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Passthrough Partner

Partnership Profits Interests 2020

By J. Leigh Griffith

Introduction

From a business perspective, the flexibility of an entity taxable as a partnership[1] is a major advantage. Because of the mix of entity and aggregate tax characteristics combined with the contractual flexibility permitted to partners by most state statutes, structures can be tailored to meet the specific desires and needs of the business deal if a partnership is used. From a tax perspective, this is achieved through the use of special allocations, special distributions, and distribution waterfalls. From a business standpoint, subject to minimum statutory provisions, the partnership agreement can set forth the negotiated business deal and through the use of limited liability companies, all members can have limited liability with respect to the activities of the partnership. Moving past mere structure, the ability to provide an equity interest in the future appreciation and/or operating income of a partnership to incentivize service providers in a manner that does not cause the recognition of income when granted or vested is a significant additional advantage to engaging in business through a partnership. This equity interest, called a "profits interest" is the subject of this column.

The use of profits interests to reward and incentivize performance of services is not available to corporations or associations that elect to be taxable as corporations or any other form of business entity not taxed as a partnership. As discussed below, a profits interest is somewhat a product of judicial decisions,[2] but presently is primarily a product of forbearance by the IRS. If certain requirements as set forth in Rev. Proc. 93-27 (the "93 Revenue Procedure") and Rev. Proc. 2001-42 (the "2001 Revenue Procedure") (collectively the "Revenue Procedures") are met, the IRS will not raise what it considers to be the substantive issue—the taxation of the fair market value of the profits interest.[3]

While tax professionals are familiar with the Revenue Procedures, the *Sol Diamond*[4] case (in which the Tax Court and Seventh Circuit found the receipt of a profits interest taxable) and the *Campbell*[5] case (reversing the Tax Court and finding the receipt of a profits interest not taxable), the business community is aware of an incentive for service providers that does not entail immediate taxation and which has the potential to provide the service provider with the potential for future capital gain. Generally the business community, however, is not aware of the necessary "details." There is more to providing a profits interest than just calling it a profits interest. This is a unique and valuable tool with relatively clear rules for implementation that are all too often not met.

In 2005, the Treasury issued Proposed Regulations[6] (the "2005 Proposed Regulations") which, if ever finalized, would reject the notion that the receipt of a profits interest for services is not a realization event. The 2005 Proposed Regulations would also repeal the Revenue Procedures, apply to both capital and profits interests and provide an elective mechanism *via* Notice 2005-43[7] with its proposed revenue procedure to preserve the result of no taxation on the issuance of a profits interest if a liquidation paradigm is adopted for all compensatory partnership interests. This would be achieved with a great deal of complexity and collateral "costs" that may be unacceptable to many, if not most, traditional service partnerships.[8] After almost 15 years, however, those proposed regulations have neither been finalized nor withdrawn. Venturing outside the safe-harbor of the Revenue Procedures is dangerous. There is a head-on collision of the aggregate theory of partnership taxation, Code Sec. 83, the practical reality as to how to value a profits interest often requiring ongoing services, and then innumerable occasions in which people form and join partnerships to operate small businesses.

Through the Revenue Procedures the IRS has provided a user-friendly way of providing a significant benefit to service providers to a partnership.

The 2005 Proposed Regulations became caught up in the political controversy of the taxation of the managers of "hedge funds" and "private equity" carried interest taxation.[9] Whether the reason or the excuse, the 2005 Proposed Regulations apparently entered purgatory awaiting a political outcome. The Tax Cuts and Jobs Act introduced Code Sec.1061 which is applicable to tax years beginning after December 31, 2017, and applies a new three year holding period for long term capital gains to "applicable partnership interests."[10,11] The intricacies and uncertainties of this provision are beyond the scope of this column,[12] although the intent is that a service provider holding a carried interest and only engaged in a real operating business is not supposed to be subject to this provision. It is unclear to the author, however, if this will be deemed to be the political solution and lead to the withdrawal, reworking or promulgation of the 2005 Proposed Regulations. In the interim, it remains prudent for careful drafters of partnership agreements contemplating the issuance of profits interests to comply with certain provisions in the proposed revenue procedure and add contingent provisions in the event a version of the 2005 Proposed Regulations are adopted to provide a mechanism for the partnership to:

