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No Sweat (Equity): Tax Court Addresses Partnership Profits Interests

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When a person contributes property to a partnership in exchange for a partnership interest, the transaction is usually not subject to federal income tax. In contrast, when a person performs services for a partnership in exchange for a capital interest in the partnership, the transaction is generally taxable.

Prior to 1993, there was conflicting authority as to whether a partner who provides services to a partnership in exchange for a profits interest is taxable upon receipt of the profits interest. In 1993, the IRS effectively resolved this uncertainty by issuing Revenue Procedure 93-27. The revenue procedure provides a safe harbor pursuant to which, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the IRS will not treat the receipt of the profits interest as a taxable event for either the partner or the partnership, subject to certain exceptions.

The revenue procedure defines a "profits interest" as any partnership interest that is not a capital interest. It defines a "capital interest" as an interest that would entitle the partner to a share of the partnership's proceeds if all of its assets were sold at fair market value and the proceeds were distributed to its partners in liquidation of the partnership. Whether a partnership interest is a profits interest or a capital interest is generally determined at the time of receipt.

In a recent case, *ES NPA Holding, LLC v. Commissioner,* T.C. Memo 2023-55, the Tax Court interpreted Revenue Procedure 93-27 favorably. In that case, the petitioner had acquired Class C units in Integrated Development Solutions, LLC ("IDS") from IDS's other member, NPA, Inc. in exchange for $100,000 and services rendered or to be rendered. IDS was a holding company that owned an interest in National Performance Agency, LLC ("NPA LLC"), which operated a consumer financing business. The interests in IDS tracked IDS's interest in NPA LLC, and IDS had no material assets other than its interest in NPA LLC. Both IDS and NPA LLC were treated as partnerships for federal income tax purposes.

The IRS argued that the revenue procedure should not apply, and thus that the partnership interest received by the petitioner was taxable, because the services to be rendered were for NPA, Inc. rather than IDS. The Tax Court disagreed, stating that the services were for the benefit of NPA LLC, the operating business. The court found that the existence of IDS, the holding company that issued the profits interest, was of no significance since IDS was a mere conduit, and the liquidation rights of the members of IDS tracked IDS's liquidation rights in NPA LLC. The court therefore held that the revenue procedure applied.

The IRS had also argued that, even if the revenue procedure applied, the partnership interest issued to the petitioner constituted a capital interest rather than a profits interest, and thus was taxable. It was undisputed that under the operating agreements, the petitioner was entitled to receive proceeds from a liquidation only after the other members first received distributions equal to their capital accounts. The other member in NPA LLC had a capital account of approximately $21 million and the other member in IDS had a capital account of approximately $9 million. Thus, the petitioner's partnership interest would be considered a capital interest if the value of NPA LLC was more than $30 million at the time the interest was issued.

The IRS had retained an expert witness who had appraised the value of NPA LLC at approximately $52 million. However, the IRS's expert was unaware of the fact that, immediately prior to the issuance of the partnership interest to the petitioner, the other partner of NPA LLC had purchased its interest at a price that valued the company at approximately $30 million. The IRS had argued that this sale was not at arms' length, since the seller was unsophisticated and under duress. However, the court disagreed, finding no evidence for this. The court stated that an arms' length sale occurring sufficiently close to the relevant valuation date is the best evidence of fair market value. The court therefore disregarded the IRS expert's appraisal as speculative. Because the court found that the value of NPA LLC was no more than $30 million, it agreed with the petitioner that its interest qualified as a partnership profits interest rather than a capital interest. In accordance with the revenue procedure, the petitioner's receipt of the interest was therefore not taxable.

Although the Tax Court's decision may seem obviously correct, it nonetheless provides additional comfort to taxpayers receiving partnership profits interests in exchange for services, and indicates the court's willingness to apply the revenue procedure outside of its literal words. Many real estate and private equity funds use tiered partnership structures to acquire assets, and this case makes clear that issuing profits interests at the upper-tier level will not run afoul of the revenue procedure. Nonetheless, this case shows the IRS's willingness to litigate these types of issues, and taxpayers receiving partnership profits interests should be careful to ensure that they have satisfied all requirements of the revenue procedure.

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