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Practical Considerations for Issuing Profits Interests, Part 2

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In this report, Beyzaee discusses how profits interests can provide an equity incentive to people providing services to a partnership. The tax treatment to the recipient is favorable, and there are almost endless possibilities in terms of how they are structured. But their use raises a host of issues, in both implementation and administration, that practitioners should be attuned to. And although profits interests have been sanctioned by the IRS for some time, many unanswered questions about their treatment remain.

This report is being published in two parts. The first part, published June 9, discussed the current state of the law governing profits interests. This second part includes practical guidance for establishing these arrangements.

The information contained herein is of a general nature and is based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser. This report represents the views of the author only and does not necessarily represent the views or professional advice of Liner LLP.

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III. Structuring Profits Interests

There are almost infinite possibilities for structuring variations on the profits interests, giving practitioners and business owners great flexibility in achieving their desired outcomes. This section will provide some examples of how profits interests are structured, followed by drafting techniques for implementing those structures.

A. Structuring Techniques

There are many ways to economically structure profits interests. This section will examine several approaches that can be used, but they are by no means exhaustive — creative taxpayers and practitioners can certainly develop others.

1. Fixed profit share. The most common form of profits interest is probably one in which the holder is entitled to share in a fixed percentage of any gains or profits above the value of the partnership at the time the interest is granted, or some higher specified threshold. For example, if the partnership is worth $1 million when the profits interest is granted, the holder might be entitled to 5 percent of all gains and profits exceeding $1 million. Alternatively, the holder might be entitled to 5 percent of all gains and profits exceeding $1.5 million or 5 percent of all gains and profits after the existing partners have received the $1 million plus a preferred return thereon.

This structure would clearly satisfy the safe harbor requirement that the profits interest have a zero liquidation value. The one caveat, however, is that the parties must be confident that the specified value for allowing the profits interest holder to participate is not below the current liquidation value of the partnership.[117]

2. Catch-up right. A problem with the kind of profits interest described above is that a service provider that is promised a fixed percentage of the entire partnership for its services is really not getting a share of the existing value of the partnership. Although it does not exactly accomplish this goal, there is a second approach that attempts to approximate that result while still qualifying as a profits interest: Allocate the first gains and profits of the partnership only to the profits interest holder until the holder is economically *pari passu* with the other partners and only thereafter sharing gains and profits pro rata.

Example 13: Partnership AB is worth $1 million when a service provider, C, is granted a profits interest. The parties want to give C a one-third interest in the partnership. This catch-up approach would allocate the first $500,000 of gains and profits and one-third of all subsequent gains and profits to C.[118] Table 1 shows what C would receive in a hypothetical liquidation of the partnership in this example at various liquidation values:

Table 1 — Example 13

AB Liquidation Value	C's Share of Proceeds	C's Percentage of Value
$500,000	$0	0%
$1,000,000	$0	0%
$1,200,000	$200,000	16.67%
$1,500,000	$500,000	33.33%
$3,000,000	$1,000,000	33.33%

A prime example of this approach is in connection with the management fee waiver technique used in many private equity funds. There, the partnership interest received by the waiver partner typically entitles the holder to this kind of catch-up allocation until the amount of the management fee "waived" is reached and then a pro rata share of future gains and profits of the fund is distributed.[119]

This approach can itself take many different forms. For example, the catch-up need not start at the value of the partnership at the time of the grant; instead, it can apply starting at a higher threshold (perhaps $1.2 million in Example 13). Likewise, the catch-up does not need to provide the same percentage of the existing value as the future sharing percentage. So the holder might get only a 5 percent catch-up on existing capital, together with a 10 percent share of future profits, or a 10 percent catch-up with a 5 percent share of future profits.

As with the first approach, this structure would clearly satisfy the safe harbor requirement of having a zero liquidation value. But here again, even more so than in the first approach, the parties should be careful not to underestimate the existing value of the partnership. Because of the "juiced" catch-up rights of the profits interest, the holder of the profits interest would likely be taxed immediately to the full extent of any understatement of value because all that value would accrue to the interest. In Example 13, if the value of the partnership were really $1.2 million but the parties treated it as only $1 million, the profits interest would have a liquidation value of $200,000 upon grant, which amount would likely be fully taxable to C at the time of grant.

3. Gross allocations. A more exotic technique is to start with one of the first two approaches but add a "gross" twist. Tax items arising after the date of grant (not including built-in gains and losses) are allocated on a gross basis (that is, allocations of gross items of profits and losses, rather than net profits or losses) among the partners, with gross profits being allocated to the profits interest holder and gross losses allocated to the other partners until their respective capital accounts match up with the desired economics. The holder of the profits interest will at no time be entitled to share in any value in excess of its capital account.

Example 14: Partnership AB has a liquidation value of $1 million, consisting entirely of cash, when a profits interest is granted to a service provider, C. The business goal is that C share in 10 percent of all value of the partnership, so this gross allocation approach is used. In the first year after

[117]*See* Section IV.I for a discussion of valuation issues.

[118]The amount of the initial catch-up allocation can be calculated using the following formula, where x is the percentage of the partnership to be given to the profits interest holder:

$$\textit{Catch-Up Amount} = \frac{\textit{Value of Partnership at Grant}}{(1 - x)}$$

The profits interest holder's share of liquidation proceeds can be represented by the following Excel formula:

$$= min\,(max(0, (l - i)), (x * l))$$

where
x = the profits interest holder's share
l = the liquidation value of the partnership at liquidation
i = the liquidation value of the partnership at the time of the grant of the profits interest.

[119]For a more detailed analysis of the management fee waiver approach, see Afshin Beyzaee, "Current Tax Structuring Techniques for Private Equity Funds," 20 *J. Tax'n & Reg. of Fin. Inst*. 16, 18-20 (May/June 2007).

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Table 2 — Example 14					
Net Profit (Loss)	Gross Profit to Profits Interest Partner	Gross Losses to Other Partners	Liquidation Proceeds	Profits Interest Proceeds	Percentage of Proceeds
($10,000)	$50,000	($60,000)	$990,000	$50,000	5.05%
($10,000)	$99,000	($109,000)	$990,000	$99,000	10.00%
$0	$50,000	($50,000)	$1,000,000	$50,000	5.00%
$10,000	$30,000	($20,000)	$1,010,000	$30,000	2.97%
$10,000	$101,000	($91,000)	$1,010,000	$101,000	10.00%

grant, the partnership has no net profits or net losses (that is, it breaks even for tax purposes), consisting of $100,000 of gross profits and $100,000 of gross losses. The partnership allocates $100,000 of gross profits to C, bringing its capital account up to $100,000, and $100,000 of gross losses to the other partners, bringing their aggregate capital accounts down to $900,000. When the partnership later liquidates at a liquidation value of $1 million, C receives $100,000 and the other partners receive $900,000. Table 2, above, shows other outcomes based on different amounts of gross profits and losses of the partnership.

As Example 14 illustrates, there are situations in which even if the partnership has an overall net loss, the profits interest holder will receive a full 10 percent of the liquidation proceeds.