1. Elect to have the partnership make the Safe-Harbor Election or its equivalent;
2. Authorize and direct the partner responsible for tax filings to make appropriate elections for the partnership necessary to implement a Safe-Harbor Election or its equivalent once the partnership has acted to make the election;
3. Bind each partner by such provisions (and perhaps make partners liable to the other partners for damages if such partner [or the partner's owner] breaches such agreement);
4. Contain covenants from partners prohibiting them from taking actions or making elections that would disqualify the election;
5. Make each partner or transferee obligated to execute separate binding agreements as may be required and requested by the partnership; and
6. Provide information necessary or appropriate for the partnership to comply with the Safe-Harbor (or its equivalent) and to cause any of its owners to do the same if requested by the partnership.

In addition to having the mechanism to obtain partner approval for the partnership to make the election, the partnership agreement should have a mechanism for partner approval to revoke the election if it has been made. These provisions should be effective only upon approvals as specified in the operating agreement. Depending on the final form of any regulations, many partnerships are likely to decline the opportunity to utilize the Safe-Harbor. For those partnerships that do wish to elect, however, in the absence of having an enabling provision in the partnership agreement, obtaining unanimous approval and executed agreements may be impossible, even when the Safe-Harbor or equivalent is clearly beneficial to the partnership. Therefore, many drafters prudently continue to insert the required provisions in the original partnership documents.

Rev. Proc. 93-27

The 93 Revenue Procedure was issued after *Campbell* and is the core of the applicable rules creating the Safe-Harbor for the non-taxation of profits interests.[13] With three exceptions, the 93 Revenue Procedure provides that a "profits interest" (i) received for services (ii) to or for the benefit of a partnership (iii) in a partner capacity or in anticipation of being a partner will not be treated as a taxable event for either the partner or the partnership.

Definition of Profits Interest

A "profits interest" is defined by the 93 Revenue Procedure by identifying what it is not. A profits interest is a partnership interest other than a partnership interest that is a capital interest. The 93 Revenue Procedure defines "capital interest" as: "[a]n 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."[14] This is commonly referred to as the "liquidation method" and creates the minimum threshold[15] (the "Threshold") for value that the other partners (measured at the time of the grant of the profits interest) must receive before the holder of a profits interest participates in the value of the partnership in order to have a profits interest. The Threshold, however, does not prevent the service provider from participating in future operating profits before the then existing partners or membership units receive an amount at least equal to the Threshold.

Must Not Be a Capital Interest

This is basically a definitional requirement. If using the liquidation value of the partnership at the date of grant results in anything received by a service provider immediately following the grant, the interest will not be a profits interest but rather a capital interest. Importantly, the measure of a profits interest vs. a capital interest is not fair market value but rather liquidation value. Liquidation value will generally be more than fair market value for a minority interest in a closely held partnership. There are no minority discounts, illiquidity discounts, *etc*. Conversely, there are no control premiums, so liquidation value may be less than the fair market value of a controlling interest.

Received for Services

A profits interest must be received for services. A capital contribution of property or that involves property (unless the capital portion can be separated from the service component) will disqualify the issuance of a profits interest vs. a capital interest. Code Sec. 721 provides that gain or loss is not recognized by the contributor or the partnership if there is a contribution of property to a partnership for an interest in the partnership. It should be possible to contribute capital to a partnership in exchange for a capital partnership interest and to separately provide services to the partnership in exchange for a profits interest. If that is done, however, there should be a clear distinction between the contribution of property and the receipt of a capital interest for such property and the provision of services and the receipt of a profits interest for such services. Although at the end of the day there will likely be one capital account,[16] there should be separate interests, and these should be documented as such.

Provided to or for the Benefit of the Partnership

Providing services directly to or on behalf of the issuing partnership would certainly satisfy this requirement. It is generally believed that providing services to or on behalf of a subsidiary of a partnership is providing service for the benefit of the partnership. It is unclear if a quantum of ownership is required. How much ownership must the issuing partnership have of the direct or indirect subsidiary for the services to be for the benefit of the issuing partnership? Is there an analysis based on the percentage of the second entity the partnership owns? Perhaps there is a different answer when the partnership owns 80% or more of the equity than when the partnership owns 20% or less of the equity of the entity receiving the services. Is the percentage or dollar value of the partnership's assets represented by the equity in the service recipient relevant? If the service recipient equity represents 99% of the assets of the partnership, is that a different situation than if such equity represents 1% of the assets of the partnership (even if the dollar value of the equity owned by the issuer is the same)?

