THE LAW OFFICES OF STEPHEN M. FLYNN

**Stephen M. Flynn**
smflynn@smflynn-law.com
www.smflynn-law.com

71 Stevenson Street, Suite 400
San Francisco, CA 94105
Tel. 415-655-6631

# TAXATION OF PARTNERSHIP INTERESTS FOR SERVICES

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

***Receipt of a Partnership Interest for Services May be Taxable***. Under §721 of the Internal Revenue Code (the "Code"), the contribution of *money* or *property* to a partnership (or limited liability company) does not result in tax to the partnership, its partners or the contributing partner. Section 721 reflects the general rule that contributions to a partnership are not taxable.

Section 721 does not apply to *services.* As a result, the receipt of a partnership interest in exchange for either past or future *services* can be a taxable event. Worse, the transaction is taxable even if the service partner receives no cash (resulting in tax on so-called "phantom income").

The receipt of a partnership interest in exchange for services arises in multiple and unique contexts. Real estate syndicators typically locate property, gather investors and secure financing. In exchange, they receive an interest in the new ownership entity, typically as a manager or general partner. Unless structured properly, the syndicator will be taxed, at ordinary income rates, on day one, on the value of his or her interest in the new entity.

The issue also arises with developers. For example, assume A owns vacant land worth $1 million and B is an experienced developer. A and B agree to form a partnership with A contributing the land and B agreeing to use his experience and expertise to entitle it, develop it, and sell it once completed. Assume further that A and B each receive a 50% interest in the new partnership. Under this hypothetical, B has $500,000 of *ordinary* income the day the partnership is created. It does not matter that B never received $500,000 in cash. From the perspective of the IRS, a 50% interest in land worth $1 million is the same as $500,000 cash.

The problem is not limited to real estate partnerships. The most infamous example of the service partner is the hedge fund manager. These individuals and firms raise money, invest it and manage it. In exchange, they receive an interest in the investment entity. Another common example is the broker who in lieu of a cash commission receives a partnership interest.

The issue can arise in a host of other situations. For example, assume that X owns a patent to create a new widget and Y has significant experience producing and marketing widgets. If X and Y form a partnership, with X contributing the patent and Y agreeing to produce and market it, Y will be taxed in an amount equal to his interest in the partnership.

The taxation of service partners does not depend on whether the partnership interest is given for past or future services. Thus, if C performs valuable work for D, and D chooses to compensate C by giving him an interest in a partnership, C will be taxed the day he receives his interest.

There are ways to structure deals to avoid taxation of the service partner on his or her receipt of a partnership interest, but these methods substantively affect the business deal itself. Before discussing those structures, the history of the "service" partner problem needs further elaboration.

***A Brief History***. Under §61(a) of the Code, "gross income means all income from whatever source derived," including, without limitation, "compensation for services." Under the §61 regulations, "if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation" (Treas. Reg. §1.61-2(d)(1)). Thus, if A performs services, and receives a partnership interest – *and that interest is considered "property"* – A has recognized income equal to the fair value of that property.

Easy enough, but the complexity and confusion stems from defining *what is <u>property</u>?* The answer to this question often turns on *what type* of partnership interest is being received. In this regard, the IRS and the courts have typically drawn a distinction between a "capital interest" and a "profit interest."

These concepts will be explored in further detail below. For now, it is sufficient to observe that the receipt of an interest in the *capital* of a partnership is (and always has been) considered "property." Section 1.721-1(b)(1) of the Regulations provides:

> 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 [the general non-recognition rule] 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.

Under §1.721-1(b)(1), anytime a service partner receives an interest in partnership property for which he does not pay fair value, it is treated as the receipt of a capital interest in exchange for services and is immediately taxable as ordinary income.

For example, assume A and B form a partnership and each has a 50% interest in the capital of the partnership. If A contributes $100,000 and B receives his 50% interest in exchange for past services, A has effectively "given up" $50,000 in favor of B because if the new partnership were liquidated immediately after its creation, A would receive $50,000 and B would receive $50,000. Under this scenario, A has "given up his right to be repaid his contribution" in favor of B as compensation for services, and the transaction is taxable.

Or, assume C and D are partners in a partnership with property worth $1 million. If C and D admit E and give him a right to 1/3rd of the capital of the partnership, D has received $333,333 in income because C and D have each "given up" this amount.

Note that §1.721-1(b)(1) appears to carve out "a share in partnership *profits*" from the rule a service partner is taxed in receipt for an in a partnership. Thus, what happens if the service partner only receives a right to the profits of the partnership? For example, assume X and Y form a 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 the partnership, but no right to the $500,000 contributed by X. Does this affect the analysis?

The answer to the question has not been consistent. In *Diamond v. Commissioner* (1971) 56 T.C. 530, the taxpayer, a mortgage broker, received a 60% profits interest in a partnership in compensation for services rendered obtaining a mortgage loan. Three weeks after acquiring the partnership interest, the taxpayer sold it for $40,000. The taxpayer reported the income as short term capital gain. The IRS challenged this claiming it was ordinary income received for services.

The Tax Court held Diamond's receipt of a "profits interest" was property and thus taxable. The court rejected the taxpayer's argument that §1.721-1(b)(1) carves out profits interests and found the value of the profits interest was readily determinable because it was sold 3 weeks after it was acquired.

In *Campbell v. Commissioner* (8th Cir. 1991) 943 F.2d 815, the taxpayer, a real estate syndicator, bargained for a profits interest in each new limited partnership he helped create, form and finance. Relying on *Diamond*, the tax court held the receipt of a profits interest was taxable upon its acquisition in accordance with §83 (see below). The Eight Circuit reversed.

The Eight Circuit acknowledged the distinction between a profits interest and a capital interest in that the former involved no "capital shift." Stated differently, when a profits interest is granted "prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account" (*id.* at 822). As explained by the court:

> 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 (*id.*).

However, despite acknowledging the distinction, the court ultimately held the granting of the profits interest was non-taxable on the grounds the profits interest granted *in that case* was not capable of being valued.

The court reasoned that the partnership interest Campbell received had restrictions on transferability and no participation rights in management. Further, the partnership was newly created, and therefore had no "track record" and as such, predictions in the offering memorandum "as to the ultimate success of the operations were speculative" (*id.* at 823). The court also rejected a valuation based on what certain Class A limited partners paid for their partnership interests because those interests had superior rights to cash distributions as well as some rights of participation. Thus, the court left open the possibility a profits interest *could* be taxable if its value were not speculative.

Adding more confusion to the treatment of profits interest was §83, enacted in 1969. Section 83(a) provides:

> If, in the connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of (1) the fair market value of such property . . . at the first time the rights

> of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services.

Section 83 does not answer the question of "what is property", or whether a profits interest is or is not "property." Further, §83 is generally regarded as a *timing* statute as opposed to a statute defining *what is* income. Thus, §83 (unlike §61) does not define what is income, but merely sets forth the timing rule that property received in exchange for services is taxable when the interest in such property is either transferrable or not subject to a substantial risk of forfeiture.

Nevertheless, relying on §83, some courts concluded that under certain circumstances, the receipt of a profits interest by a service partner could be taxable, at least where the value was non-speculative (*Caldwell v. Commissioner*, TCM 1990-236; *St. John v. United States*, No. 82-1134 (C.D.Ill. 1983).

***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."

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.

***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.[1] But what is the value of a profits interest in other situations?

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)).

---

[1] The value in such a situation is likely the predicted cash flow discounted to present value.

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.

***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 move 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.

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.