Because the safe harbor looks to whether the profits interest shares in any proceeds on a hypothetical liquidation generally tested at the time of receipt, this type of profits interest should again qualify for the safe harbor. That said, the reliance on gross allocations rather than a form of net allocations significantly increases the likelihood that the holder will share in distributions from the partnership. This alone should not be a problem. But if the partnership has any gross items of income that are substantially certain and predictable, this approach may result in the interest failing the requirement that it not relate to a substantially certain and predictable stream of income.[120]

When implementing this approach, the partnership should take care at the time of grant to identify existing built-in gains and not allocate those to the profits interest recipient.[121] This will prevent the interest from sharing in the liquidation value of the partnership in violation of the safe harbor rules. As discussed below, taxpayers can consider a non-safe-harbor profits interest that permits a sharing of those built-in gains, but that feature raises additional risks.[122]

One other thing to be careful about is how leveraged distributions are addressed. Because simply incurring debt does not add to the partners' capital accounts, if holders of profits interests are not permitted to share in distributions that exceed their capital accounts, they would likely be unable to participate in some or all of any leveraged distributions. As mentioned above, it is unclear whether permitting them to share in those distributions would spoil the profits interest treatment.[123] But if profits interest holders are to participate in those leveraged distributions, a special dispensation from this rule should be included to permit that.

4. Capped participation. In some cases, the parties want the service provider to share in some of the growth of the partnership but not above a specific point. In that situation, they might cap the participation of the profits interest.

Example 15: Partnership AB is worth $1 million when a service provider, C, is granted a profits interest. Under this capped participation approach, C could be given 10 percent of only the first $2 million of the partnership's gains and profits.

Some might argue that this kind of profits interest is not a true partnership interest. But the fact that its participation is limited should not alone convert an otherwise real partnership interest into some other kind of arrangement.[124] If preferred stock with merely a preference on liquidation can be respected as equity, there is no reason a profits interest whose participation is capped would not be.[125] Moreover, the interest will still have features discussed above that would support treatment of its holder as a partner.[126]

That said, once the profits interest has received the full amount of its participation, it would likely be viewed as though that partnership interest terminated for tax purposes, because the holder would

[120]*See* Section II.E.1 (Part 1 of report).

[121]One way to accomplish this is to revalue partnership assets in connection with the grant. *See* Section IV.K.

[122]*See* Section III.A.6.

[123]*See* Section II.F.4 (Part 1 of report).

[124]*See* Section II.E.5.e (Part 1 of report).

[125]*See* TAM 200116002 (preferred stock with no dividend rights and preference on liquidation respected as stock).

[126]*See* Section II.E.5.e (Part 1 of report).

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no longer have any economic rights in the partnership. So, parties that are concerned about the effect of such an interest disappearing should ensure that they limit distributions to avoid the participation being satisfied or that the holder otherwise has a partnership interest that will not terminate.

5. Liquidity event participation. As mentioned above, one of the problems with granting a profits interest is that the holders will generally be allocated a share of a partnership's current income, which, for an operating business, is normally ordinary income.[127] However, many people ask why the profits interest holder can't have capital gain treatment. One way to largely achieve that result is to permit the profits interest to participate only in specified liquidity events.

This approach gives profits interests only a right to gains and losses on specific events that result principally in capital gain income. Those events might include the sale of particular capital assets or a sale of all or a division of the partnership business.[128]

Example 16: Partnership AB is worth $1 million when a service provider, C, is granted a profits interest. The profits interest entitles C to 10 percent of any gains realized by AB upon a sale of the partnership business. If the partnership business is later sold for $1.2 million, C will receive a distribution of $20,000 (20 percent of $200,000).

In this example, C would not participate in the operating income of the partnership, so it would be reasonable not to allocate any of that ordinary income to C. A better approach would be to allocate to C only its share of the gain on the sale of the partnership business, which would likely be principally capital gain.[129]

A few things to keep in mind: First, as with the gross allocations approach, the parties should revalue the assets or otherwise ensure that the profits interest holder does not share in existing built-in gain in the business unless the parties knowingly take on the risks described below in Section III.A.6. Second, the parties should be sensitive to the risk that if they too closely link the distribution rights to specific assets, the interest will be treated as an interest in those assets rather than a partnership interest.[130] Third, the parties should consider including a provision in the partnership agreement that would allocate sales proceeds on a sale of the equity of the partnership to avoid a discount on the relative value of the profits interests because of these limitations.

6. Share of built-in gain. Yet another approach builds on the gross allocations approach by looking not just to future gains and profits but also to existing built-in gains and profits to build the profits interest holder's capital account.[131]

Example 17: Partnership AB has a liquidation value of $1 million, consisting of property worth $1 million with a tax basis of $700,000 and no debt. The business wants C to share in 10 percent of all value of the partnership, so the share of built-in gain approach is used. The profits interest is given the right to share in any gains or profits of the partnership, including the $300,000 of built-in gain. If the property were sold for $800,000, C could still receive $80,000, because $100,000 of gain would be recognized by the partnership. Along with that, C would be allocated $80,000 of the partnership gain recognized on the sale of the property.

Obviously, a profits interest granted under this approach would not qualify for safe harbor treatment because if there were an immediate hypothetical liquidation, the holder of the profits interest would receive a distribution. Instead, this approach is based on a rather aggressive reading of the law. The theory is that because the value to the recipient is still based on recognizing a gain on property held by the partnership, that value is still speculative. And because the profits interest holder is allocated a corresponding portion of the taxable income, the holder is in no different tax position than if it were granted an identical interest when the value of the property equaled its book value. Indeed, if the profits interest holder were taxed on the receipt of the interest and still allocated a share of the income, the holder would effectively be double-taxed on that income and left only with excess outside basis that it could not use until it disposes of the profits interest.[132]

The IRS would almost certainly challenge the grant of this kind of interest being treated as nontaxable. In GCM 36346, the IRS Office of Chief Counsel considered a revenue ruling that would

[127]For partnerships that have principally investment assets held for appreciation (rather than current income), such as private equity funds, this is not as much of a concern, because the partnership's income will be primarily capital gain.

[128]Subject to the discussion in Section II.F.4 (Part 1 of report), the profits interest may also be able to participate in some refinancing proceeds.

[129]The gain attributable to "hot assets" that would be treated as ordinary income under section 751.

[130]*See supra* text accompanying note 93 (Part 1 of report).

[131]To accomplish this, the partnership should not revalue its assets when the profits interest is granted. *See* Section IV.K.

[132]And if there is a loss on that later disposition, the taxpayer may never recoup that second tax on the income because it is severely limited in its ability to (or, for individuals, unable to) carry back that loss or use it to offset other kinds of income (in the case of a capital loss).

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have treated built-in gain as part of the ''capital'' of a partnership that would be taxable to the extent a service provider received a partnership interest that would participate in that built-in gain. As support for that conclusion, the revenue ruling pointed to legislative history for a bill that was never passed. The revenue ruling was never approved or issued, but was ''deferred pending further discussion of the alternative positions available to the Service in resolving the issue involved.''[133] Moreover, its analysis was not included in either of the revenue procedures when they were eventually released. Nevertheless, it suggests that the IRS is inclined to treat interests granted under the share of built-in gain approach as capital interests rather than profits.

Thus, while this approach has some appeal, it will likely face significant scrutiny, and it is very uncertain whether courts would agree with it. Other factors may heighten the risks, such as situations in which the asset with built-in gain is very liquid (such as marketable securities) or otherwise easily valued, or the asset is being held out for sale or marketed at the time of the grant of the profits interest or is disposed of shortly after the profits interest is granted. Accordingly, any practitioner or taxpayer contemplating this structure should tread lightly and carefully consider the risks before adopting it.

7. Deficit restoration obligation. Although I have not seen an example of this out in the wild, another possible way of permitting a profits interest holder to share in distributions from the time of grant is to subject any pre-profit distributions to a deficit restoration obligation. The idea here is that by imposing a deficit restoration obligation, the result of any immediate distributions is still that the profits interest holder would not receive any net proceeds on a hypothetical liquidation.