It appears to be the IRS's position that services provided before there is a partnership, at least where the ultimate partnership is composed of the service partner and only one other partner, is not to or for the benefit of the partnership, but services for the other person who pays the service provider with property which they both use to start the partnership.[17] The IRS seems to have the view those services will be for the benefit of the other partner vs. the partnership and the recipient partner is deemed to provide property to pay the service provider and then such property is contributed to the partnership to start the partnership.[18] The author conceptually disagrees with the IRS's position if the services are such that they facilitate the creation and operation of a partnership. The partnership would seem to clearly benefit from being created and the service partner is anticipating becoming a partner as a result. The better approach, however, is to have the partnership formed before the service provider provides too much of the service provider's services so the services are being performed to or for the benefit of the existing partnership.

Threshold

While the concept of the liquidation threshold is easily understood, how does the partnership determine what that value is? There is not an actual sale and liquidation. Rarely does the author see businesses obtain an appraisal at the time a profits interest is issued. There is generally an adverse interest between the parties. What the holder of the profits interest receives reduces what is received by the other owners. In the context of capital account maintenance, the regulations provide:

> … the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in an arm's-length negotiations, and (2) the partners have sufficiently adverse interests …[19]

The Threshold should be in good faith and realistic and the holders should receive K-1s reflecting the appropriate information for the profits interest of the holder. For those to whom Code Sec. 1061 applies, a three-year holding period is required if long term capital gain is to be achieved.

Similarly, in the context of payments for a partner's interest in a partnership, the regulations in part provide:

> Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's-length agreement will be regarded as correct.[20]

In both of the above situations, the "new partner" is providing goods and/or services that the existing partners desire the partnership to have. Assuming the parties are acting at arm's-length, it seems appropriate that a similar level of deference should be given to the establishment of the Threshold. If the owners want the service provider to have "skin in the game," the question arises as to whether the service provider can contribute cash or property as well as services. In addressing the profits interest, the 93 Revenue Procedure clearly requires no capital interest. Nevertheless, it appears under the appropriate circumstances the service provider can receive a *bona fide* separate capital interest for a contribution of property and a separate profits interest for services.[21] Great care should be taken to demonstrate that the interests are separate and that the contribution of cash or property was of equivalent value to the capital interest received. In all cases, the general partner, manager or board establishing the Threshold should have a good faith belief that the Threshold is at least the liquidation value and at least a rational thought process for the determination of such value. It is useful if the rationale for the determination of the Threshold is documented. Foreseeable future events, favorable or unfavorable to the partnership, should be considered and factored into the Threshold. The IRS will have the benefit of hindsight if an issue arises.

At times the Threshold is higher than the parties would prefer. Rather than playing fast and loose with the Threshold, the well-advised partnership may provide for a disproportionately large portion of a specific amount of appreciation above the Threshold will go to the profits interest holder and achieve the desired business result, if there is sufficient appreciation. An example would be a base profits interest of 10% with a threshold or $2,000,000 being received by the other partners from a sale or other disposition of the assets of the partnership before the holder of the profits interest participates in sale proceeds and a participation of 10% of the operating profits of the partnership. However, to achieve economics consistent with a participation above $1,000,000 (the desired economic starting place of the parties), the grant agreement may provide with respect to the first $500,000 of appreciation above the $2,000,000, the holder of the profits interest would receive 30% of such appreciation and 10% thereafter. Therefore, if the value of the partnership at the time of a sale has increased to $2,500,000 or more, the holder of the profits interest receives the equivalent of 10% of the appreciation above $1,000,000.[22] If, however, there is appreciation, but insufficient appreciation in the assets, the holder of the profits interest will not receive the desired economics. That risk makes it real and the terms of such a profits interest legitimate.

