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INSIDE THIS ISSUE

1 Taxation of Partnership Interests for Services

1 Recap of Part 1

1 Revenue Procedure 93-27

2 2005 Proposed Regulations

4 What to Do?

"Under Revenue Procedure 93-27, "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."."

Taxation of Partnership Interests in Exchange for Services – *Part 2 of 2.*

This is the second of a two part article which discusses the uncertain and complex tax issues which arise when a partnership interest is issued in exchange for past or future *services*.

Recap of Part 1 – The Uncertain Treatment of Partnership Interests Received in Exchange for Services

Section 721 of the Internal Revenue Code (the "Code"), which provides that the contribution of money or property to a partnership does not result in tax to the partnership, its partners or the contributing partner, does not apply to a partnership interest received in exchange for past or future *services*.

With respect to services, under the case law, the courts distinguished between "capital" interests and "profits" interests. The receipt of a "capital" interest by a service partner was universally held to be taxable to the service partner in the amount of the capital interest received. However, with respect to the receipt of a "profits" interest by a service partner, some courts held the transaction was not taxable, but other courts reached the opposite conclusion. This conflict created uncertainty and confusion for taxpayers and their planners.

Enter Revenue Procedure 93-27

In 1993, the Treasury attempted to resolve the confusion by issuing Revenue Procedure 93-27. Under Revenue Procedure 93-27, "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."

Please see *Rev. Proc. 93-27* on page 2

Rev. Proc. 93-27

Under the Revenue Procedure, a "capital interest" was defined to mean "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." This determination is "generally" made at the time of receipt of the partnership interest. A "profits interest" was defined to mean anything other than a capital interest.

Revenue Procedure 93-27 contained three important exceptions. The rule a profits interest is not taxable upon its receipt does not apply if (i) the profits interest "relates to a substantially certain and predicable stream of income from partnership assets, such as income from a high-quality debt securities or a high-quality net lease", (ii) if the partner disposes of his interest within two years of receipt, or (iii) the profits interest is an interest in a publically traded partnership.

Revenue Procedure 93-27 seemingly resolved the pre-1993 confusion as to the proper treatment of profits interests.

"Not content with the administrative truce drawn in 1993, in 2005, the IRS published proposed regulations which once again threw the issue into disarray. The proposed regulations do away with the distinction between a "capital interest" and a "profits interest", and instead treat any partnership interest as "property" for purposes of §83.

2005 Proposed Regulations

Not content with the administrative truce drawn in 1993, in 2005, the IRS published proposed regulations which once again threw the issue into disarray. The proposed regulations do away with the distinction between a "capital interest" and a "profits interest", and instead treat any partnership interest as "property" for purposes of §83. Under proposed §1.721-1(b)(1), the "transfer of a partnership interest to a person in connection with the performance of services constitutes a transfer of property to which section 83 and the regulations thereunder apply." Under proposed §1.83-3(e), property is defined to mean "a partnership interest."

While the proposed regulations solve the quandary of "what is property," the pre-1993 problem which plagued the courts of how to value a profits interest in a partnership remains. As recognized in Revenue Procedure 93-27, a non-speculative value can be placed on certain profits interests, such as a profits interest in a partnership which owns property subject to a high-quality net lease. But what is the value of a profits interest in other situations?

Please see *Proposed Regulations* on page 3

Proposed Regulations, continued.

The proposed regulations attempt to address this by providing a safe harbor election in proposed §1.83-3(e)(i)(1). Under the safe harbor, a partnership may elect to treat the value of the partnership interest as being equal to the liquidation value of that interest, thus preserving the rule of non-taxability for profits interests.

To explain how this works, let's return to an example from above. X and Y form Z partnership. X contributes $500,000 and Y agrees to provide services. It is agreed that Y only has a right to 50% of the profits of Z partnership, but no right to the $500,000 contributed by X. If Z partnership made the safe harbor election, the liquidation value of Y's interest is zero because if Z liquidated on day one, X would receive $500,000 and Y would receive nothing. Y is therefore not taxed on his receipt of a profits interest.