This approach would not be particularly appealing to a profits interest holder in the ordinary course, however, because the holder would initially have no basis in the interest. Even though the distribution would be subject to a deficit restoration obligation, the holder would be taxed on the distribution if it were a distribution of cash.[134] In the long run, the holder would receive an offsetting loss on the disposition of the interest, but that is likely to be of little comfort to the holder.

Still, there may be some situations in which this approach would have appeal. One might be when there will be distributions of property. The holder of the profits interest would receive a carryover basis in the distributed property, limited by the holder's outside basis (presumably of $0), rather than recognize gain.[135]

Likewise, this approach might be appealing if partnership liabilities are allocated to the partner. As discussed above in Section II.F.3 (Part 1 of report), the holder's share of the liabilities should create basis, which could shelter some of the distributions.

Example 18: The facts are the same as in Example 12, but the partnership has a provision that would require C to restore any negative capital account to the partnership on a liquidation of the partnership.

In this example, presumably the profits interest holder could receive up to $30,000 of distributions on a tax-free basis while potentially still qualifying for safe harbor treatment.

Unfortunately, there is no guidance on this type of approach to profits interests. Neither the revenue procedures nor the proposed compensatory interests regulations provide any guidance on how deficit restoration obligations are treated when determining the liquidation values of partnership interests. Moreover, this is not an approach that is commonly used in the market (if ever). Therefore, practitioners and taxpayers should again take care when adopting it.

B. Timing Considerations

The foregoing discussion of structuring techniques addressed how the overall economics of the partnership are to be shared. But it does not specifically address the issue of timing. For many, the question of when a partner will share in distributions is at least as important as the question of the amount of distributions.

Some tend to think about profits interests as having a ''last-out'' right to economics of the partnership. In other words, they think the other partners must get the full liquidation value distributed to them before the profits interest holder can share. But this is not the case. As long as there are profits, the profits interest holders can share in current distributions and still fall within the safe harbor.

Example 19: Partnership AB is worth $1 million when a service provider, C, is granted a profits interest. Partnership AB has $100,000 of net profits in year 1. There is no reason why C cannot get up to $100,000 of distributions in year 1.

Provided the right to distributions depends on the partnership having profits, the interest does not violate the prohibition on receiving any proceeds on a hypothetical liquidation at the time of grant. This

[133] GCM 36346.

[134] Section 731(a).

[135] Sections 731, 732.

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is useful for partnerships that want to begin sharing distributions with profits interest holders right away.

Oddly, perhaps, it appears that there is not even a requirement that the partnership have net *taxable* gain or profits to allow a holder of a profits interest to share in distributions and still qualify for the safe harbor. For example, in capital-intensive partnerships, such as real estate partnerships, depreciation or amortization deductions may exceed any taxable receipts. The partnership may have a positive cash flow, even with no net taxable income. Alternatively, the partnership may hold an asset with a built-in loss when the profits interest is granted. The value of the property may later increase to equal its tax basis before being sold. In either case, the holder of the profits interest may well have had no share in the liquidation value of the partnership when it was granted, but the value of the partnership property has now increased to the point at which the holder would share in a liquidation of the partnership.[136] There is no apparent reason why allowing the holder of the profits interest to share this way should take it out of the safe harbor treatment.

C. Drafting Approaches

Just as there are a variety of ways to structure profits interests, there are several drafting approaches. This section will summarize three categories of drafting techniques. The first category relies on the specific distribution waterfall(s) in the partnership agreement to establish the profits interest (the waterfall-driven approach). The second category relies on assigning each profits interest a distribution threshold to qualify it as a profits interest (the distribution threshold approach). The third category relies on general language in the agreement limiting distributions to profits interests as a way to qualify it as a profits interest (the safe harbor limiter approach).

This discussion is far from exhaustive. Many of the structures described above require careful drafting that is beyond the scope of this report. My hope is, however, that these examples will help novices to gain a footing, as it were, in the land of profits interests.

1. Waterfall-driven approach. The waterfall-driven approach involves drafting the basic distribution, or waterfall, provisions of the partnership agreement in a way that results in specified interests being profits interests. For example, the waterfall might provide that distributions be made only to the existing partners until a specific amount equal to or greater than the liquidation value is distributed, followed by distributions to all partners:

> *Distributions shall be made in the following order and priority:*
>
> a. *first, to all Preferred Partners,*[137] *pro rata in proportion to the Percentage Interests*[138] *of each partner at such time, until one million dollars ($1,000,000)*[139] *has been distributed pursuant to this subparagraph, and*
>
> b. *thereafter, to all partners, pro rata in proportion to the Percentage Interest of each partner at such time.*

Or, if at the time the profits interest is granted, the aggregate capital contributions of the other partners equals or exceeds the liquidation value of the partnership and no distributions have been made to the partners, the waterfall might provide that distributions first return capital and then be shared pro rata:

> *Distributions shall be made in the following order and priority:*
>
> a. *first, to all partners, pro rata in proportion to the Unreturned Capital*[140] *of each partner at such time, until the Unreturned Capital of all partners is reduced to zero ($0), and*
>
> b. *thereafter, to all partners, pro rata in proportion to the Percentage Interest of each partner at such time.*

If the partnership has more than one waterfall — such as one waterfall for current distributions and another for liquidating distributions — then, at a minimum, the waterfall for liquidating distributions should be drafted in accordance with one of the foregoing. Whether all of the waterfalls need to satisfy these tests will depend on how the parties come out on the no liquidation value test.[141]

This approach is the simplest to draft, but it does not easily adapt to changing circumstances. The first example would not take into account future capital contributions by the partners. If the liquidation value of the partnership increases after the first

[136]These situations would likely result in unintuitive tax allocations (or lack thereof), outside basis that does not match capital accounts, taxable distributions, or combinations of these.

[137]"Preferred Partners" would be defined to include all partners other than the profits interest holders.

[138]"Percentage Interest" would be defined to represent the percentage of the residual gains and profits that each partner is entitled to.

[139]The amount used here (less any previous distributions) must be equal to or higher than the liquidation value of the partnership when the profits interests are granted.

[140]"Unreturned Capital" would be defined as the aggregate net capital contributions made by a partner, less the amount of any distributions made to the partner under clause (a).

[141]*See* Section II.E.1 (Part 1 of report).

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profits interest is granted, neither example could accommodate the granting of later profits interests. As a result, new situations like those would require amendments to the partnership agreement. Moreover, several of the structuring techniques discussed above would be difficult or impossible to implement by simply using this approach.

2. Distribution threshold approach. Under the distribution threshold approach, the primary waterfall is essentially left untouched. Instead, the real action comes from the use of a ''distribution threshold'' to prevent holders of profits interests from sharing in the existing value of the partnership.