Providing Services as a Partner or in Anticipation of Becoming a Partner

A requirement that appears to have not received a lot of attention is the requirement that the service provider must be providing services as a partner or in anticipation of being a partner. What exactly does that mean? As discussed earlier in this column, the IRS has taken the position that if services are provided before a partnership is formed, those services cannot be for the benefit of a partnership that does not yet exist.[23] The rationale appears to be that in the formation stage, services are provided for another person who then transfers a portion of the assets it was to contribute to the service provider in compensation for the services and both contribute to start the partnership.

If a person provides services after becoming a partner, is that sufficient? How does one determine if a person has become a partner other than (i) title, (ii) books and records of the partnership, (iii) and K-1? If a person has been promised that if he or she provides services for a period time he or she may be made a partner and in good faith the person believes that promise, is that person providing services in anticipation of become a partner? Are there types of services that are "partner like" and other services that are not? In many smaller businesses, the owners answer the phone and sweep the floors. Thus far, to the author's knowledge, it appears that the IRS has not attempted to determine what are partner-like services vs. non-partner like services or whether a person has anticipated being a partner or is providing services as a partner if there is a pre-existing partnership. If the partnership is willing to hold the service provider out as a partner and issue a K-1 rather than a W-2, that appears to be sufficient.

Exceptions with Respect to Partnership Interests That Would Otherwise Qualify

The 93 Revenue Procedure provides three exceptions applicable to interests that are otherwise described therein. The following interests are outside the safe-harbor:

(i) If the profits interest relates to a substantially certain and predictable stream of income for partnership assets[24];
(ii) If within two years of receipt, the partner disposes of the profits interest;
(iii) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code Sec. 7704(b).[25]

The history of the "profits interest" provides color to two of the three exceptions. Both the Seventh Circuit in *Sol Diamond* and the Fifth Circuit in *Campbell* were concerned about the difficulty of valuation of most profits interests. In *Sol Diamond*, the court found the value was readily ascertainable because the recipient of the profits interest sold it within a few weeks. In *Campbell*, the Fifth Circuit focused on the difficulty of determining the value of such an interest and found the value, if any, to be highly speculative and reversed the Tax Court.[26] A substantially certain and predictable stream of income is rather easily valued and a sale within two years is within the audit timeframe and will generally provide a basis for determining the earlier value. Perhaps the two-year period also reflects a period the IRS felt indicated the recipient was truly a "partner" and therefore in the absence of a two-year holding period such holder neither provided services in anticipation of becoming a partner nor in the capacity of a partner. The proposed revenue procedure in Notice 2005-43 rephrased this two-year requirement as "transferred in anticipation of a subsequent disposition" and indicates the two-year period created a rebuttable presumption.[27]

The actual rationale for the exclusion of interests in publicly traded partnerships is unknown by the author but may include the fact the market for a publicly traded partnership will assist in the valuation and publicly traded partnerships generally utilize significant capital as a material income producing factor and are generally not heavily service oriented.

In short, it appears the 93 Revenue Procedure excludes the type of partnerships and situations in which it is more likely a value could be established with reasonable certainty. In addition, remaining a partner for less than two years may indicate the recipient was not really a partner or intending to be a partner. Finally, a benchmark for determining value is presented within the statute of limitations and the general audit period.

Rev. Proc. 2001-43 Addresses Profits Interests with Risk of Forfeiture

Rev. Proc. 2001-43 (the "2001 Revenue Procedure") represents an important enhancement/expansion to the safe-harbor use of profits interests. If three additional conditions (detailed below) are met, profits interests that are substantially non-vested (within the meaning of Reg. §1.83-3(b)) but otherwise meeting the requirements of the 93 Revenue Procedure are included within the ambit of the 2001 Revenue Procedure and are excluded from the application of Code Sec. 83 in that:

(i) The testing date for determining whether the partnership interest is a profits interest is the date of issuance of the profits interest, not the date of its vesting; and
(ii) No Code Sec. 83(b) election is required.[28]

Under Code Sec. 83, valuation measurement takes place when the property vests. If such approach was followed in the context of a profits interest, the Threshold would have to be determined at the time of vesting.

Under Code Sec. 83, in order to utilize the date of grant or transfer of property subject to a substantial risk of forfeiture for determining value, an election (referred to as a Code Sec. 83(b) Election) must be made and filed with the IRS within 30 days of receipt. Pursuant to the 2001 Revenue Procedure, no filing is required with respect to a profits interest.

