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Compensatory Distribution Of Partnership Interests

By John H. Skarbnik and Frank Brunetti

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In this report, Skarbnik and Brunetti discuss the taxation of partnership profits interests received by service providers in exchange for services, and they consider whether recent developments may signal a shift in the IRS's position.

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I. Introduction

This report explores whether the receipt of a partnership interest in consideration for a partner's services or future services is treated as a taxable event. This has been a contested matter for several years.

The law is clear about the tax consequences that arise when an individual exchanges property for a partnership interest. When an individual provides services in exchange for a capital interest in a partnership, the service provider will generally treat the fair market value of the interest as compensation, and the partnership will either get a compensation deduction or be required to capitalize the amount treated as compensation.

Before the issuance of Rev. Proc. 93-27, 1993-2 C.B. 343, courts struggled with whether the grant of a profit and loss interest to a service provider, without the receipt of a capital interest, is taxable. If it is, how does the court determine the amount of the compensation? What is the value of a profits interest when the service provider would receive nothing if, at the time the interest was granted, the partnership liquidated?

Rev. Proc. 93-27 provides a safe harbor for the tax-free receipt of some profits interests. This led many partnerships and partners to believe that a truce may have been reached with the IRS on this issue.

However, as discussed in this report, recent litigation and proposed regulations may signal a new effort by the IRS to tax partnership profits interests received by service providers in exchange for services. In *United States v. Stewart*,[1] the IRS asserted that no partnership existed and that approximately $20 million received by oil and gas managers for their services was taxable as ordinary income rather than capital gain. And in July 2015, the IRS issued proposed regulations titled, "Disguised payments for services."[2]

II. Receipt of Partnership Interest

A. General Rules

The code provides that "no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership."[3] In a nontaxable contribution of property by a partner, the partnership will acquire the transferor partner's tax basis in the property.[4] The partner's tax basis in his partnership's interest will be equal to the basis of the property and the money contributed.[5] If the property contributed to the partnership is capital gain property or property that

[1]*Stewart*, No. 4:10-cv-00294 (S.D. Tex. 2015).
[2]Prop. reg. section 1.707-2; REG-115242-14.
[3]Section 721(a).
[4]Section 723.
[5]Section 722.

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will be used by the partnership in its trade or business, the partnership's holding period for the purpose of determining how long it owned the property includes the transferor partner's holding period.[6] The partner's holding period in the partnership interest he receives in consideration for the transfer of capital gain property or for property that will be used by the partnership in its trade or business includes the holding period of the property that the partner transferred.[7]

To prevent partners from shifting pre-contribution gain or loss to other individuals, the code requires income, gain, loss, and deductions arising from the property to take into account pre-contribution appreciation and depreciation.[8]

B. Contribution of Property Interests

Property contributions include property that is self-created by the contributing partner. The contribution of self-created property qualifies for nonrecognition under section 721(a), and the code provides for the amortization of intangible property contributed to a partnership.[9] Self-created property may include goodwill, going concern value, workforce in place, and customer-based and supply-based intangibles.[10] For example, in one case, upon the sale of a dental practice to a partnership in which the seller was a partner, the seller recognized a capital gain on the sale of the practice's goodwill.[11]

The taxpayer bears the burden of proof of showing that there was an actual sale of goodwill to the purchaser.[12] When the goodwill is personal to an individual partner, he should execute a covenant not to compete to substantiate that the goodwill was owned by him. However, the IRS has ruled that no depreciation recapture is recognized upon the sale of self-created customer rights if the taxpayer has sufficient records and information to distinguish self-created customers from purchased customers.[13]

The Fifth Circuit has held that the contribution of valuable maps to a partnership that resulted in discovery and production of oil-producing properties can be considered property.[14] It remanded the case to the district court to determine whether the maps remained the personal property of the contributor or were contributed to the venture.

The Eleventh Circuit held that the receipt of a limited partnership interest valued at $100,000 in exchange for a nonbinding letter of intent negotiated by the contributing partner was not taxable.[15] The district court had concluded that because the letter of intent was not legally enforceable, it was not property, and that the partner was ineligible for nonrecognition. In reversing the district court, the Eleventh Circuit found that the transfer of the letter of intent outlining major terms of a proposed loan and lease agreement to which both parties felt morally bound is closely analogous to a transfer of goodwill. Accordingly, the transfer was a property right, and the partner was not taxable on the receipt of the partnership interest.