With this approach, each profits interest that is issued is assigned a distribution threshold. The distribution threshold must be an amount at or above the liquidation value of the partnership at the time the profits interest is granted.[142] A provision is then included in the partnership agreement that prevents any distributions from being made in respect of the profits interest before aggregate distributions equal to the distribution threshold have been made to all other partners:

> *Notwithstanding [the normal distribution and liquidation provisions], no distributions shall be made in respect of any partnership interest with a Distribution Threshold (''Profits Interest'') unless and until aggregate distributions previously or concurrently made in respect of all other partnership interests since the date of issuance of such Profits Interest equal or exceed the Distribution Threshold of such Profits Interest at such time.*

Alternatively, the partnership agreement can treat those interests as not outstanding for the purposes of the distributions until the distributions threshold has been met:

> *Solely for the purposes of making distributions pursuant to [the normal distribution and liquidation provisions], any partnership interest with a Distribution Threshold (''Profits Interest'') shall be treated as not outstanding unless and until aggregate distributions previously or concurrently made in respect of all other partnership interests since the date of issuance of such Profits Interest equal or exceed the Distribution Threshold of such Profits Interest at such time.*

When the partnership agreement designates partnership interests as units, the agreement can instead use a concept of an eligible unit in the distributions. That concept can then be included in any step of a waterfall in which the profits interest is to participate once the distribution threshold is met:

> *''Eligible Unit'' means at any time (i) each outstanding Common Unit*[143] *and (ii) each outstanding Profits Unit with respect to which an amount equal to its Distribution Threshold has been distributed to the partners (other than in respect of such Profits Unit*[144]*) subsequent to the issuance of such Profits Unit pursuant to the provisions of this agreement.*
>
> * * *
>
> *Distributions shall be made to all partners, pro rata in proportion to the number of Eligible Units held by each at such time.*
>
> **OR**
>
> *Distributions shall be made in the following order and priority:*
>
> a. *first, to the partners holding Common Units, pro rata in proportion to the Unreturned Capital in respect of the Common Units held by each partner at such time, until the Unreturned Capital in respect of each Common Unit is reduced to zero ($0), and*
>
> b. *thereafter, to all partners, pro rata in proportion to the number of Eligible Units held by each at such time.*

Another important aspect of this approach is to account for capital contributions made after the date the profits interest is granted. If there is nothing that adjusts the rights of the holders of profits interests, this can result in a capital shift to the profits interest holder. Given that a profits interest, by definition, is given in connection with the performance of services, any capital shift to the holder of the interest is likely to result in ordinary income for the holder.[145] To avoid a capital shift, the distribution threshold for some profits interests may need to be adjusted at the time of the contribution:

> *Unless otherwise determined by the general partner, the Distribution Threshold applicable to each [Profits Interest/Unit] shall be adjusted upward by the amount of any capital contributions made to the partnership at the time such capital contributions are made.*

---

[142]The distribution threshold would typically be specified in any documentation, such as a grant agreement, whereby the profits interest is issued.

[143]Common units would be held by the non-profits-interest partners.

[144]This parenthetical is included to account for tax distributions made regarding a profits interest, as discussed in Section IV.E.

[145]*See* reg. section 1.721-1(b)(1).

There will be situations in which a capital contribution will not on its own result in a capital shift to the holder of the profits interest.[146] But more often it will result in a capital shift absent an adjustment in the distribution threshold.[147] Accordingly, it is wise to make the default adjustment as conservative as possible and let the general partner (or other decision maker or makers) make a different adjustment if appropriate.

This approach has many advantages: It is an unobtrusive way to insert a profits interest mechanic into an existing agreement or form of agreement. It allows for easily granting future profits interests without further amendments to the agreement. Business people and profits interest recipients have little difficulty understanding how the mechanic works. And from an operational perspective, it is not difficult to account for the economics of each profits interest if the partnership's financial records are otherwise in good order.

3. Safe harbor limiter approach. The safe harbor limiter approach operates again not by adjusting the normal waterfalls of the partnership but by providing an override mechanism to establish the profits interest status. The override is simply a requirement that distributions for a profits interest be limited to the extent necessary for the interest to qualify for the safe harbor treatment:

> *It is the intention of the partners that distributions under this agreement with respect to [Profits Interests/Units] be limited to the extent necessary so that each [Profits Interest/Unit] constitutes a "profits interest" for federal income tax purposes under Rev. Proc. 93-27, Rev. Proc. 2001-43, and any final Treasury regulations concerning the U.S. federal income tax consequences of the grant and forfeiture of compensatory partnership interests, and, in effect, will only be entitled to distributions under [the normal distribution and liquidation provisions] to the extent of the income, gains, or profits generated by the partnership's assets and activities, or the subsequent (or, to the extent consistent with the intent expressed above, prior) appreciation in the assets of the partnership after the grant of the [Profits Interests/Units]. In furtherance of the foregoing, the [general partner] shall, if necessary (as determined in its sole good-faith discretion), limit distributions in respect of any [Profits Interests/Units] under [the normal distribution and liquidation provisions] so that such distributions, in the aggregate, do not exceed the amount necessary to preserve such characterization (as determined by the [general partner] in its sole good faith discretion). If the distributions in respect of the [Profits Interests/Units] are reduced pursuant to the preceding sentence, an amount equal to such excess distributions shall be treated instead as apportioned to the other partners under [the normal distribution and liquidation provisions], and the [general partner] shall make appropriate adjustments (as determined by the [general partner] in its sole good faith discretion) to future distributions, if any, to the partners receiving such excess distributions so that the amount distributed in respect of such [Profits Interests/Units] (subject to and consistent with the principles of this paragraph) equal the amount that would have been distributed in respect of such [Profits Interests/Units] but for this paragraph.*

The effect of this language is to make a profits interest as close as possible, economically, to any other partnership interest. So it is an ideal way to implement the catch-up form of a profits interest and to allow current distributions to holders of profits interests. Moreover, it automatically accounts for any capital contributions made to the partnership after the grant of a profits interest.

That said, this approach is more difficult to administer than the previous approaches. It requires someone to make a legal determination of whether a profits interest can participate in the distribution and, if so, how much. As a result, the partnership will typically need to look to its tax advisers for assistance before making any distributions. Also, given the areas of ambiguity surrounding profits interests, it may be unclear how much distributions must be limited. Therefore, it is important to have clear language that establishes how that determination is to be made to avoid disputes over the amounts of the distributions. In the text above, for example, that determination is to be made by the general partner in its sole good-faith discretion.

D. Issuing Unvested Profits Interests

The parties will also typically want to impose vesting restrictions on profits interests that are granted in anticipation of future services. Again, there is no single way to treat unvested profits interests. Here I will go over three different ways to treat distributions for unvested profits interest: current sharing of distributions, withholding of distributions until vesting, and no sharing of distributions before vesting. These types of provisions can generally be used in conjunction with any

[146]This might happen, for example, when the distribution threshold for a profits interest is higher than the liquidation value of the partnership immediately after the capital contribution.

[147]This might happen, for example, when the distribution threshold is exactly equal to the liquidation value of the partnership immediately before the capital contribution and the partner making the capital contribution is not entitled to a priority return of capital in the distribution waterfall.

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of the drafting approaches described above in Section III.C. Special considerations for profit and loss allocations for these interests will be addressed below in Section III.E.3.

1. Current sharing of distributions. First, the partnership agreement can provide that for the purposes of distributions, an unvested profits interest will be treated the same as if it were vested. In terms of drafting, these economics are the easiest to capture, because the agreement makes no distinction between vested and unvested profits interests.

2. Withholding of distributions until vesting. Second, the partnership can provide that unvested profits interests will not currently share in distributions but will receive a distribution of their shares of those distributions immediately upon vesting. As with the current sharing of distributions, the agreement generally will not distinguish between vested and unvested profits interests for the purposes of distributions. However, another provision will require that distributions for an unvested profits interest be held back until the profits interest vests:

> *Notwithstanding [the normal distribution and liquidation provisions], no amounts shall be distributed in respect of any unvested [Profits Interests/Units]. Instead, the portion of any distribution that would be made in respect of unvested [Profits Interests/Units] in the absence of this paragraph (the "Unvested Amount") shall be set aside in a segregated account of the partnership. The Unvested Amount shall be held in such account until the earlier of the vesting, forfeiture, or repurchase by the Company of such unvested Incentive Units. To the extent such unvested [Profits Interests/Units] become vested, the partnership shall promptly distribute such Unvested Amount to the owner of the vesting [Profits Interest/Units] upon (and to the extent of) such vesting. Upon a forfeiture or repurchase of any such unvested [Profits Interest/Unit], the Unvested Amount in respect of such forfeited or repurchased unvested [Profits Interest/Unit] shall be removed from the segregated account and added to the general funds of the partnership. Upon the liquidation of the partnership, the Unvested Amount remaining in the segregated account shall be removed from the segregated account and added to the general funds of the partnership to be apportioned in accordance with [the liquidation provision].*

This language contemplates putting the withheld amounts in a segregated account. This is not necessary, but it may be a way of providing reassurance to profits interest holders that the funds will actually get paid to them if the profits interest vests.

