Unconventional Profits Interest Structures Find New Support

By **Daren Shaver** (May 30, 2023)

Daren Shaver

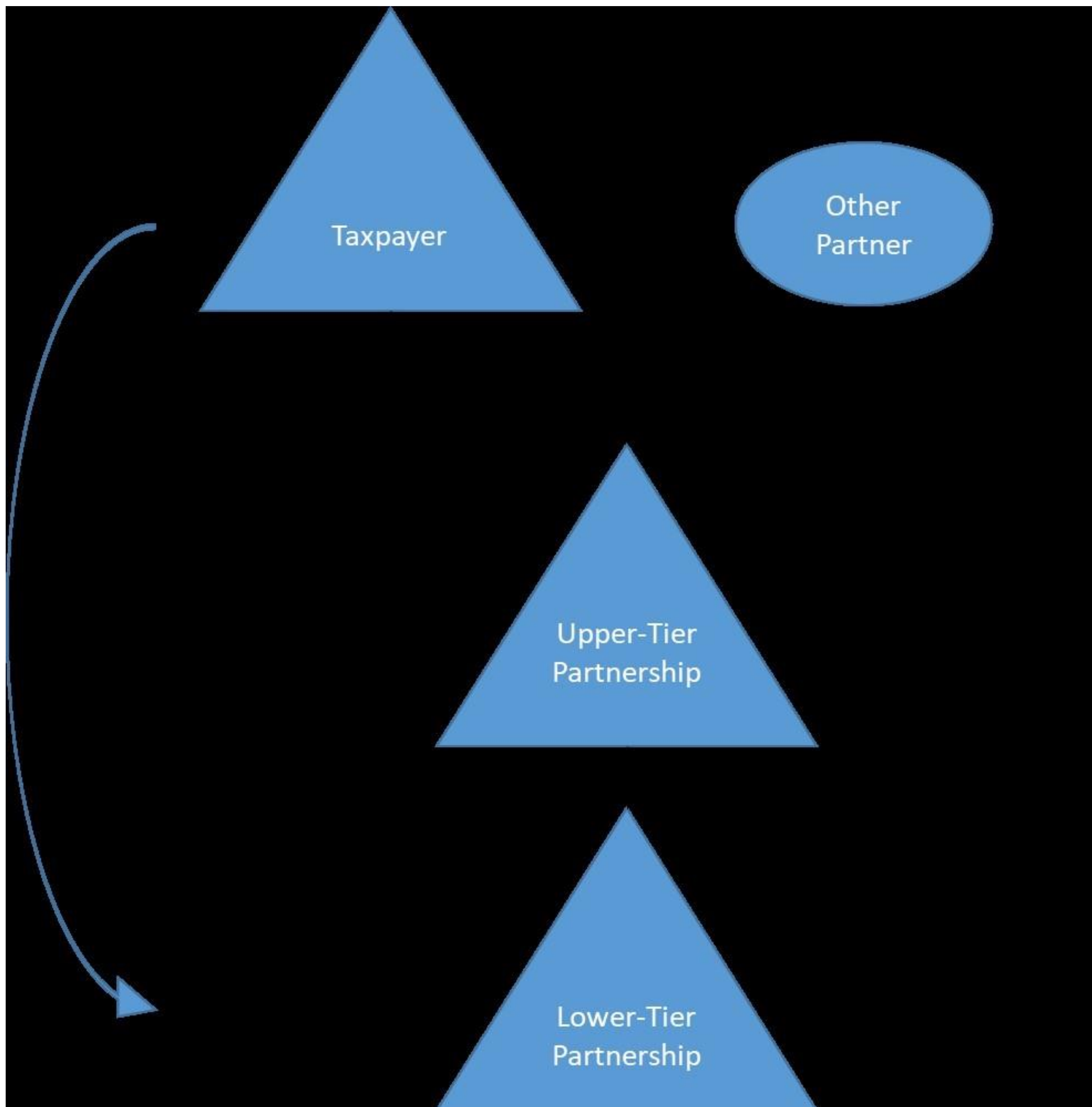
The U.S. Tax Court recently issued a memorandum opinion, ES NPA Holding LLC v. Commissioner, holding that a partnership did not recognize income after receiving an interest in an upper-tier partnership.

Instead, the Tax Court ruled that the partnership interest was received in exchange for services and qualified as a nontaxable grant of a profits interest within the meaning of Internal Revenue Service Revenue Procedure 93-27.

Profitable Structures

In ES NPA Holding, the taxpayer — actually a partnership for U.S. federal income tax purposes — held an indirect interest in a lower-tier partnership through its receipt of an interest in an upper-tier partnership. Both the taxpayer and the IRS agreed that the upper-tier partnership interest was received in exchange for services provided to the lower-tier partnership.