C. Receipt of Capital Interest

The regulations make clear that the nonrecognition rule applies only for a contribution of property. If a partner receives a capital interest in exchange for services, he will be taxable on the receipt of the interest. Reg. section 1.721-1(b)(1) 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 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. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for the past services or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time which such income is realized depends on all the facts and circumstances including any substantial restrictions on conditions on the compensation partner's right to withdraw or otherwise dispose of such interest.

Under that regulation, a service provider will be taxed on the portion of a capital account that he receives in exchange for his services. That rule does not apply when the service provider receives only a profits interest.

[6]Section 1223(2).

[7]Section 1223(1).

[8]Section 704(c). *See* reg. section 1.704-3.

[9]Section 197(f)(2)(B). This section provides that it applies to property contributed under section 721. *See* section 197(f)(2)(A).

[10]Section 197(d). *See* Rev. Rul. 79-288, 1979-2 C.B. 139; and Rev. Rul. 70-45, 1970-1 C.B. 17.

[11]*Rees v. United States*, 187 F. Supp. 924 (D. Ore. 1960), *aff'd*, 295 F.2d 817 (9th Cir. 1961); *see also Butler v. Commissioner*, 46 T.C. 280 (1966).

[12]*Kennedy v. Commissioner*, T.C. Memo. 2010-206.

[13]LTR 201016053.

[14]*See United States v. Frazel*, 335 F.2d 487 (5th Cir. 1964).

[15]*United States v. Stafford*, 727 F.2d 1043 (11th Cir. 1984).

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D. Receipt of Profits Interest

1. Case law before Rev. Proc. 93-27. *Diamond v. Commissioner*[16] involved an individual, Philip Kargman, who acquired an option to buy an office building. He agreed to give the taxpayer, Sol Diamond, 60 percent of the profits after Kargman recovered all his expenses, if Diamond could arrange financing for the entire $1.1 million purchase price of the building. Diamond was able to obtain a mortgage for the full amount, and he and Kargman entered into an agreement under which the profits were to be divided 40 percent to Kargman and 60 percent to Diamond. In March 1962, less than a month after the closing on the purchase of the building, Diamond sold his interest in the partnership to Kargman for $40,000.

On his 1962 tax return, Diamond reported the gain from the sale of the partnership interest as a short-term $40,000 capital gain. He offset the gain by an unrelated short-term capital loss. The Tax Court found adequate support that the FMV of the interest acquired by Diamond was $40,000 and that the amount should be included in his ordinary income.

On appeal, the Eleventh Circuit noted that there was a great deal written by academics that the receipt of a profits interest should not be taxable. The court said that in the absence of regulations that answer the question, it would defer to the expertise of the Tax Court. Therefore, the Eleventh Circuit upheld the decision that Diamond was taxable on the receipt of his interest in the partnership, which had a $40,000 FMV.

In *St. John v. United States*,[17] the taxpayer, Donald St. John, received a 15 percent profits interest in a partnership. That interest would become effective after the contributing partners received a distribution of their initial contributions. The district court accepted St. John's argument that if there was a liquidation of the interest when a substantial risk of forfeiture of his interest lapsed, he would receive nothing. It thus held that St. John should not be taxed on the receipt of the profits interest.

2. Rev. Proc. 93-27 — receipt of profits interest is generally not taxable. In July 1993 the IRS issued Rev. Proc. 93-27 to provide guidance on the treatment of a receipt of a partnership profits interest. The ruling defines a profits interest as a partnership interest other than a capital interest. A capital interest is defined as ''an interest that would give the holder a share of the proceeds if the partnership's assets were sold at a fair market value and the proceeds were distributed in a complete liquidation of the partnership.''[18] The revenue procedure provides that ''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 IRS will not treat the receipt of that interest as a taxable event for the partner or the partnership.[19]

Rev. Proc. 93-27 does not apply in the following three circumstances:

1. if the profits interest relates to a substantially certain and predictable stream of income from the partnership assets;

2. if within two years of receipt the partner disposes of the profits interest; or

3. if the profits interest is a limited partnership interest in a publicly traded partnership.

Rev. Proc. 2001-43, 2001-2 C.B. 191, clarifies Rev. Proc. 93-27 by providing that the grant of a partnership profits interest that is substantially nonvested, as determined under section 83, qualifies as a profits interest measured at the time the interest is granted. Also, the event that causes the interest to be substantially vested will not be treated as a taxable event.