Note, however, that while the withheld amounts are placed in a segregated account, they are not set aside in an escrow or otherwise removed from the assets of the partnership and protected from the claims of its general creditors. This is to avoid constructive receipt of the distribution by the profits interest holder. If the amounts are put beyond the reach of the partnership's general creditors, they would almost certainly be treated as received by the profits interest holder.[148] Likewise, giving the holder the right to separately direct and control the investment of that amount could be treated as a distribution of those amounts to the holder.[149] But simply holding the funds in segregated account should not trigger a deemed distribution. To give the profits interest holders more reassurance, practitioners might also consider the use of a rabbi-trust-like arrangement.[150]

Whether the constructive receipt of the distribution would even be a problem will likely depend primarily on the way profits and losses are allocated for the unvested profits interest. For example, if the profits interest holder would otherwise not be allocated income for that withheld amount, a constructive distribution to the holder would likely result in a taxable distribution in excess of the holder's basis. However, if the profits interest holder would be allocated a corresponding amount of income, the holder would likely obtain sufficient basis to prevent a constructive receipt from being taxable. The related issues, which again are beyond the scope of this discussion, are the consequences to the holder of the loss of the constructively received amount if the profits interest is forfeited before vesting, and the consequences to the partnership when that amount reverts to the partnership.

3. No distributions before vesting. A third alternative is to simply not share any distributions with a profits interest holder before the profits interest vests. This approach can be reflected in a partnership agreement much in the same way a distribution threshold mechanic is included:

> *Notwithstanding [the normal distribution and liquidation provisions], no distributions shall be made in respect of any unvested [Profits Interest/Unit].*

OR

> *Solely for the purposes of making distributions pursuant to [the normal distribution and liquidation provisions], any unvested [Profits Interest/Unit] shall be treated as not outstanding unless and until it is vested.*

OR

> *"Eligible Unit" means (i) each outstanding Common Unit and (ii) each outstanding vested Profits*

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[148] Reg. section 1.83-3(e).
[149] *See* Rev. Rul. 55-39, 1955-1 C.B. 403.
[150] *See, e.g.*, LTR 8113107, LTR 8329070.

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Unit with respect to which an amount equal to its Distribution Threshold has been distributed to the partners (other than in respect of such Profits Unit) subsequent to the issuance of such Profits Unit pursuant to the provisions of this agreement.[151]

Further, there should be clear language indicating that the profits interest is not entitled to any kind of catch-up for the amounts being withheld from it:

Any amounts that would be distributed in respect of any unvested [Profits Interest/Unit] but that are not distributed in respect of such [Profits Interest/Unit] solely by reason of such [Profits Interest/Unit] being unvested shall be treated as having been distributed to such [Profits Interest/Unit] for the purposes of determining the amount of any subsequent distributions to be made to such [Profits Interest/Unit] pursuant to [the normal distribution and liquidation provisions].

E. Tax Allocations

After the parties have decided how the profits interests should work from a business perspective, the tax practitioner is left to prepare tax allocations that will correspond to the economic rights. As discussed above, the economic rights of a profits interest holder can be quite complex. So the specific allocation approach will depend on the combination of economic rights associated with the profits interests. At a very high level, the two main allocation methods are a ''layer cake'' and a ''target'' (sometimes called a ''forced'') method of allocating tax items. Depending on the structure of the profits interest and the drafting approach used, one method may have advantages over the other. In either case, however, practitioners should be careful of the complications that arise from the introduction of unvested profits interests.

1. Layer cake allocations. The tried-and-true practice of specifically describing the amount and order of allocations of the profits and losses (or specific items of profits and losses) of a partnership — often informally referred to as ''layer cake allocations'' — remains an option when dealing with profits interests.

This method is an obvious choice when implementing a capital-account-driven drafting approach for the profits interest because it is the allocations that will determine the economic rights of the profits interest holder. Likewise, it is generally easy to use when a partnership is relying on the waterfall-driven drafting approach for establishing the profits interest status of the interest, because it is unlikely that the allocations would have to be any different than they would have been if there were no profits interests.

In a distribution threshold approach, the layer cake method starts requiring some adjustment. One way to accommodate that approach in this kind of allocation method is to reference the distribution threshold much in the same way as with the distribution and liquidation provisions:

Notwithstanding the [other profit allocation provisions], no net profits shall be allocated in respect of any [Profits Interest/Unit] unless and until the aggregate capital accounts attributable to all other partnership interests equals the excess, if any, of (i) the Distribution Threshold of the [Profits Interest/Unit] over (ii) the aggregate distributions made by the partnership between the time of issuance of the [Profits Interest/Unit] and the end of the taxable period with respect to which the allocation is being made.

If the loss allocations have the typical language reversing overall net profits and reducing capital accounts to zero before otherwise sharing losses, it is unlikely that any special loss provision will be needed to accommodate a profits interest.

However, this allocation method would be difficult to use with the safe harbor limiter approach for drafting distributions. As discussed above, with that drafting approach, the economics are typically unclear when the interest is granted because they rely on determinations that are to be made in the future.[152] The pre-baked nature of the layer cake method would generally not allow for that kind of uncertainty.

2. Target allocations. The target allocation method (or forced allocation method) is rapidly gaining popularity as an alternative to layer cake allocations, particularly in partnerships with complicated economic arrangements. The principle in this method is that tax items be allocated to make the capital accounts of the partners match, as much as possible, some specified capital account targets. Normally, the target capital account of each partner will be the amount the partner would receive on a hypothetical liquidation of the partnership based on the current book values (subject to some adjustments) as of the end of the applicable tax period.[153]

While there are several issues to consider in general when adopting this approach to allocations, it is often easier to draft these allocation provisions

[151]Note the added qualifier ''vested'' to the term ''Profits Unit.''

[152]*See* Section III.C.3.

[153]*See* Robert L. Whitmire et al., *Structuring & Drafting Partnership Agreements: Including LLC Agreements*, para. 5.05[2] (2003, with updates through May 2014) (discussion of ''forced allocation technique'').

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than layer cake allocations for many types of profits interests.[154] Indeed, there is typically nothing unique about profits interests that would require any different drafting than in any other partnership agreement using this approach.

The place where this approach may require special care is if the gross allocation or share of built-in gain profits interest techniques are used. In those cases, the distribution rights of the holder are driven by the allocations. Thus, using a target capital account determined on the basis of a hypothetical liquidation in accordance with the normal distribution provisions would likely be circular (the allocations would be based on the hypothetical liquidation, which would be based on the allocations, which would be based on the hypothetical liquidation). An alternative target could be used, but the drafter must ensure that the target used will yield a result consistent with the economics sought by the parties.