The three additional requirements imposed by the 2001 Revenue Procedure that must be met are:

(i) The partnership and the service provider must treat the service provider as the owner of the partnership interest from the date of grant;

(ii) The service provider must take into account the distributive share of partnership income, gain, loss, deduction and credit associated with the interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; and

(iii) Neither the partnership nor any of its partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest.

What Constitutes Treating the Service Provider as the Owner?

Under the IRS's current view of the law, a partner cannot be an employee of a partnership in which he or she is a partner.[29] This means the holder of a profits interest must receive a K-1 and not a W-2.[30] This also means that there is no withholding,[31] the recipient of a profits interest will have a more complex tax return, will not qualify for cafeteria plan benefits and certain other limited benefits,[32] but can deduct the recipient's business expenses whereas employee business expenses are now non-deductible.[33] The author is surprised how many times otherwise sophisticated executives are truly upset that they will receive K-1s rather than W-2s, even if they are to be grossed up so that their net taxable income after medical insurance and various retirement contributions are the same. For partnerships involved in multi-state businesses, the additional state tax compliance for the individual can be material.[34] However, if a profits interest is to be used and the holder is to receive a W-2, the executive must either (i) work for an entity regarded for federal income tax purposes in which the partnership owns a [significant (?)] interest or otherwise receives significant financial benefits from so that such services are "for the benefit" of the partnership, (ii) have a partnership in which the holder has the profits interest between the holder and the regarded entity for which the holder provides services for compensation. Otherwise the holder must receive a K-1 from the partnership rather than a W-2.

Taking into Account the Distributive Share Associated with the Interest

Each holder of a profits interest must take into account the distributive share of partnership income, gain, loss, deduction and credit associated with the interest for the entire period such party holds the partnership interest. It is important to recognize it is the distributive share that is associated with the profits interest that must be accounted for throughout the time the interest is held. This does not mean the service provider is required to receive a distributive share each year. If the profits interest is not entitled to participate in the partnership's operating income, a K-1 with a zero should nevertheless be filed and any compensation paid to the holder reported as a guaranteed payment or, with respect to a profit based bonus, reported as a distributive share. A profits interest may be as simple as a fixed percentage of all partnership items. However, a profits interest may be complex. As part of the flexibility of the partnership tax and state law rules, an interest in a partnership may have allocations of income, gain and loss that are not uniform but differ among various classes of interests. It is commonly believed that partnership interests can be structured in a manner to only participate in the growth in value of the partnership's tangible and intangible property and are often coupled with guaranteed payments to the service provider for current services. Other partners may disproportionately participate in current operating income while receiving a small portion of the growth in value of the partnership. The variations and permutations are innumerable. If the holder of the profits interest receives a K-1 and reports a guaranteed payment for the compensation earned and, assuming there is none allocated, report no other allocation of income, gain or loss from the partnership's operations, is not the partnership and the service provider treating the service provider as the owner of the partnership interest? If the holder of the profits interest were entitled to a bonus based on the success of the partnership, such "bonus" should be treated as a distributive share of partnership earnings and reported as such on the partnership's Form 1065, *U.S. Return of Partnership Income* and on the profits interest partner's

K-1. In a liquidity event, however, such holder of the profits interest would be entitled to participate in the gain and distributions once the Threshold was exceeded.

No Deduction

The 2001 Revenue Procedure requires that neither the partnership nor any partner may deduct any amount for the fair market value of the interest.

Conclusion

Through the Revenue Procedures the IRS has provided a user-friendly way of providing a significant benefit to service providers to a partnership. The theoretical framework and analysis is rather foggy and perhaps controversial as the courts have failed to present a coherent articulation of the analysis and the IRS has taken inconsistent positions at times. Nevertheless, the IRS has provided understandable rules to enjoy a safe-harbor. These rules should be carefully followed. The Threshold should be in good faith and realistic and the holders should receive K-1s reflecting the appropriate information for the profits interest of the holder. For those to whom Code Sec. 1061 applies, a three-year holding period is required if long term capital gain is to be achieved.[35]

ENDNOTES

1 Entities that can be taxable as a partnership include general partnerships, limited partnerships, limited liability partnerships, limited liability companies and series limited liability companies. Throughout this column the term partnership encompasses all entities taxable as partnerships regardless of state law form. The limited liability company, however, is perhaps the most common form of partnership.