The proposed regulations add the burden of making the safe harbor election an affirmative obligation of the partnership. To take advantage of the safe harbor, the tax matters partner must make an election to apply the safe harbor to all partnership interests transferred in connection with services (Prop. Treas. Reg. §1.83-3(e)(1)(ii)(A)). In addition, the partnership agreement must contain provisions legally binding on all partners stating that the partnership is authorized and directed to elect the safe harbor, and the partnership and each of the partners agrees to comply with all requirements of the safe harbor (Prop. Treas. Reg. §1.83-3(e)(1)(ii)(B)).

The proposed regulations, however, provide no guidance in the case where the value of a profits interest is truly speculative and where the partnership fails to make the safe harbor election. How the speculative value of a profits interest in such a case is to be taxed remains a mystery.

Finally, because §83 applies to all partnership interests, the same timing rules apply. Thus, the receipt of a partnership interest which is both non-transferrable and subject to a substantial risk of forfeiture is not immediately subject to taxation, unless the service partner makes a §83(b) election.

The proposed regulations have not been finalized and are therefore not binding. Thus, taxpayers may continue to rely on Revenue Procedure 93-27 to the extent it applies. For partnership interests to which Revenue Procedure 93-27 does not apply (such as partnerships which invest in high-quality debt securities or net leases), it is unclear whether to what extent, if any, the proposed regulations and the safe harbor may help.

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What to Do?

Despite the uncertainty and complexity, in most instances, the problem can be resolved with proper advanced planning. The first step is to identify when a partner is receiving a partnership interest for services. Sadly, this is the most overlooked step.

The second step is to determine what kind of partnership interest the service partner is receiving. As a general rule, if the service partner has a capital account in excess of any money or property he or she puts into the deal (and as a result, the other partners have a corresponding decline in their capital accounts), a "capital interest" has been created.

In most instances, to avoid tax on so-called phantom income, it is preferable to structure the interest received as a profits interest. Note – this may alter the "business deal" itself and needs to be explained to the partners.

The easiest way to create a profits interest is to allocate net profits to the non-service partners until such time as the non-service partners have been allocated net profits equal to the amount of their capital contributions.

From a business perspective, this is often untenable for the service partner who does not want to wait years before he sees a single cent of profit allocated to him. Therefore, from a practical perspective, the more palatable approach to is bifurcate allocations of operating income from allocations of income arising from capital events (such as a sale of partnership assets). When structured in this manner, the service partner is allocated his or her percentage interest of all operating profits of the partnership. In the case of a capital event, like the sale of partnership property, net income is first allocated to the non-service partners until they receive 100% of their contributions.

What to Do, continued.

After this, there is a business choice to be made. The service partner can either be allocated his or her share of profits, or he or she can be allocated all profits until an amount equal to his or her share has been realized.

Returning to the example of X and Y who formed Z partnership. Recall that X contributed $500,000 and Y agreed to provide services. Y had a right to 50% of the profits of Z partnership, but no right to the $500,000 contributed by X. After $500,000 has been allocated to X, the partnership can either allocate the next $500,000 to Y, or it can allocate profits 50/50 each partner. The service partner, here Y, obviously, prefers the first option.

As a result, the allocations frequently work as follows: first, to the capital partners, until such time as they have been allocated an amount equal to their capital contribution, second, to the service partner until he or she has been allocated an amount equal to his percentage interest in the partnership, and then, to each partner according to his or her percentage interest in the partnership.

There are multiple ways of creating a profits interest with different economic results for each partner. Regardless, when drafting a partnership agreement which includes a service partner, the key question to keep in mind is this: ***if the partnership dissolved on day one, would the service partner receive any cash or property***?

If the answer to that question is "no," you have likely succeeded in creating a profits interest which is not taxable to the service partner.