3. Allocations to unvested profits interests. As discussed above, it is far from clear how an unvested profits interest must share in partnership allocations.[155] How you ultimately resolve the issues described above will dictate the appropriate drafting approach. Because there are many ways to resolve them, I will not cover all the drafting permutations. But we will look at a few key things to focus on when drafting.

a. Layer cake allocations for unvested profits interests. Let's start with layer cake allocations. If your conclusion is that any unvested profits interest should be allocated tax items as if it were fully vested, the basic allocations should be drafted no differently. The difficulty, as discussed above, is what happens if there are distributions while unvested interests that do not share in the distributions are outstanding or if the interests are forfeited before vesting. One possibility is to give a decision maker the ability to make appropriate adjustments to address any issues:

> *It is the intention of the partners and the partnership that the foregoing allocations be consistent with the requirements of the Internal Revenue Code and Treasury regulations (the "Tax Law"). In the event that the general partner determines that as a result of distributions made by the partnership while any [Profits Interest/Unit] is unvested or the forfeiture of any [Profits Interest/Unit] prior to its vesting, it is prudent to modify or make adjustments to the allocations or the capital accounts of the partners so as to comply with the Tax Law, the general partner may make (or cause the partnership to make) such modifications or adjustments (or both), provided, however, any such modification or adjustment that has a material adverse effect upon any partner's economic entitlement under this agreement must first be approved in writing by such partner.*[156]

Obviously, this only kicks the can down the road and does not present a rule to use. But it allows the actual facts to arise before making any decision about the appropriate way to adjust for the discrepancies. If the parties want something more concrete, there is, unfortunately, no standard way of addressing the issue.[157] So a drafter must determine the parties' desires (which will probably be difficult) and draft language specific to that intent.

If you conclude that profits interests should start sharing in allocations only after they have vested or to the extent of distributions, the adjustment should be made at the time of vesting rather than the time of forfeiture. One possibility is to prevent the interests from receiving any allocations before vesting but give them special catch-up allocations on vesting to account for any mismatches:

> *Notwithstanding [the normal allocations provisions], no allocations of net profits or net losses (or gross items thereof) shall be allocated with respect to any unvested [Profits Interests/Units] for any taxable period prior to that in which they vest, except to the extent of any distributions made in respect of such [Profits Interests/Units]. Subject to [the regulatory allocations], beginning with the taxable period in which any [Profit Interests/Unit] vests, net profits and net losses [(or gross items thereof)]*[158] *shall be allocated first to the partner holding such [Profits Interest/Unit] in an amount sufficient to make the capital account balance of the partner holding such [Profits Interest/Unit] equal to the balance it would have had if the [Profits Interests/Units] had never been unvested prior to making any allocations under [the normal allocations provisions].*

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[154]*Id.*

[155]*See* Section II.E.5.a (Part 1 of report).

[156]The final proviso may, of course, be omitted. An alternative that may also be used is "provided, however, any such modification or adjustment that materially and disproportionately affects any partner must first be approved by such partner."

[157]Indeed, most agreements tend to disregard the issue entirely.

[158]Allowing gross allocations will likely benefit the partners other than the holder of the vesting profits interest in that it could give them allocations of losses even when the partnership has a net profit. However, the parties should keep in mind that if the tax distribution provision would allow for a distribution to the holder of the vesting profits interest, a gross allocation provision may require the partnership to make a distribution that it otherwise would not be required to make (or require it to make a larger distribution).

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b. Target allocations for unvested profits interests. With target allocations, there is less concern about dealing with adjustments depending on whether the profits interest vests. For the most part, the target allocation method will resolve discrepancies automatically.[159] The primary question is how the target should be adjusted, if at all, to take into account the unvested profits interest.

If an unvested profits interest is treated as vested for the purposes of allocations, some language to that effect should be included:

> *Notwithstanding any other provision of this agreement, outstanding unvested [Profits Interests/Units] shall be treated as vested [Profits Interests/Units] for purposes of allocating profits and losses pursuant to [the allocations provisions] (including for the purposes of determining amounts distributable to the partners in the case of any hypothetical distribution or liquidation).*

But if you want to make allocations for an unvested profits interest only to the extent of any distributions made for the profits interest before vesting, then, generally, no changes to the target allocation provisions will be necessary.

F. Boilerplate Profits Interests Provisions

Before we put aside the discussion of drafting, I want to identify a couple of boilerplate provisions that should usually be in a partnership agreement that includes profits interests. The first is a provision outlining the intended treatment of the profits interest. The second is designed to allow the partnership agreement to satisfy a safe harbor in the proposed compensatory interests regulations.

1. Profits interest treatment. As mentioned above, many partnership agreements that include profits interests will forbid the partnership or its partners from taking specific actions that are inconsistent with the treatment of those interests as profits interests. For a partnership agreement with profits interests that are intended to constitute safe harbor profits interests, there might be language like the following:

> *Absent a contrary determination by a court or by [the general partner] following the date hereof based on a change in law governing the taxation of any interest in the partnership issued in connection with the performance of services for or for the benefit of the partnership or any of its subsidiaries, (A) the partnership and each partner shall treat each [Profits Interest/Unit] as a "profits interest" within the meaning of Rev. Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev. Proc. 2001-43, 2001-34 IRB 191; (B) the partnership and each partner shall treat each partner as the owner of its [Profits Interests/Units] (whether vested or unvested) from the date such [Profits Interests/Units] are granted until such [Profits Interests/Units] are forfeited or otherwise disposed of; (C) each holder of a [Profits Interest/Unit] agrees to take into account such distributive share of the partnership's income, gain, deduction and loss in computing its U.S. federal income tax liability for the entire period during which it holds such [Profits Interests/Units]; (D) the partnership and each partner agree not to claim a deduction (as wages, compensation or otherwise) for any value attributable to any [Profits Interest/Unit] either upon grant or vesting of the [Profits Interest/Unit] and (E) the holder of a [Profits Interest/Unit] agrees not to transfer or otherwise dispose of that [Profits Interest/Unit] within two (2) years of date such [Profits Interest/Unit] is granted.*

If the profits interests are not intended to constitute safe harbor profits interests, the language might read something like this instead:

> *Absent a contrary determination by a court or by [the general partner] following the date hereof based on a change in law governing the taxation of any interest in the partnership issued in connection with the performance of services for or for the benefit of the partnership or any of its subsidiaries, (A) the partnership and each partner shall treat each [Profits Interest/Unit] as being without any liquidation value or fair market value and thereby not taxable to the recipient of the [Profits Interest/Unit] in accordance with* Kenroy Inc. v. Commissioner, *T.C. Memo. 1984-232,* and Campbell v. Commissioner, *943 F.2d 815 (8th Cir. 1991); (B) the partnership and each partner shall treat each partner as the owner of its [Profits Interests/Units] (whether vested or unvested) from the date such [Profits Interests/Units] are granted until such [Profits Interests/Units] are forfeited or otherwise disposed of; (C) each holder of a [Profits Interest/Unit] agrees to take into account such distributive share of the partnership's income, gain, deduction and loss in computing its U.S. federal income tax liability for the entire period during which it holds such [Profits Interests/Units]; (D) the partnership and each partner agree not to claim a deduction (as wages, compensation, or otherwise) for any value attributable to any [Profits Interest/Unit] either upon grant or vesting of the [Profits Interest/Unit]; and (E) the holder of a [Profits Interest/Unit]*

[159]The principal exception is the question of what happens to the capital account attributable to a profits interest held by a person that does not otherwise have a partnership interest that receives allocations of profits but forfeits the interest before it vests. However, as discussed above in Section II.E.5.a (Part 1 of report), there appears to be no way to resolve this through allocations anyway.