2 The analysis by the courts has been inconsistent and less than stellar.

3 For a much more in depth look at profits interests and the 2005 Proposed Regulation, *see* J. Leigh Griffith, *Transfer of Partnership Interest for Services Revisited—Part I*, TAXES, December 2013, at 21 and J. Leigh Griffith, *Transfer of Partnership Interest for Services Revisited—Part II*, TAXES, February 2014, at 21. Portions of such article are incorporated into this article.

4 *S. Diamond*, 56 TC 530, Dec. 30,838 (1971), *aff'd.*, CA-7, 74-1 USTC ¶9306, 492 F2d 286.

5 *W.G. Campbell*, 59 TCM 236, Dec. 46,493(M), TC Memo. 1990-162, *rev'd on this issue*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815. *See also, St. John*, No. 82-1134 (C.D. Ill. Nov. 16, 1983).

6 NPRM REG-105346-03.

7 Notice 2005-24, IRB 2005-24, 1221.

8 *See* J. Leigh Griffith, *Transfer of Partnership Interest for Services Revisited—Part II*, TAXES, February 2014, at 21.

9 Crystal Tandon, *Partnership Guidance On Hold Pending Legislative Action, Treasury Officials Say*, 2009 TNT 100-3 (2009).

10 An "applicable partnership interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer or a related person in a trade or business actively conducted on a regular, continuous and substantial basis consisting in whole or in part in raising or returning capital and either investing or disposing of specified assets or developing specified assets. Code Sec. 1061(c)(3) defines "specified assets" as including securities, commodities, rental or investment real estate, cash or cash equivalents, options or derivative contracts with respect to such assets or an interest in a partnership to the extent of the partnership's interest in such assets. Partnership interests held by corporations are not subject to this rule nor are capital interests in which the partner shares proportionate to capital contributed or for which the partner included the value of the interest in income under Code Sec. 83.

11 Code Sec. 1061 excludes from its ambit interests held by corporations. In Notice 2018-18, IRB 2018-12, 443, the IRS stated that it intended to issue regulations providing that the exclusion of corporations from the application of Code Sec. 1061 would not include S corporations.

12 Proposed Regulations to implement Code Sec. 1061 are anticipated in the near future.

13 As discussed later herein, the Revenue Procedure was supplemented by Rev. Proc. 2001-43.

14 Rev. Proc. 93-27, Section 2.01.

15 There is nothing in the requirements that prevent the Threshold from being a higher amount than the liquidation value. It is not uncommon to see profits interests (particularly one that is issued at or about the formation of a partnership) keyed to a Threshold that is the estimated value at issuance increased by a percentage each year or based on an internal rate of return. With the internal rate of return, the prior units receive a return of their funds plus an internal rate of return yield. The longer it takes to achieve a return of the value plus yield, the more absolute dollars that have to be returned.

16 Reg. §1.704-1(b)(2)(iv)(b).

17 Mr. McDougal owned a racehorse, and Mr. McClanahan, a horse trainer, agreed to form a partnership with Mr. McDougal contributing the horse and Mr. McClanahan contributing certain services. Upon McDougal recovering his cost, the horse was actually contributed to a partnership with Mr. McClanahan receiving a profits interest and entitled to half the profits—all of the losses were to be allocated to Mr. McDougal. The court found that a half interest in the horse was transferred to Mr. McClanahan, and that Mr. McDougal and Mr. McClanahan each made a property contribution of undivided interests in the horse to the partnership. It appears that the government's position is that if a partnership does not otherwise exist, the services are rendered to a party other than the partnership and therefore do not meet the requirements of the Revenue Procedures. Indeed the preamble to the 2005 Proposed Treasury Regulations states: "... the rule providing for the nonrecognition of gain or loss does not apply to the transfer or substantial vesting of an interest in an eligible entity ... that becomes a partnership under Reg. §301.7701-3(f)(2) as a result of the transfer or substantial vesting of the interest."

18 *See F.C. McDougal*, 62 TC 720, Dec. 32,746 (1974), *acq.*, 1975-2 CB 2.