Issues involving whether a taxpayer was vested arose in *Crescent Holdings LLC v. Commissioner*.[20] Crescent Holdings LLC, a limited liability company formed on September 7, 2006, was wholly owned by Duke Energy Corp., a publicly traded company. Duke Energy was also the sole owner of Crescent Resources, which developed and managed commercial, residential, and multifamily real estate projects. Crescent Resources and Duke Ventures, an indirect wholly owned subsidiary of Duke Energy, entered into an agreement with Morgan Stanley on September 7, 2006, for the sale of a partial interest in Crescent Resources. Under the agreement, Duke Ventures contributed 100 percent of its interest in Crescent Resources to Crescent Holdings.

Crescent Holdings membership interests were held 98 percent by Duke Ventures and 2 percent by Arthur Fields, the president of Crescent Resources, who was also a member of the Duke Energy executive team. Fields's 2 percent interest would be forfeited if he terminated his employment with Crescent Resources before the third anniversary of

[16]*Diamond*, 56 T.C. 530 (1971), *aff'd*, 92 F.2d 286 (7th Cir. 1974).

[17]*St. John*, No. 82-1134 (C.D. Ill. 1983). *See also Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), *rev'g* T.C. Memo. 1990-162.

[18]Rev. Proc. 93-27, sections 2.01 and 2.02.

[19]Rev. Proc. 93-27, section 4.01.

[20]*Crescent Holdings*, 141 T.C. 477 (2013).

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the formation of Crescent Holdings. Fields did not file a section 83(b) election with the IRS.[21]

At the time of those transfers, Crescent Resources entered into a credit agreement and borrowed $1.225 billion, of which $1.187 billion was distributed to Crescent Holdings. Crescent Holdings distributed the money to Duke Ventures. Duke Ventures also sold a 49 percent member interest in Crescent Holdings to the initial Morgan Stanley hedge funds for approximately $415 million.

To his surprise, Fields received a 2006 Schedule K-1 from the partnership allocating $423,611 of partnership income to him, even though no distributions had been made to him that year. Fields spoke to Crescent Resources' CFO, who told him that he should not have received a Schedule K-1 because he was not a partner. Fields nonetheless reported the distribution on his 2006 return, believing the matter would be taken care of by the partnership the next year. In 2008 Fields received a 2007 Schedule K-1 allocating $3,608,218 of partnership income to him. The CFO spoke to the accounting firm, which said that Fields was a partner. Fields wanted to avoid penalties, so he reported the Schedule K-1 items on his 2008 return.

In July 2008 an agreement was reached between Fields and Crescent Resources. Crescent Resources agreed to distribute $1,900,040 to Fields to cover the taxes he paid on the income allocations in 2006 and 2007, and in January 2009, Crescent Resources paid Fields $524,500 to cover his estimated tax for 2008.

Crescent Resources' financial condition deteriorated rapidly in 2009. Fields resigned on May 29, 2009 — less than three years after the formation of Crescent Resources. Fields forfeited his interest in Crescent Holdings because he was not employed by Crescent Resources three years after he was granted a 2 percent interest in Crescent Holdings. Less than two weeks later, Crescent Holdings and Crescent Resources filed for bankruptcy. Those entities filed an adverse complaint in the bankruptcy court seeking a repayment from Fields of the $2,424,250 paid to him to cover his taxes. Fields entered into an agreement with the creditors under which he agreed to make an immediate payment of $600,000, file amended income tax returns, and repay the creditors the balance of the tax-advance payments when he received refunds based on the amended returns.

The IRS issued a final partnership administrative adjustment for Crescent Holdings' 2006 year, increasing its income by approximately $11.2 million. For 2007 the IRS issued an FPAA decreasing the partnership's income by approximately $6 million. The 2006 and 2007 FPAAs also determined that Fields was a partner for the purpose of allocating partnership items.

Whether Fields was taxable on the income earned on the 2 percent interest depended on whether he was subject to Rev. Proc. 93-27. The Tax Court noted that one of the conditions for Rev. Proc. 93-27 to apply is that the service provider must receive a profits interest, not a capital interest. The court quoted from section 2.01 of Rev. Proc. 93-27, which says that a "capital interest is an interest that would give the holder a share of the proceeds if the partnership assets were sold at fair market value and then the proceeds were distributed in a completed liquidation of the partnership."