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> *agrees not to transfer or otherwise dispose of that [Profits Interest/Unit] within two (2) years of date such [Profits Interest/Unit] is granted.*[160]

One thing to note is that these provisions contain language regarding the holding period of the profits interest. Normally, partnership agreements heavily restrict the ability to transfer profits interests. As a result, if those transfer restrictions would subsume the holding period clause, that clause can be omitted.

This type of provision is by no means required for an interest to qualify as a profits interest. However, it would give a recipient and the other partners more assurance that they will all treat the grant of the interest consistently and will not take any action that would likely disqualify an interest from that treatment.

2. Proposed compensatory interests regulations. The proposed compensatory interests regulations, as discussed above, include a safe harbor election to treat a compensatory partnership interest as having a FMV equal to its liquidation value. To qualify for that election, the partners must agree to specific items. Accordingly, partnership agreements that grant compensatory partnership interests (including profits interests) generally include language that would allow the partnership to qualify to make that election:

> *[The general partner] may cause the partnership to make the safe harbor election provided for by the proposed revenue procedure included in Notice 2005-43, or any similar election provided in a final revenue procedure or other official guidance relating to the compensatory transfer of partnership interests (a "Safe Harbor Election"). Each partner agrees to comply with all requirements of the proposed revenue procedure included in Notice 2005-43, or any similar final revenue procedure or other guidance relating to the compensatory transfer of partnership interests, if a Safe Harbor Election is made. The partners also hereby authorize [the general partner] to make any required changes to the maintenance of the partners' capital accounts and the allocations of items of income, gain, deduction, and loss as may be required in any final regulations issued in connection with such proposed revenue procedure or any other guidance pertaining to the compensatory transfer of partnership interests.*

Again, this language is not required to qualify partnership interests as profits interests, but it gives the general partner (or other decision maker or makers) the ability to take advantage of the safe harbor election (if the proposed compensatory interests regulations are finalized) without the need to amend the partnership agreement.

IV. Practical Considerations

In this section, I will discuss several other practical issues that the parties should consider when deciding whether to use profits interests and how they should be structured.

A. Tax Reporting

Something that may not be immediately apparent to business people when they are considering the use of profits interests is some of the tax reporting it entails. As a partner, the holder of a profits interest will receive a Schedule K-1 from the partnership each year.[161] When there are many holders of profits interests, this means that the partnership will be required to issue many more Schedules K-1 than it would if those holders simply participated in a bonus plan.

The corollary, of course, is that as partners, the holders will not receive a Form W-2 for any compensation paid to them for services performed for the partnership.[162] Rather, that compensation will be reflected as a guaranteed payment on the recipient's Schedule K-1.[163]

This will likely puzzle many of the holders if they have not been prepared in advance for this kind of reporting. Likewise, if they have not been warned, the holders may not understand that they may not receive the Schedule K-1 until much later than they would ordinarily receive a Form W-2, which may delay their ability to file their own tax returns.

Accordingly, it is important that everyone involved be aware of this alternative reporting up front.

B. Self-Employment Taxes

Just as holders of profits interests will receive Schedules K-1 instead of Forms W-2, because they are partners, their compensation for services will be subject to self-employment taxes rather than payroll taxes.[164] As a result, the partnership will not withhold or pay payroll taxes (Social Security, Medicare, and unemployment taxes) on the compensation paid to the holders. Instead, the compensation would constitute guaranteed payments, and the

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[160]Because the non-safe-harbor profits interest does not have a strict holding period requirement, the two-year restriction in clause (E) can probably be lowered somewhat while still preserving the profits interest status of the interest.

[161]Reg. section 1.6031(b)-1T.

[162]*See* section 6051.

[163]2013 Instructions for Form 1065, line 10.

[164]Rev. Rul. 69-184, 1969-1 C.B. 256; *cf.* ILM 200215053.

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holder would be required to pay self-employment taxes on that compensation.[165]

As a result of shifting the payroll taxes to self-employment taxes, if the holder's compensation does not change after the receipt of the profits interest, the holder's after-tax income will be lower than before the receipt of the interest. But by the same token, the partnership will no longer be required to pay the employer share of any payroll taxes, so the partnership will have a lower out-of-pocket cost for that level of compensation. Accordingly, to reduce this hardship on the recipient of the interest, the partnership can consider paying the recipient the amount it saves on the employer share of those payroll taxes as additional compensation.

Further, if the profits interests are general partner interests, the holder's distributive share of any income arising from a trade or business carried on by the partnership will also be subject to self-employment taxes.[166] If the profits interests are limited partner interests or membership interests in a limited liability company, the law is muddy, but there is a good chance the IRS will argue that the holder has the same result as if the interest were a general partner interest, particularly if the holder is a full-time service provider.[167] That said, this rule generally does not apply to income that is in the nature of investment income or capital gain, so for investment partnerships, this is likely to be less of a concern.[168]

For most recipients of profits interests, these consequences will be very surprising, especially for individuals who have only ever had salary income. And there are real economic burdens for the holders. So it is critical to make them aware of these issues when they receive the interests, ideally in a written summary provided when the interest is granted.

[165]Reg. section 1.1402(a)-1(b).

[166]Section 1402(a).

[167]*See* William S. McKee et al., *Federal Taxation of Partnerships and Partners*, para. 9.02[5][b] (2007, with updates through May 2014) and *compare* section 1402(a)(13) ("there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments . . . for . . . services") *with* prop. reg. section 1.1402-2(h) (a person is not a limited partner if the person has authority to contract on behalf of the entity or participates in its trade or business for more than 500 hours during the entity's tax year); *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011) (holding that attorney partners of a limited liability partnership were liable for self-employment taxes on their distributive shares from the partnership).

[168]*See* section 1402(a)(2) (excluding from self-employment income dividends and interest not related to a trade or business), and section 1402(a)(3) (excluding from self-employment income gain or loss from the sale or exchange of a capital asset).

C. Type of Partnership Interest

These days, it is usually an LLC that is issuing a profits interest, so there is no question about whether the recipient has limited liability — it does. For a general partnership, there is similarly nothing that can be done to avoid the recipient of a profits interest being a general partner, because all partners of a general partnership are general partners.[169]

But for limited partnerships, there is a choice: The profits interest can be a limited partner interest or a general partner interest. The standard practice is to make profits interests in these situations limited partner interests. However, the parties should be aware that even if the interests are denominated as limited partner interests, the holders may in some cases have liability for the partnership's obligations if they participate in the control of the business.[170]

If a service provider is receiving a profits interest from a true partnership, it is worth considering setting up a wholly owned LLC to hold the interest. Even when the interest is a limited partner interest, this may give the holder more assurance that it is not subject to the liabilities of the partnership, especially if the holder has significant management authority over the partnership.

D. Profits Interests' Voting Rights

Whether the profits interest is in a true partnership or an LLC, there is a question about the voting rights of the profits interests. Subject to some statutory constraints on disenfranchising members or partners, the parties are generally entitled under state law to specify in the governing agreement whether particular partners, such as profits interest holders, are entitled to vote.[171]

From a tax perspective, the voting rights have a limited effect on the analysis of the interest's status. As observed above, the right to vote is one of the factors considered in the status of a holder of a profits interest as a partner for tax purposes.[172] Many profits interests are given few, if any, voting rights. This is largely because the principal investors do not want to have to deal with the hassle of rounding up votes from diverse, potentially unsophisticated parties. That said, if the parties are concerned that the holders of the interests they design are not partners, they should consider giving them voting rights.

[169]*See, e.g.*, 6 Del. Code section 16-306, Cal. Corp. Code section 16306.

[170]*See, e.g.*, 6 Del. Code section 17-303, Cal. Corp. Code. section 15903.03.

