



TaxNewsFlash

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U.S. Tax Court: Receipt of profits interest in partnership in exchange for services not taxable

The U.S. Tax Court today released a memorandum opinion holding that under Rev. Proc. 93-27, the taxpayer, a partnership for U.S. federal income tax purposes, did not recognize any income upon the receipt of an interest in an upper-tier partnership because such interest was a profits interest granted in exchange for services provided to or for the benefit of a lower-tier partnership.

The case is: *ES NPA Holding LLC v. Commissioner*, T.C. Memo 2023-55 (May 3, 2023). Read the Tax Court's [opinion](#) [PDF 244 KB]

Summary

The taxpayer received a partnership interest in another partnership (UTP) in exchange for services provided to a different partnership (LTP) owned by UTP. The taxpayer took the position that its indirect receipt of the interest in LTP (through its receipt of the interest in UTP) was a profits interest, as defined in Rev. Proc. 93-27 and related caselaw, that was excludable from income.

The IRS rejected the taxpayer's position, arguing that Rev. Proc. 93-27 is inapplicable because the taxpayer did not provide services to UTP. The IRS also argued that the safe harbor in Rev. Proc. 93-27 was inapplicable because the taxpayer received a taxable capital interest in UTP.

Under Rev. Proc. 93-27, the receipt of a capital interest for services is taxable as compensation, but the receipt of a profits interest for services is not a taxable event. Rev. Proc. 93-27 defines a profits interest as a partnership interest "other than a capital interest," and a capital interest is, in turn, 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." Under Rev. Proc. 93-27 such a profits interest is not treated as income upon its acquisition if a person receives it "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 Tax Court determined that it was uncontroverted that the taxpayer provided services to LTP in exchange for its interest in UTP and that the taxpayer's interest in UTP, which tracked the interest in LTP held by UTP, was identical in all respects to such interest. The court thus found that, as required by Rev. Proc. 93-27, the taxpayer directly (or through its principals), before and after formation, provided services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner. The court found that it was immaterial that the taxpayer's interest in LTP was held indirectly through UTP, which was a mere conduit since the liquidation rights in the interest in both UTP and LTP were identical.

The Tax Court further determined that the interest in UTP received by the taxpayer qualified as a profits interest under Rev. Proc. 93-27 because the taxpayer would have received nothing upon a hypothetical liquidation of UTP, at the time of receipt.

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