Tax Court Holds Indirect Grant of Profits Interest To Be Non-Taxable, Citing IRS Guidance

Skadden

05 / 11 / 23

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the next page or call your regular Skadden contact.

One Manhattan West
New York, NY 10001
212.735.3000

On May 3, 2023, the U.S. Tax Court upheld a taxpayer's reliance on Revenue Procedure 93-27 to characterize as a profits interest a partnership interest granted in exchange for services that were provided indirectly for the benefit of an operating partnership in a tiered partnership context. *ES NPA Holding LLC v. Commissioner*, T.C. Memo 2023-55 (May 3, 2023). In addition, the court rejected the Internal Revenue Service (IRS) claim that the interest was actually a capital interest, rather than a profits interest.

The decision is consistent with the positions generally adopted by market participants, but will provide reassurance to sponsors of private equity funds and other investment partnerships who are compensated with profit interests.

Application of Revenue Procedure 93-27 to Indirect Grants of Partnership Interests

As background, Revenue Procedure 93-27 provides that a person's receipt of a profits interest in exchange for the provision of services to or for the benefit of a partnership in a partner capacity (or in anticipation of being a partner), is not a taxable event for the partner or the partnership. Revenue Procedure 93-27 does not apply, however, if the profits interest relates to a substantially certain and predictable stream of income, the recipient disposes of the profits interest within two years, or the profits interest is a limited partnership interest granted by a "publicly-traded partnership" within the meaning of Section 7704(b) of the Code. In *ES NPA Holding*, the IRS took issue with whether the subject interests were profits interests and whether the recipients provided services to the issuing partnership in a manner that would qualify it for the treatment set forth in the Revenue Procedure, and did not challenge that the other requirements were met.

The U.S. Tax Court held that the taxpayer did not recognize any income upon the receipt of a partnership interest in an upper-tier partnership (Issuing Partnership) because that interest was a profits interest granted in exchange for services provided to or for the benefit of a lower-tier partnership (Operating Partnership) in which all material assets of the subject business were held.

In its holding, the court rejected the IRS argument that the taxpayer had provided services only "to" a corporate partner in the Issuing Partnership and that, therefore, Revenue Procedure 93-27 was inapplicable. The court instead found that the taxpayer's services were performed for the benefit of the Operating Partnership in anticipation that the corporate partner would contribute the business to the Operating Partnership, and that the Issuing Partnership was a mere conduit between its partners, including the taxpayer, and the Operating Partnership. Accordingly, the issuance was in exchange for services "to or for the benefit of a partnership." The court rejected the IRS's view that the safe harbor of the Revenue Procedure has only limited application, instead treating it as administrative guidance whose intended parameters should be analyzed by the court.

Valuation: Importance of Contemporaneous Arm's-Length Transactions in Determining Fair Market Value

The IRS also challenged the classification of the partnership interest as a profits interest, arguing that it was instead a capital interest and that, therefore, the taxpayer's receipt of the partnership interest was taxable. 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 a complete liquidation of the partnership." This determination is made at the time of the receipt of the partnership interest. A profits interest is a partnership interest other than a capital interest.

Tax Court Holds Indirect Grant of Profits Interest To Be Non-Taxable, Citing IRS Guidance

The partnership interest at issue in this case entitled the taxpayer to distributions only after the other partners had received distributions returning all of their capital. The taxpayer contended that it would not have been entitled to any distribution in a hypothetical liquidation of the partnership at the time the interest was granted, based on the taxpayer's assessment that the fair market value of the Operating Partnership was approximately $30 million then. That value was based on the sale of a 70% interest in the Operating Partnership to a group of third-party investors at the same time as the grant of the subject partnership interest to the taxpayer.

The IRS argued, based on appraisal testimony by its expert witness, that a much higher valuation was appropriate (in excess of $52 million), which would have resulted in a distribution to the taxpayer upon hypothetical liquidation on the grant date of the partnership interest. While the IRS did not dispute that, as a general matter, the best evidence of fair market value is an actual arm's length sale involving the property in question, it urged the court to disregard the contemporaneous transaction in this case, maintaining that it was not arm's-length. It alleged that the seller was pressured to sell, failed to obtain a formal appraisal, and lacked sophistication and education, so the court should adopt a different valuation methodology.

The court declined to do so. Instead, it found that the contemporaneous *bona fide* transaction between third parties was the best evidence of value and there was nothing in the record to dispute that the contemporaneous transaction in this case was arm's length and *bona fide*. On this basis, the court found that the partnership interest in question was a profits interest and eligible for the tax treatment described in Revenue Procedure 93-27.

Key Points:

- In some contexts, the receipt of a profits interest in an upper-tier partnership by a recipient that provides services to or for the benefit of a lower-tier partnership may be eligible for the treatment described in Revenue Procedure 93-27, provided that the services benefit the upper-tier partnership in its capacity as an owner of the lower-tier partnership. Taxpayers considering granting profits interests should, however, consult with counsel to evaluate such a grant in light of the particular services being provided and the issuing partnership's organizational structure.
- In determining the value of a grant of partnership interests for purposes of applying Revenue Procedure 93-27, taxpayers generally should be able to rely on the value established for the partnership in an arm's-length transaction that occurred close in time to the date of grant, even without a formal appraisal.
- If a profits interest is granted at a time when there is no proximate third-party transaction, care should be given to the drafting of the partnership agreement and the valuation of the assets in the partnership to ensure that the definition of profits interest is satisfied. Depending on the circumstances, it may be prudent to obtain an independent appraisal of the assets of the partnership.

The court's conclusions are consistent with the positions generally adopted by market participants, but it is helpful to have those confirmed and the reasons articulated.

Contacts

Nickolas Gianou
Partner / Chicago
312.407.0504
nickolas.gianou@skadden.com

Nathan W. Giesselman
Partner / Palo Alto
650.470.3182
nathan.giesselman@skadden.com

Kathleen (Kat) Saunders Gregor
Partner / Boston
617.573.4808
kat.gregor@skadden.com

Nazmiye Anna Gökçebay
Partner / New York
212.735.2292
nazmiye.gokcebay@skadden.com

Shalom D. Huber
Partner / New York
212.735.2483
shalom.huber@skadden.com

Sarah Beth Rizzo
Partner / Chicago
312.407.0674
sarahbeth.rizzo@skadden.com

Paul Schockett
Partner / Washington, D.C.
202.371.7815
paul.schockett@skadden.com

Krissy A. Annunziata
Associate / New York
212.735.3328
kristian.annunziata@skadden.com