Based on the partnership agreement, the Tax Court determined that if there was a liquidation of Crescent Holdings on the date Fields received his interest, he would have received a capital distribution. Thus, the interest he received was not a profits interest, and Rev. Proc. 93-27 did not apply.

The Tax Court further held that Fields was not taxable on the amounts allocated to him on the 2006 and 2007 Schedules K-1 because his interest was not vested. His interest would have been forfeited if he was not working for Crescent Resources within three years from the date he received his interest. Regarding the income allocated to Fields's interest as set forth in the Schedules K-1, the Tax Court said, "Petitioner's right to receive the undistributed income allocated attributable to the 2 percent interest was subject to the same substantial risk of forfeiture as his right to the 2 percent interest. If petitioner forfeited his right to the 2 percent interest, then he would also forfeit his right to receive any benefit from the undistributed income allocations." The Tax Court held that the undistributed partnership allocations to a nonvested partner's capital interest were not to be included in the partner's income. The income should be recognized in the gross income of the transferors, the other equity owners.

3. Partnership distribution to partner who received profits interest in exchange for services. Section 702(b) provides:

> The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly

[21]Section 83(b) gives a service provider who receives a nonvested property interest the option of reporting the interest at the time of receipt rather than when the interest vests. By making the election, a taxpayer can reduce the amount of ordinary income recognized if the value of the nonvested property increases from the date it is received to the date it vests. The section 83(b) election is made within 30 days of the date of transfer.

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from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Reg. section 1.702-1(b) provides:

> The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

The Supreme Court in *United States v. Basye*[22] said "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a portion of the total income as if the partnership were merely an agent or conduit through which the income passed."

In Rev. Rul. 68-79, 1968-1 C.B. 310, the IRS, citing section 702(b), ruled that a partner recognized a long-term gain on the disposition of property even though he held his partnership for only several months. The characterization of the gain was determined at the partnership level, and because the gain was long-term capital gain to the partnership, the gain allocated to each of the partners was long-term capital gain.

In Rev. Rul. 2008-39, 2008-32 C.B. 252, the IRS ruled that management fees incurred by an upper-tier partnership in the management of its lower-tier partnership could not be used to offset income of the lower-tier partnership. Rather, the expenses of the upper-tier partnership were incurred in managing properties held for investment under section 212. The upper-tier partnership does not include the management fee in its calculation of its taxable income. Instead, it is a separately stated item of expense that passes through to the partners.

In *Campbell v. United States*,[23] the Fifth Circuit held that losses in real estate ventures allocated to limited partners were not net operating losses for NOL carryback purposes. The taxpayer argued that he was involved in the real estate business and should be allowed to carry back the losses. Citing section 702(b), the court said, "The attribution of a loss to a trade or business purpose must be made at the partnership level."

III. Does a Partnership Exist?

To deny favorable tax treatment, the IRS may allege that a partnership does not exist. If it does not exist, the partnership characterizations rules discussed in Section II.D.3 do not apply.

Section 761(a) defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."

Reg. section 301.7701-1(a)(2) provides:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.[24]

As noted earlier, the IRS may dispute whether a partnership exists. It may argue that a service provider received ordinary income rather than capital gain on the receipt of a distribution from a partnership. That was the issue in *Stewart*.

The case involved Hydrocarbon Capital LLC, which in March 2003 purchased a portfolio of oil and gas properties from Mirant Corp. Hydrocarbon

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[22] *Basye*, 410 U.S. 441 (1973).

[23] *Campbell*, 813 F.2d 694 (5th Cir. 1987).

[24] The regulation is referenced by reg. section 1.761-1(a). *See* *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

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asked the five executives at Mirant who managed those properties to continue managing them. The five individuals formed Odyssey Capital Energy LP, which entered into an agreement with Hydrocarbon. The agreement provided that:

- Odyssey would manage exploration and production of the oil and gas properties acquired by Hydrocarbon;
- Odyssey would operate the wells or work with other operators;
- Hydrocarbon had to approve all expenses, but Odyssey fully controlled the operations;
- Hydrocarbon would lend Odyssey $6 million as working capital on a nonrecourse basis; and
- when the oil and gas properties were sold by Mirant, Odyssey would receive 20 percent of the profits after Hydrocarbon recouped its expenses, received a 10 percent return on its investment, and was repaid the loan.

