RECEIPT OF A PROFITS INTEREST IN A PARTNERSHIP BY A SERVICE PROVIDER – NOT TAXABLE

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INTRODUCTION

In *E.S. N.P.A. Holding L.L.C. v. Commr.*,[1] the U.S. Tax Court decided that the indirect receipt of a profits interest in a partnership in exchange for services was not a taxable event for the recipient. The ruling was largely an application of Revenue Procedure 93-27, in which the I.R.S. provided guidance on the tax treatment of an individual who directly provides services to a partnership in exchange for the receipt of a profits interest in the partnership. The court notably held for the taxpayer even though the taxpayer provided services and received a profits interest indirectly, a situation not specifically addressed in the revenue procedure.

This article explains the applicable regulations, an important 8th Cir. Case reversing a decision of the U.S. Tax Court, the Revenue Procedure mentioned above, and finally *E.S. N.P.A. Holding v. Commr.,* a case in which certain applicable tax rules were stretched by the court.

REGULATIONS

U.S. law generally gives tax-free treatment to contributions of property to an entity in exchange for ownership interests in the entity, provided certain requirements are met.[2] But this favorable treatment is typically unavailable if the item contributed is viewed to be services instead of property.[3] In the partnership context, Treas. Reg. §1.721-1(b)(1) states that the "receipt of a partnership capital interest in exchange for services is taxable to the service provider." In explaining the rule, however, the regulation distinguishes between the receipt of a capital interest – *viz.*, an immediate interest in the assets of the partnership, which can be received on termination of the partnership – from the receipt of a profits interest – meaning an interest in a share of future profit:

> To the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. [Emphasis added.]

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1 T.C. Memo. 2023-55 (2023).

2 See Code §§351, 721.

3 See Code §351(d).

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CAMPBELL V. COMMR.

Many commentators interpreted this language to mean that the receipt of a profits interest in return for the provision of services would not result in taxable income and that the result would not differ whether the services were performed before or after the partnership interest was received.[4] However, in *Campbell v. Commr.,*[5] the Tax Court determined, *inter alia*, that the receipt of a partnership interest for past services performed as an employee was a taxable event, stating as follows in pertinent part:

> We reject petitioners [sic] argument that we should no longer follow our decision in the *Diamond* case and reaffirm our holding that section 721(a) and the regulations thereunder are simply inapplicable where, as in the *Diamond* case and the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership. In order to invoke the benefits of nonrecognition under section 721(a), the taxpayer must contribute "property" to the partnership in exchange for his partnership interest. *United States v. Stafford* (11th Cir. 1984). The *Stafford* case makes it clear that services are not "property" for purposes of section 721(a).
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> The considerations which underlie section 721(a) nonrecognition treatment where a taxpayer receives a partnership interest in exchange for property are vastly different from those reasons advanced by petitioners in favor of section 721(a) nonrecognition treatment where a taxpayer receives a partnership interest in exchange for services. In the former situation, there has been no disposition of the contributed property. The partnership interest such partner receives represents a mere change in the form of an asset which the taxpayer already owns. *Archbald v. Commissioner*, 27 B.T.A. 837 (1933), affd. 70 F.2d 720 (2d Cir. 1934). In the latter situation, it represents compensation for services, the value of which has not previously been reported as income.

On appeal, the I.R.S. conceded that no difference in tax treatment exists merely because a partnership interest is issued before or after services are performed. In both fact patterns, Code §721(a) applies and no income is recognized. However, it argued that the taxpayer received the partnership interests in exchange for services he provided to his employer, rather than services he provided to the partnerships. According to the I.R.S., the Tax Court essentially held that Campbell received the interests as compensation from his employer. Thus, he was not a service partner; the principles of partnership taxation did not apply; and the receipt of compensation from his employer was taxable upon receipt. The 8th Circuit disagreed with the I.R.S. and reversed the U.S. Tax Court decision,[6] stating as follows:

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4 A. Willis, Partnership Taxation, p. 125 (2d ed. 1976); Cowan, "Receipt of an Interest in Partnership Profits: The Diamond Case," 27 Tax Law Review 161 (1972)

5 T.C. Memo. 1990-162 (1990), rev'd in pertinent part, 943 F.2d 815 (8th Cir. 1991).

6 943 F.2d 815 (1991).

