Profits Interest Case—Tax Court Holds IRS to Revenue Procedure 93-27

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Recently, in a rare case addressing partnership profits interests, the Tax Court held that the grant of a profits interest to a service provider was not a taxable event. *ES NPA Holding, LLC v. Commissioner, T.C. Memo 2023-55*. The case involved an unusual fact pattern where a partnership granted a profits interest in exchange for services provided to the partnership's Corporate Owner. However, the principles that the Tax Court applied are consistent with the positions generally taken in the market and will provide additional comfort to tax advisors on structuring profits interest in tiered arrangements (including a typical private equity fund where carry is received through a general partner entity).

PROFITS INTERESTS AND REVENUE PROCEDURE 93-27

This case follows precedent set in *Campbell v. Commissioner*, where the receipt of a profits interest in a partnership in exchange for services was held not to be a taxable event, since the value of the profits interest was speculative and had no determinable value. The IRS cemented the *Campbell* decision with Revenue Procedure 93-27, which provided that the receipt of "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" will not be treated as a taxable event. Revenue Procedure 93-27 does not apply however if (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, (2) the partner disposes of the interest within two years of receipt or (3) the partnership is a publicly traded partnership.

FACTS OF THE CASE

Mr. Landy, who owned 100% of the outstanding shares in NPA, Inc. (the "Corporate Owner"), a consumer loan business, agreed to sell 70% of his interest in the business. To undertake this sale, the Corporate Owner formed two new entities, IDS (the "Upper-Tier Partnership") and NPA, LLC (the "Lower-Tier Partnership"), and contributed

substantially all of its business assets to the Lower-Tier Partnership. The Lower-Tier Partnership issued Class A, Class B and Class C units. The operating agreement of the Lower-Tier Partnership provided for pro rata sharing among the units but precluded Class C unit holders from participating in liquidating distributions unless Class A unit holders received aggregate distributions equal to their cost.

The Class A units were sold to an outside investor entity and the Class B and Class C units were issued to the Upper-Tier Partnership. The Upper-Tier Partnership issued Class B and Class C units to the Corporate Owner that directly tracked the Class B and Class C units it held in the Lower-Tier Partnership. The Corporate Owner exchanged the Upper-Tier Partnership Class C units with an entity affiliated with Mr. Landy in exchange for services provided to the Corporate Owner for strategic advice associated with enhancing the Corporate Owner's business and assembling the investor group for the sale transaction.

"SERVICES PROVIDED TO OR FOR THE BENEFIT OF THE PARTNERSHIP"

Revenue Procedure 93-27 applies only when a profits interest in a partnership is granted in return for "services provided to or for the benefit of the partnership." The IRS failed to convince the Tax Court that, because the services were provided to the Corporate Owner and not the Upper-Tier Partnership, the service requirement was not met. Instead, the Tax Court noted that the sole asset of each holding company was its direct or indirect interest in the Lower-Tier Partnership and that the services were inherently provided to and for the benefit of the future partnership. This decision favors an expansive reading of when services are provided "for the benefit of" a partnership, including where carry recipients provide services to a private equity fund and receive carried interest in a general partner entity of the fund or where employees of a corporation receive profits interests in a partnership that owns such corporation.

AFFIRMATION OF MARKET POSITION IN CONNECTION WITH VALUATION

A profits interest is a partnership interest that is not a capital interest. Revenue Procedure 93-27 defines a capital interest as 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 complete liquidation of the partnership." The determination for this hypothetical liquidation is made at the time the partnership interest is received. The Tax Court held that the best evidence for the fair market value of a partnership in a hypothetical liquidation is an actual arm's-length transaction made proximate to the valuation date. The IRS agreed but questioned the arm's-length nature of the transaction. The Tax Court held that expert evaluations will not be considered,

absent compelling evidence to question the arm's-length nature of an actual sale. An arm's-length transaction even without a formal appraisal is sufficiently reliable. This holding affirms the long-held market position regarding valuations.

ADDITIONAL OBSERVATIONS

- Although not explicitly discussed, the profits interest represented by the Class C units appears to provide for a "catch-up," whereby the Class C units captured 100% of any appreciation in the company until the liquidation value of the Class C units accreted to 30% of total value, with appreciation in excess of this amount shared pro rata. Taxpayers using management fee waiver mechanisms can take some comfort from this case.

- The court focused solely on the liquidation provisions of the operating agreement of the Lower-Tier Partnership in concluding that the Class C units represented a profits interest. The court was not concerned that current distributions made to the Class C unitholders were not subject to a clawback. Proposed regulations, however, issued in response to partnership management fee waivers provided for a safe harbor only where the profits interest was subject to a net income requirement throughout the life of the fund with a clawback requirement. In a nod to these proposed regulations, the court noted that the Class C units had "entrepreneurial risk."

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