If the sale proceeds did not exceed that amount, Odyssey would receive no profits. The agreement specifically provided that a partnership was not created between Odyssey and Hydrocarbon.

Approximately one year after acquiring the oil and gas properties, Hydrocarbon sold them. Hydrocarbon recovered its expenses and its purchase price, received a return on its investment, and was repaid the loan. Odyssey received $20,106,410, which it originally reported on its 2004 tax return as ordinary income, and each Odyssey partner received a Schedule K-1. Two years later, Odyssey filed an amended partnership return reporting $20,432,323 (with no explanation for the increase) as capital gain and issued amended Schedules K-1 to its partners. The partners then filed refund claims. Two partners, David Stewart and Richard Plato, received refunds of $1,333,067 and $520,222, respectively. A fifth partner filed a refund request in December 2007, which was denied. The partner amended his return again in January 2008. The IRS maintained that Odyssey's receipt of the distribution of 20 percent profits was compensation for services and that the earnings of Odyssey's members should be taxed as ordinary income.

The government sued Stewart and Plato to return for what it contended were erroneously issued refunds. It argued that Odyssey managed Hydrocarbon's assets and earned a commission and that no partnership existed, as the parties explicitly agreed. The government also asserted that Hydrocarbon contributed and controlled the money and owned the assets, and that Odyssey had no money at risk. It viewed Odyssey as a contract service provider that could not spend money or sell the assets without Hydrocarbon's approval. The government also noted that Hydrocarbon and Odyssey did not file a partnership tax return.

The district court held that there was a partnership between Odyssey and Hydrocarbon:

> Tax partnerships do not depend on contract language. They arise from the reality of the relationships. The partners of Odyssey were not car salesmen earning commissions from individual sales. They had an ownership interest in the value of the entire operation. Hydrocarbon contributed the properties and finances, and they contributed their expertise and energy to make a contingent interest in the asset valuable.

This arrangement is no different from flipping a house. The gain realized through sweat equity (the appreciation of the value of the house by fixing it up) is a capital gain — the very reason it is called sweat equity instead of sweat income. In the same way, Odyssey's sweat — its management — increased the value of the capital of the portfolio of properties.

Having purchased a share of the project, the partners managed the portfolio and earned the venture significant profits when it sold. The merger of execution and financing is a partnership, and its profits are long-term capital gains, the *Stewart* court said.

On a different note, the district court found that the government could timely challenge Odyssey's recharacterization of the income as capital income. The original return was filed April 15, 2005, and the amended partnership return was filed in April 2007. The government could not sue the individual partners to change the characterization of the income.[25] The district court thus held that the government did not have the right to sue the partners for the amount refunded without first changing the partnership's characterization of the income.[26]

IV. Is Interest a Disguised Payment for Services?

Despite the taxpayer's victory in *Stewart*, the future taxation of the receipt of profit and loss interests may not be so clear given the recently proposed regulations on disguised payments for services. Curiously, the IRS did not argue in *Stewart* that there was a carried interest that should be taxed as a disguised payment for services.

The origin of carried interest can be traced back to the 16th century, when European ships were crossing to Asia and the Americas. The captain of the ship would take a 20 percent share of the profit

[25]Citing section 6226.
[26]Citing section 6221.

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from the carried goods to pay for the transport and the risk of sailing over oceans.[27]

Carried interest has served as the primary source of income for managers and firms in private equity and hedge funds. Private equity firms and hedge funds generally receive relatively small annual management fees (1 percent to 2 percent of committed capital). The management fee is meant primarily to cover the costs of investing and managing the fund rather than for meaningful wealth creation for the manager. The hedge fund manager also generally receives a favorable performance-based special allocation. For example, a hedge fund manager may be allocated 20 percent of the annual appreciation of the fund. Because the manager is compensated with carried interest, the bulk of his income from the fund is taxed as a return on investment and not as compensation for services.[28] As discussed above, based on Rev. Proc. 93-27, a partner is not taxed upon the receipt of a carried interest, because it is difficult to measure the present value of an interest in future profits. Instead, the partner is taxed as the partnership earns income.