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> Contrary to the Commissioner's belief, the tax court did not hold that Campbell received his partnership interests for services he performed for his employer rather than services performed for the partnerships. In reaffirming *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir.1974), the court held "that section 721(a) and the regulations thereunder are simply inapplicable where, as in the *Diamond* case and *the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership*." *Campbell*, 59 T.C.M. at 249. [Emphasis added.] The court also noted the records of the partnerships indicate that Campbell received the partnership interests after rendering services. *Id.* at 249. The Commissioner tenuously relies on the tax court's statements that Campbell received his partnership interests in connection with services provided for his employer. *Id*. at 251-53. These statements were made in the discussion of *when* Campbell received his interests. We believe that the court did not specifically hold that the interests were received as payment for services provided to his employer.

In response to the Tax Court's observation that the statutory language did not distinguish between capital interests and profits interests, the 8th Circuit wrote that separate treatment was warranted because the issuance of a profits interest did not represent a transfer of assets to the partner.

> Section 721 codified the rule that a partner who contributes property to a partnership recognizes no income. * * * And, regulation 1.721-1(b)(1) simply clarified that the nonrecognition principles no longer apply when the right to return of that capital asset is given up by transferring it to another partner. At that time, the property has been disposed of and gain or loss, if realized, must be recognized. As a corollary, section 1.721-1(b)(1) outlines the tax treatment of the partner who receives that capital interest. A substantial distinction, however, exists between a service partner who receives a capital interest and one who receives a profits interest. When one receives a capital interest in exchange for services performed, a shift in capital occurs between the service provider and the individual partners. * * * The same is not true when a service partner receives a profits interest. In the latter situation, prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account. Receipt of a profits interest does not create the same concerns because no transfer of capital assets is involved. That is, the receipt of a profits interest never affects the nonrecognition principles of section 721. Thus, some justification exists for treating service partners who receive profits interests differently than those who receive capital interests. [Citations omitted.]

The appeals court also drew a comparison with Code §707. Under this section, a partner's provision of services to a partnership in a nonpartner capacity generates income that is immediately taxable as compensation. This contrasts with the general rule that money from a partnership to a partner represents a distributive share of partnership income. In the court's view, Code §707 would be redundant if the receipt of a profits interest for services provided as a partner were also immediately taxable as compensation.

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> Probably more relevant to our analysis, however, is section 707 of the Internal Revenue Code, which supports Campbell's argument. See I.R.C. §707 (1988). Generally, a partner receives a distributive share of income instead of compensation from his partnership. See Pratt v. Commissioner * * * (salary payments to a partner treated as a distributive share of income); Commissioner v. Moran * * * ("an individual cannot be his own employee nor can a partner be an employee of his own partnership") * * *. Except under certain circumstances, "the general statutory policy for treating partnerships for tax purposes contemplated that the income of a partnership would flow through to the individual partners." * * * Only when the transaction is treated as one between the partnership and a partner acting in a nonpartner capacity is the payment received by the partner not considered a distributive share. See * * * I.R.C. §707(a)(2)(A). Section 707 created an exception to the general rule.
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> Section 707 provides that when a partner engages in a transaction with a partnership in a nonpartner capacity that transaction will be treated as between the partnership and one who is not a partner. I.R.C. §707(a)(1). When a partner receives payment for services performed for the partnership, that transaction falls under section 707(a)(1) if "the performance of such services ... and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership." Id. section 707(a)(2)(A)(iii). This exception was enacted to prevent partnerships from using direct allocations of income to individuals, disguised as service partners, to avoid the requirement that certain expenses be capitalized. See W. McKee, supra, ¶5.02[1][b], at 5-13. However, it was not intended to apply when a service provider acts within his capacity as a partner. See §707(a)(2)(A)(iii). Arguably, section 707(a) would be unnecessary if compensatory transfers of profits interests were taxable upon receipt because, if so, every such transfer would be taxed without this section. W. McKee, supra, ¶5.02[1][b], at 5-13 to -14. [Citations omitted.]

In addition, the Appeals Court was concerned with the value given to the profits interest by the U.S. Tax Court.

