

KEY SERVICE INSIGHTS

BUSINESS TAX NEWSLETTER

PROFITS INTEREST IN TIERED PARTNERSHIPS:

Court Reaffirms Safe Harbor in *ES NPA Holding, LLC v. Commissioner T.C. Memo 2023-55*

Case Overview

Issues

- (1) Are the profits interests safe harbor rules applicable in a tiered partnership structure?
- (2) Was the interest a profits interest based on the IRS's position that the assets were undervalued and the book-up of capital accounts was insufficient, resulting in the interest being a capital interest?

Held

- (1) Yes, the partnership interest received in exchange for services in a tiered partnership structure is a profits interest. The Court rejects IRS's argument that the profits interest did not apply because Taxpayer did not provide services to the partnership in which it received the interest.
- (2) Yes, the partnership interest was a profits interest. The Court rejects the IRS's position that the assets of the underlying partnership had been undervalued and that the interest was really a capital interest.



Key Insight

In structuring a private equity fund or other tiered partnership arrangement, care must be taken to ensure the safe harbor for profits interest received for services is preserved. It is important in the issuance of profits interest to carefully document and substantiate capital account book-ups to protect against IRS contest that the interest is a capital interest.

Brief Overview

The facts of the case are too complex so the outcome will be summarized. The dispute between the Taxpayer and IRS concerned whether a partnership interest issued for services met the safe harbor of a profits interest as set forth in Revenue Procedure 93-27 and as clarified by Revenue Procedure 2001-43 (collectively, the “**Revenue Procedures**”). These Revenue Procedures generally provide that the receipt of a partnership interest for services is nontaxable to the recipient so long as the interest in question does not share in liquidation proceeds assuming a hypothetical liquidation of the partnership immediately following the grant of the partnership interest (i.e., that the partnership interest is a true “**profits interest**” and not a “**capital interest**”).

If the requirements of the Revenue Procedures are met, then the IRS will not contest that the issuance of a partnership profits interest in exchange for services is nontaxable. In this case, the Court held over the IRS's objection that the safe harbor under the Revenue Procedures applied in the context of an intricate tiered partnership structure used in an acquisition transaction.

IRS Arguments and Court Response

The IRS made two arguments as to why the Revenue Procedures were not applicable. The IRS's primary position was that the Revenue Procedures were inapplicable because the partnership interest issued was granted by the lower-tier partnership and not the upper-tier partnership for which the past and future services were performed. The Court rejected the IRS's position and held the partnership interest was a profits interest.

The IRS's alternative position is that the partnership interest issued was in fact a capital interest

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because the assets of a consumer loan portfolio that were acquired were undervalued. The IRS supported its position with a valuation expert showing the profits interest had a liquidation value of \$12 million at time of issuance. The IRS's position was that the "book up" performed in connection with the formation of the tiered partnership structure was insufficient, so the service provider received a capital interest. The Court disagreed, holding that the valuation agreed to by the parties to the transactions – approximately \$21 million – was the best evidence of the value of the consumer loan portfolio, therefore, the service provider received a nontaxable profits interest.

Conclusion

It is not surprising that the Court found that profits interest safe harbor under the Revenue Procedures applies to tiered partnership structures; this was already the position of most practitioners. The more important point of the case based on the IRS's contest to the asset valuation is that partnerships issuing profits interest should take care to accurately substantiate capital account "**book ups**" in order to protect against an argument by the IRS that the interest so issued was a taxable "capital interest" instead of a nontaxable "**profits interest**".



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