19 Reg. §1.704-1(b)(2)(iv)(h)(1).

20 Reg. §1.736-1(b)(1).

21 LTR 200329001 recited the following fact: "Participating executives will make a capital contribution of $a per unit in the Plan and will receive an initial capital account of $x per unit. In connection with the issuance of Plan units, Y [the partnership] will revalue its assets and adjust its existing partners' capital accounts." Representations were made concerning the exceptions of Rev. Proc. 93-27. The conclusion of the IRS in the LTR is: "... we conclude that the issuance and vesting of Plan units issued by Y as compensation for services performed by participating executives to or for the benefit of Y are nontaxable events under Rev. Proc. 93-27, as clarified by Rev. Proc. 2001-43." The rather ambiguous statement of facts can be read that the executives contributed cash for a capital interest and received an additional profits interest or they can be read that cash was contributed for the units constituting the profits interest and that since the assets were

revalued and capital accounts adjusted all the executives would receive on liquidation if it occurred immediately after is the capital they contributed.

22 Ten percent (10%) of the appreciation between $1,000,000 and $2,500,000 is $150,000. A 30% participation in the increase in value between $2,000,000 and $2,500,000 is $150,000.

23 It should be noted that in the facts of *Sol Diamond*, Mr. Diamond provided services prior to the acquisition of the real estate to enable Mr. Kargman to obtain financing to acquire the property. Mr. Diamond and Mr. Kargman were the only partners and Mr. Diamond's interest was transitory.

24 As examples of a "substantially certain and predictable stream of income," the Revenue Procedure provides examples of income from high quality debt securities or a high-quality net lease. Both of these examples would involve substantial capital and probably limited ongoing services and are reasonably capable of being valued.

25 Rev. Proc. 93-27, Section 4.02.

26 *W.G. Campbell,* 59 TCM 236, Dec. 46,493(M), TC Memo. 1990-162, *rev'd on this issue*, CA-8, 91-2 USTC ¶50,420, 943 F2d 815. Surprisingly, the Commissioner conceded on brief that a profits interest was not subject to taxation and changed its argument (on which it had won) from the receipt of a profits interest for services to or for the benefit of a partnership was taxable to the argument that the taxpayer did not provide services to the partnership. "At this point the Commissioner concedes that the tax court erred in holding that the receipt of a profits interest in exchange for services to the partnership should be considered ordinary income to the service provider."

27 The proposed revenue procedure found in Notice 2005-43 would rephrase the requirement as "transferred in anticipation of a subsequent disposition" and create a rebuttable presumption of anticipation if the interest were sold or disposed of (other than by death) within two years of receipt.

28 The 2005 Proposed Regulations attempted to address Code Sec. 83 and require a Code Sec. 83(b) election and use the liquidation value concept with significant other requirements.

29 Rev. Rul. 69-184, 1069-1 CB 256.

30 American Bar Association Section of Taxation, Comments on Potential Changes to Rev. Rul. 69-184 (Dec. 9, 2019), advocated for the ability of certain partners to elect to be treated as employees with respect to partnerships in which they are partners holding a relatively small interest. If this were to develop, the election with respect to the holder of a profits interest would be evidence of partner treatment.

31 Many partnerships develop a synthetic withholding in which the partnership reduces the partner's draw and remits the amount of the reduction to the IRS as estimated tax payments on behalf of the partner. Unlike an employee's actual withholding, in the event the reduction amount is not timely transmitted to the IRS or is never transmitted to the IRS, the partner will remain liable to the IRS for such amounts.

32 For a comprehensive comparison of retirement and fringe benefit federal income tax treatment of a partner vs. an employee *see* American Bar Association Section of Taxation, Comments on Potential Changes to Rev. Rul. 69-184 (Dec. 9, 2019) at Appendix 1.

33 Under the Tax Cuts and Jobs Act of 2017 (TCJA), P.L. 115-97, Code Sec. 67(g), the deduction for unreimbursed business expenses incurred by an employee in the trade or business of the employee is suspended for tax years beginning after December 31, 2017, and before January 1, 2026. The business expenses of a partner remain deductible.

34 This burden is often minimized by the partnership filing a return covering all partners and paying taxes at the highest individual rate. The partner can file a claim for a refund, but often the cost of filing is more than the potential recovery due to the difference in rates.

35 As noted earlier, proposed regulations on Code Sec. 1061 are expected in the near future, perhaps even before this article is published.