noted that Fields' right to the 2% interest and the associated income allocations were subject to the same substantial risk of forfeiture, which was conditioned on his future performance of substantial services. Since Fields forfeited his interest before it vested, he never received any economic benefit from the income allocations, and thus should not be required to recognize them in his income. The court also addressed the policy considerations underlying Section 83, emphasizing fairness in not requiring taxpayers to recognize income from property they may never own. The court rejected the argument that Section 1. 721-1(b)(1) of the Income Tax Regulations conflicted with Section 1. 83-1(a)(1), finding that the former does not address ownership of nonvested interests. The court concluded that the undistributed partnership income allocations should be allocated to the transferor, Crescent Holdings, and then pro rata to Duke Ventures and MSREF, as they received the economic benefits upon forfeiture of Fields' interest.

**Disposition**

The Tax Court ordered that the partnership profits and losses, as well as the FPAA income adjustments associated with the 2% interest in Crescent Holdings for the taxable years 2006 and 2007, be allocated on a pro rata basis to Duke Ventures and MSREF.

**Significance/Impact**

This case significantly clarified the application of Section 83 to partnership interests received in exchange for services, establishing that undistributed income allocations attributable to nonvested partnership capital interests must be recognized by the transferor. This ruling aligns with the policy of deferring income recognition until the property rights are secured and impacts how partnership income is allocated in similar situations. Subsequent courts have followed this precedent, and it has practical implications for legal practitioners in structuring partnership agreements and advising clients on the tax treatment of nonvested interests.

 