> More troubling, however, is Campbell's argument that the profits interests he received had only speculative, if any, value. We fully agree with this contention and we reverse the tax court. * * * The tax court relied too heavily on the fact that Class A limited partners were willing to pay substantial sums for their interests at the same time Campbell received his interest. Because of the difference in the nature of the investments, we believe that this fact is not relevant. The Class A limited partners had superior rights to cash distributions and return of capital, as well as some rights of participation. * * * Further, the predictions contained in the offering memoranda were just that — predictions. The partnerships had no track record. Any predictions as to the ultimate success of the operations were speculative. Thus, we hold that Campbell's profits interests * * * were without fair

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> market value at the time he received them and should not have been included in his income for the years in issue.

REV. PROC. 93-27

The I.R.S. subsequently issued Revenue Procedure 93-27. It provides the following:

> 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 being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

In addition to textual consistency, the general rule helps deal with the tricky question of valuation that the 8th Circuit found decisive. As the name suggests, profits interests are typically only a right to future profits and not a right to a partnership's current assets. Valuation is made more difficult by the fact that profits interests are usually given to service providers and rarely to third parties. This means that there is a lack of comparable prices that might otherwise be helpful in determining the value.

This problem is further compounded by partnership accounting rules. There is no accounting mechanism that increases a partner's capital account for a contribution of services, even if the corresponding profits interest has a determinable, positive value. This could lead to double taxation, as the partner would be taxed both on the receipt of the profits interest (compensation) and the realization of profits. Income would be taxed to the same taxpayer both when it is speculative and when it is concrete.

There are three exceptions to the safe harbor provided by the revenue procedure.[7] These exceptions are aimed at situations where valuation might be easier to determine with relative accuracy.

- It does not apply to a profits interest that relates to predictable streams of income from partnership assets (such as high-quality debt securities).
- It does not apply if the partner disposes of the interest within two years of receipt.[8]
- It does not apply to a profits interest in a publicly traded partnership.[9]

E.S. N.P.A. V. COMMR.

E.S. N.P.A. differs from the usual fact pattern that often involves the grant of a profits interest to an individual in the financial-services sector. Rather, it is about how an individual running a lending business through a taxable C-corporation was able to (i)

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[7] Note that being outside of the safe harbor does not necessarily mean that the receipt of the profits interest will be taxed.

[8] However, certain dispositions may not establish value. For example, a gratuitous transfer in the context of wealth planning for a family may technically be outside the scope of the revenue procedure but might not lead to adverse results.

[9] Under Code §7704, a publicly traded partnership generally is treated as a corporation for U.S. income tax purposes.

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arrange a sale of 70% of the C-corporation's business to new investors bringing in fresh capital, and by choosing a proper structure and (ii) by doing so, open a pathway to receive future profits without channeling income through the C-corporation.