Interestingly, it appeared of no import to the Tax Court that the services were rendered by ES NPA Holding, as opposed to any specific individual. A simplified illustration of the multitier partnership structure is as follows:



The IRS took the position that the grant of the upper-tier partnership interest was taxable based on two arguments: (1) Revenue Procedure 93-27 is inapplicable because the taxpayer did not provide services directly to the partnership that issued the interest, i.e. the upper-tier), and (2) that, in the alternative, the safe harbor provided by Revenue Procedure 93-27 is inapplicable because the taxpayer received a taxable capital interest, not a profits interest.

Under Section 1.721-1(b)(1) of the Treasury Regulations, the "receipt of a partnership capital interest in exchange for services is taxable to the service provider."

Capital Arguments

As to the first argument, the Tax Court concluded that the taxpayer partnership, through its

principals, provided services to the lower-tier partnership in exchange for its interest in the upper-tier partnership.

Critically, the Tax Court also determined that the upper-tier partnership interest was economically identical to the interest held in the lower-tier partnership — i.e., the upper-tier partnership interest mirrored the economics of the lower-tier partnership interest.

The opinion does not go into great detail on this point, but presumably the terms of the partnership agreements reflected a back-to-back grant of tracking partnership interests.

Thus, the court found that the taxpayer's interest in the upper-tier partnership was also a profits interest and therefore not subject to taxation under Revenue Procedure 93-27. The Tax Court noted that an alternative reading of the revenue procedure, namely that the profits interest must be granted by the entity to which services are performed, would be unreasonably narrow.

The IRS also argued that the upper-tier partnership was not a profits interest, but instead a capital interest, based on a valuation conducted by its own expert witness.

The revenue procedure and related guidance requires the issuing partnership to value itself, and its assets, so as to ensure that the profits interest would not be entitled to proceeds if the partnership were to liquidate immediately after grant — i.e., a capital interest. This is commonly done by setting a benchmark or distribution threshold over and above which a profits interest may participate.

In addition to establishing this threshold, it is prudent for an issuing partnership to engage in a so-called book-up under Internal Revenue Code Section 704(b) and corresponding Treasury regulations. Put simply, a "book-up" is yet another means to ensure that a newly admitted partner does not share in existing value of the partnership.

As the Tax Court noted in ES NPA Holding, "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership" would constitute a capital interest.

Accordingly, any benchmark or distribution threshold associated with a profits interest grant must be set high enough to avoid that result. In this case, it appears that the benchmark was set by reference to the value placed on the capital interest of the lower-tier partnership in connection with a contemporaneous purchase of such interests by a third party.

In dispensing with the valuation report offered by the IRS, the Tax Court helpfully noted that "actual arm's-length sales occurring sufficiently close to the valuation date are the best evidence of value, and typically dispositive, over other valuation methods."

Taxpayers and their advisers often wrestle with the question of valuation — and liquidation value — when issuing profits interest grants. Many look to a valuation safe harbor such as exists for valuing private stock in connection with option and stock grants.

Unfortunately, in the context of partnership profits interest grants, there is no corollary to the Section 409A valuation safe harbor. Thus, the use of contemporaneous arm's length transactions can be seen as a reasonable solution to one of the most difficult logistical challenges inherent to any profits interest structure, ensuring that the partnership is appropriately valued in order to prevent the profits interest from being treated as a

compensatory capital interest.

Conclusion and Important Takeaways

This opinion should provide comfort to less-than-plain-vanilla profits interest structures provided that the terms of the partnership interest, through all partnership tiers, meet the definition of a profits interest. Such structures are commonly developed to achieve complicated economic arrangements — whether in the context of an acquisition, as here, or otherwise — or to simplify incentive plan administration and, in some cases, to address the IRS' own restriction against dual employee-partner status.

The opinion may also be of interest to fund managers who receive carried interest grants in their underlying investment fund partnerships. Carried interest grants are also intended to qualify as profits interests and often involve multitier partnership structures. In addition to providing support for the structure generally, the opinion may lend support to special allocation structures designed to comply with the requirements of IRC Section 1061.

Most relevantly, IRC Section 1061 can alter the tax treatment of carried interests held by individuals in investment funds. Its purpose is to extend the holding period for long-term capital gains tax treatment from one year to three years for applicable partnership interests.

Because capital interests are excluded from the reach of Section 1061, it is prudent to track capital interests separately from profits interests. In some cases, it may even be possible to argue that a profits interest crystallizes into a capital interest.

Provided the terms of the partnership agreement are designed to track such distinctions across all tiers — e.g., through the use of special allocations, or otherwise — it may be possible to generate more optimal tax outcomes. ES NPA Holding's apparent blessing of tracking partnership interests appears to support these planning efforts.

Daren R. Shaver is a partner at Hanson Bridgett LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.