The preamble to the recently proposed regulations discusses the general rules under section 707, under which payments by a partnership to a partner may be treated as (1) a distributive share of partnership profits; (2) a guaranteed payment; or (3) a transaction in which a partner has rendered services to the partnership in his capacity as other than a partner. The preamble states:

> Congress indicated that the most important factor in determining whether or not an arrangement constitutes a payment for services is that the allocation and distribution is subject to significant entrepreneurial risk. . . . Congress noted that partners extract the profits of the partnership based on the business success of the venture, while third parties generally receive payments that are not subject to this risk. . . . The proposed regulations reflect this factor is the most important. Under the proposed regulations, an arrangement that lacks significant entrepreneurial risk constitutes a disguised payment for services. An arrangement in which allocations and distributions to the service provider are subject to significant entrepreneurial risk will generally be recognized as a distributive share but the ultimate determination depends on the totality of the facts and circumstances.

The proposed regulations provide rules for characterizing arrangements as disguised payments for services.[29] They list six nonexclusive factors that should be considered in determining whether a payment is for services:

> 1. the arrangement lacks significant entrepreneurial risk;
>
> 2. the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;
>
> 3. the service provider receives an allocation and distribution in a time frame comparable to the time frame during which a non-partner service provider would typically receive a payment;
>
> 4. the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third-party capacity;
>
> 5. the value of the service provider's interest in general and continuing partnership profits is small in relation to the allocation and distribution; and
>
> 6. the arrangement provides for different allocations or distributions for different services received, the services are provided either by one person or by persons that are related under section 707(b) or 267(b), and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.[30]

Factor 1, which was identified in the preamble as the most important factor, has clear implications for the *Stewart* facts. There was a significant entrepreneurial risk because there were no capped allocations, nor was it highly likely (under a formula or otherwise) that sufficient net profits would be available to the service provider. We also think that factors 2-6 would not have been found by the court.

V. Conclusion

The receipt of a partnership interest in consideration for services rendered or to be rendered to a partnership may become slightly more problematic. Certainly, the receipt of a profits interest that meets the test in Rev. Proc. 93-27 should not be subject to tax.

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[27]James M. Kocis et al., *Inside Private Equity* 22 (2009).

[28]Mark Jickling and Donald J. Marples, "Taxation of Hedge Funds and Private Equity Managers," Congressional Research Service, RS22689 (Jan. 2, 2014).

[29]Prop. reg. section 1.707-2(a).

[30]Prop. reg. section 1.707-2(c). A full discussion of the proposed disguised payment rules is beyond the scope of this report.

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However, in light of its litigation position in *Stewart*, the IRS may challenge whether there was an actual partnership. If a partnership does not exist, the receipt of distributions from the partnership may be characterized as compensation for services. Also, even if a partnership exists, the IRS may argue that the receipt of distributions from the partnership should be characterized as a disguised payment for services.[31]

[31]*See* prop. reg. section 1.707-2(a).

IN THE WORKS

A look ahead to planned commentary and analysis.

When practicality takes a vacation, this happens (*State Tax Notes*)

Garry Fujita uses several examples that illustrate Washington's trend to determine a taxpayer's tax status by another party's activities and explains why it is bad tax policy to go beyond a taxpayer's activities, books, and records to establish that taxpayer's proper reporting requirements.

A SALT guide to the Internal Revenue Code (*State Tax Notes*)

Vito Cosmo, Michael Beck, and Steve Allenson discuss how state rules may differ from those in the Internal Revenue Code in several areas including depreciation, distributions, pre-acquisition attributes, and dividends received deductions.

Once more unto the breach: The deteriorating fiscal outlook (*Tax Notes*)

Alan J. Auerbach and William G. Gale examine why the long-term fiscal outlook of the country has declined over the past year and conclude that even with low interest rates, the budget is unsustainable.

Problems at the IRS in attempting to provide service to taxpayers (*Tax Notes*)

T. Keith Fogg and Leslie Book consider the ramifications of decreased telephone service at the IRS and propose a more personal approach and appropriate funds from Congress for a solution.

VAT fraud mutation, part 2: *Citibank* as a transition (*Tax Notes International*)

In the second part of a three-part series, Richard T. Ainsworth discusses *Citibank*, which marks a transition from push-type (externally controlled) missing trader intra-Community fraud to sustained, pull-type (economically controlled) fraud.

Flexing the arm's-length principle in Australia: The *Chevron* case (*Tax Notes International*)

Stephen Banfield discusses the Federal Court of Australia's landmark decision in *Chevron*, in which transfer pricing adjustments made by the Australian Taxation Office were upheld under the court's interpretation of the arm's-length principle.

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