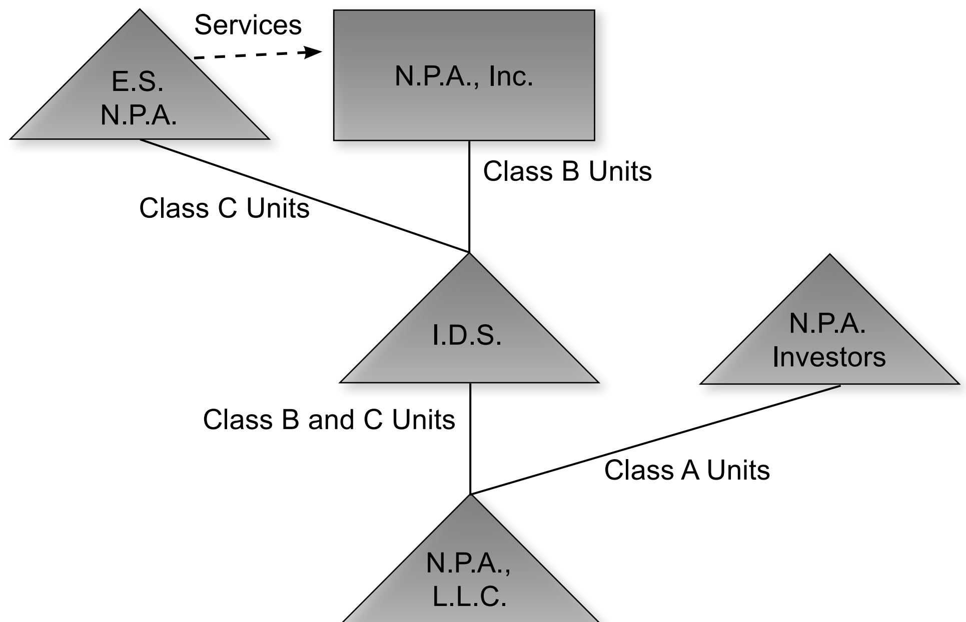
Facts

In *E.S. N.P.A.*, an individual proposed selling his consumer loan business, National Processing of America, Inc. ("N.P.A., Inc."). N.P.A. Inc. formed two L.L.C.'s, referred to as I.D.S. and N.P.A., L.L.C. Then, N.P.A., Inc. contributed business assets to N.P.A., L.L.C. and contributed the membership interests in N.P.A., L.L.C. to I.D.S., creating a three-tier structure with N.P.A., Inc. at the top, I.D.S. in the middle, and N.P.A., L.L.C. at the bottom. Both I.D.S. and N.P.A., L.L.C. were flow-through entities for U.S. income tax purposes, leading up to N.P.A. Inc., the C corporation.

I.D.S. had two classes of membership units called Class B and Class C units. N.P.A., L.L.C. had three classes of membership called Class A, Class B, and Class C. I.D.S. Class B and Class C units tracked, respectively, the Class B and Class C units in N.P.A., L.L.C. This meant that the owner of I.D.S. Class B units was entitled to all payments to which the owner of N.P.A., L.L.C. Class B units was entitled.

An entity named N.P.A. Investors, L.P. ("N.P.A. Investors") purchased all of N.P.A., L.L.C.'s class A units from I.D.S. in exchange for $14,502,436. On the same day, E.S. N.P.A. exercised a call option granted by N.P.A., Inc. to acquire all of the I.D.S. Class C units in exchange for E.S. N.P.A.'s payment to N.P.A., Inc. of $100,000 and services provided or to be provided. The services were to consist of "strategic advice for the purpose of enhancing the performance of [N.P.A. Inc.'s] business and to assemble an investor group that would purchase 40 [sic] percent of [N.P.A. Inc.'s] business for approximately $21 million."[10] As a result, the I.D.S. Class C units reflected an indirect interest in the class C units of N.P.A., L.L.C."

The following diagram illustrates the structure of the reorganized business:



[10] The quoted material comes from a call option that gave N.P.A., Inc. the right to acquire the Class C units of I.D.S.

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Tax Return and I.R.S. Assertion

E.S. N.P.A.'s partnership return reflected the view that its indirect receipt of the Class C units in N.P.A., L.L.C. (through the Class C units in I.D.S.) was properly categorized as the receipt of a "profits interest" in N.P.A. L.L.C. For that reason, the value of the profits interest was not taxable under case law, and under Revenue Procedure 93-27, was properly excluded from income.

On examination of the partnership tax return, the I.R.S. determined that Revenue Procedure 93-27 was inapplicable because E.S. N.P.A. did not provide services to I.D.S.[11] The I.R.S. determined that E.S. N.P.A. failed to report income and pay tax on the receipt of the Class C units in I.D.S. The I.R.S. position reflected alternative arguments. First, it asserted that Revenue Procedure 93-27 was inapplicable because no services were performed for the benefit of a partnership. Second, it argued that under the revenue procedure's definition, the taxpayer's interest was a capital interest instead of a profits interest. It determined that the fair market value of E.S. N.P.A.'s class C units in I.D.S. exceeded $12 million and that the total amount of unreported income exceeded $16 million.

"This question is factual, and the answer came down to valuation . . ."

Tax Court Determination

The court held that the partnership interest held by E.S. N.P.A. was a profits interest. Revenue Procedure 93-27 defines a profits interest as any interest in a partnership other than a capital interest. A capital interest is an interest that would give the interest holder a share of the liquidation proceeds if the partnership were to sell its assets at fair market value and distribute the proceeds in liquidation immediately thereafter.

This question is factual, and the answer came down to valuation. The operating agreement of N.P.A., L.L.C. provided that Class C holders would receive distributions only after the Class A and Class B holders received distributions equal to their capital accounts. Thus, if the fair market value of N.P.A., L.L.C.'s assets was sufficient to repay the capital contributions of Class A holders ($21 million) and Class B holders ($9 million) and have enough left over to make distributions to the Class C owner, E.S. N.P.A.'s indirect interest in N.P.A., L.L.C. would be a capital interest. Otherwise, the interest would be a profits interest.

E.S. N.P.A.'s expert testified that the Class A units in N.P.A., L.L.C. (representing 70% of the ownership interests) had been sold to an outside party for $21 million. The taxpayer applied this figure to the partnership proportionately and produced a valuation of $30 million, which would not leave anything to the Class C holders. In comparison, the I.R.S. expert looked to the values of comparable businesses that were sold, justifying a valuation of $52 million. The result was that the Class C interest was worth $12 million in a hypothetical liquidation. In the end, the Court looked to the actual sale of 70% of the business, which was the method used by the taxpayer's expert. The I.R.S. expert had been unaware of the actual sale and conceded that it was the best indicator of value.

[11] Under Code §6221, any adjustment to a partnership-related item is determined, at the partnership level and tax, penalties and interest are collected at the partnership level.

The more novel question was whether the taxpayer provided services to N.P.A., L.L.C. As the I.R.S. pointed out, the taxpayer provided services to N.P.A., Inc., the upper-tier corporation, and received a direct interest in I.D.S, the middle-tier partnership. The I.R.S. therefore concluded that the taxpayer did not provide services to the lower-tier partnership, N.P.A., L.L.C., and did not hold an ownership interest in the lower-tier partnership. This view is in line with regulations that were proposed in 2005, which limited a profits interest in a partnership to an interest that is received for providing services directly to the partnership.[12]

While the I.R.S. characterized Revenue Procedure 93-27 as a narrow safe harbor, the court believed that it provided broadly applicable guidance and rejected the I.R.S. view, describing it as "unreasonably narrow." Using this logic, the court agreed with the taxpayer that the Revenue Procedure applied to the situation. It cited several reasons for disregarding the intermediate entities between the taxpayer and the lower-tier partnership:

- The material assets were held in the lower-tier partnership.
- The taxpayer's activities were for the benefit of this partnership.
- The middle-tier partnership was a mere conduit. This was because the Class C units in both partnerships were identical.
- The taxpayer took on entrepreneurial risk and received a profits interest in a partner capacity.

PATH FORWARD

Several related questions remain open.

- It is not clear whether the court would have reached the same conclusion if the two types of Class C units were not identical. The court's generally broad reading suggests that the answer might be yes, as long as the partnership is benefiting from the provision of services in some way (even if indirectly).
- Neither the I.R.S. nor the court took issue with the fact that not all of the taxpayer's services were for the benefit of the lower-tier partnership. The taxpayer was obligated to provide advice on expanding the business, which was clearly related to the lower-tier partnership, as it held the business, and on finding buyers for N.P.A., Inc.'s business, arguably more of a service for the upper-tier partner's benefit than for the lower-tier partnership's benefit. This implicitly suggests that services do not have to be solely for the benefit of the partnership.

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[12] Prop. Reg. §1.721-1(b)(3) ("…an interest in the transferring partnership that is transferred in connection with the performance of services for that partnership…"). These proposed regulations would have changed the rule of Rev. Proc. 93-27 by potentially making the receipt of partnership interests (whether capital or profits) in exchange for services taxable upon receipt. However, the interests would have been valued in the same way as Rev. Proc. 93-27, *i.e.*, by using a hypothetical liquidation. In the near-20 years since these regulations were proposed, there has been little indication that the I.R.S. intends to finalize and adopt them.

- The case expands the boundaries of Revenue Procedure 93-27. Prior to this case, the extent of the Revenue Procedure's application was not clear. Arguably, Revenue Procedure 93-27 can now apply even if (i) services are not provided directly to a partnership, provided the partnership still benefits, (ii) the taxpayer receives the profits interest from another partner instead of the partnership, or (iii) the partnership interest is held indirectly. This affirms that the issuance of indirect interests in more complex structures will be respected. But given the court's emphasis on the provision of services that benefit a partnership, the case suggests that any indirect issuance of a profits interest to a service provider should be accompanied by documentation clearly showing how the partnership will benefit from these services.

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