[171]*See, e.g.*, 6 Del. Code section 18-302, Cal. Corp. Code section 17704.07.

[172]*See* Section II.E.5.e (Part 1 of report).

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E. Tax Distributions

Because it is the owners, not the partnership, that are taxed on a partnership's income, it is common for partnership agreements to provide for tax distributions to the partners to cover those tax liabilities. Typically, the parties view the tax distribution as being the equivalent of the business actually paying the tax liability directly if it had been a corporation.

When profits interests are issued, the question of tax distributions is often particularly sensitive for the recipients of the interests. The recipients ordinarily consist of individuals who lack the resources to pay substantial tax liabilities without distributions from the partnership. And in a structure in which the other partners receive return-of-capital or similar distributions before the profits interest holders participate, the profits interest holders could have taxable income for a long time before they receive distributions in the ordinary course.

As a result, it is typical for partnership agreements to include holders of profits interests in any tax distributions. There are, however, a few special considerations that arise in connection with profits interests.

First, the parties need to decide the amount of the tax distributions. Typically, the partnership agreement will provide for an amount equal to the product of the income allocated to the partner and an assumed tax rate. The assumed tax rate is normally the highest applicable combined federal and state income tax rate for an individual resident in the state with the highest tax rate that any partner is a resident of. For profits interest holders, however, the income allocated to them might also be subject to self-employment tax.[173] So the parties should consider whether the assumed rate should include self-employment taxes.

Relatedly, the parties typically do not want the tax distributions to include tax liabilities for any salary or other fixed compensation paid to service providers that happen to also own profits interests. While typical tax distribution provisions can usually be read to apply only to allocations of net profits, it would be a good idea to make it clear that the tax distributions do not include tax liabilities arising from guaranteed payments.

Second, the parties should consider whether holders of unvested profits interests should get tax distributions and whether there should be a clawback of those distributions if the profits interests are forfeited before vesting. Regarding the former, the holders have the same concerns as holders of vested profits interests about phantom income. From the other partners' perspective, the tax distributions to the holders of unvested profits interests should generally not be particularly problematic, because the tax distributions would correspond to taxable income that is allocated away from those partners to the holder of the unvested profits interests. Moreover, tax distributions typically are set up to be advances of other distributions to the partners. So the fact that the tax distributions are going to the holders of unvested profits interests may be viewed by the other partners as a good thing because those amounts do not reduce any of their future preferred distributions or reduce their preferred return accruals. If the parties take this route, the drafter should ensure there is a carveout for tax distributions within any language that would prevent holders of unvested profits interests from sharing in distributions.

The potential problem for the other partners is in connection with any forfeiture of an unvested profits interest. If, as discussed above, the forfeiture results in a taxable capital shift to the other partners, they may be upset that the tax distributions essentially attributable to that capital shift were distributed to the holder of the interest before the forfeiture.[174] It may be particularly frustrating if the profits interest holder is at the same time allowed a loss for the forfeiture.[175] Here is where it may be useful to have a provision requiring the holder to promptly return the tax distributions to the partnership if the interest is forfeited. Naturally, this may be a difficult right to enforce if the holder lacks the resources to repay that amount. The holder is also likely to chafe at this unless the clawback is limited to any tax benefit the holder receives in connection with the forfeiture. So it is reasonable not to demand this, but it is worth considering.

F. Multiplicity of Partners

Before adopting a plan to issue profits interests, the parties should also consider the increased number of partners that the partnership will have.

For state law purposes, each holder of a profits interest will usually be a partner or member of the partnership or LLC, respectively.[176] Under state law, they could be entitled to specified information from

[173]*See* Section IV.B.

[174]*See* Section II.E.5.a (Part 1 of report).

[175]*Id.*

[176]Technically, because a partnership interest does not have to be a legal ownership interest in an entity, neither does a profits interest. *See, e.g.*, *Wheeler v. Commissioner*, T.C. Memo. 1978-208; ILM 200215053. But not making the holder a legal owner will increase the risk that the holder is not considered a partner (and the interest not a profits interest) if other factors also do not support the holder's status as a partner. *See* Section II.E.6 (Part 1 of report).

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the partnership,[177] the benefit of fiduciary duties,[178] or other state law privileges or rights that they would lack if they were simply service providers to the partnership.

As owners, the partnership would also need the cooperation of profit interest holders in selling or pledging all the equity of the partnership. Drag-along provisions and obligations to pledge interests could be included in the governing documents to try to avoid problems in these areas. But if the partners still do not cooperate, the partnership could incur significant expenses trying to enforce these provisions. A more robust solution might be to also have the business and its assets and operations held in a wholly owned, disregarded subsidiary of the partnership. This would permit all the equity of the business to be sold or pledged by the parent partnership without rounding up all the partners to participate.[179]

Another concern with many owners is the increased risk that the partners take positions on tax returns that are inconsistent with the partnership's returns. Again, the governing documents can require partners to file their returns consistently with the tax return of the partnership, but as with selling and pledging interests, these may be difficult covenants to enforce. Indeed, because partners are subject to overriding legal obligations to file tax returns in good faith, there may be situations in which courts find this kind of provision unenforceable.[180]

Finally, the multiplicity of partners increases the risk that the partnership inadvertently becomes a publicly traded partnership. In most cases, partnerships use the 100-partner safe harbor for avoiding being treated as a publicly traded partnership.[181] This safe harbor does not include any carveouts from the 100-partner limit for profits interests. So if the partnership issues a large number of profits interests, it will need to look to another safe harbor or other basis to avoid becoming a publicly traded partnership.

G. Drag-Along Provisions

As discussed in the previous section, it is usually important for the investor partners to be able to force holders of profits interests to sell their interests at the same time the investor partners sell their interests. This means that most agreements include a drag-along that permits a group of partners desiring to sell at least some threshold portion of the partnership interests (usually somewhere between a majority of and all of the partnership interests) to require the other partners (including holders of profits interests) to sell their interests on the same terms as the selling partners.

The tricky part is that when you say the holders of profits interests will be required to sell their interests "on the same terms," you probably mean "on the same terms, subject to accounting for the differing economic interests of the partnership interests." When allocating the aggregate consideration, the parties do not want the consideration allocated to a profits interest to be the same as what is allocated to interests that also have a right to capital.

This is a concern any time a partnership has interests that do not all have the same economic rights. But normally, if there are differences, it is just among various classes or series of interests — it is unusual for there to be economic differences within a class or series. Often, however, profits interests are grouped together as a single class or series but different profits interests within that class have different distribution thresholds or other economic rights based on differing issue dates or vesting. Thus, allocating the purchase price becomes more complicated with profits interests.

Although it does not have to be done this way, probably the most appropriate way to allocate the purchase consideration is based on the interests' respective liquidation values as inferred from the consideration being paid:

> *"Drag-Along Consideration" means with respect to each partnership interest a value equal to the*

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[177] *See*, *e.g.*, Cal. Corp. Code section 15903.04 (California limited partnerships), Cal. Corp. Code section 17704.10 (California LLCs), Del. Code section 17-305 (Delaware limited partnerships), Del. Code section 18-305 (Delaware LLCs).

[178] *See*, *e.g.*, Cal. Corp. Code section 15904.08 (California limited partnerships), Cal. Corp. Code section 17704.09 (California LLCs).

[179] For a sale, the proceeds could then be distributed by the parent partnership in complete liquidation. Practitioners should remember, however, that a sale of the wholly owned, disregarded subsidiary followed by a complete liquidation is not always a perfect substitute for a sale of the partnership interests by the partners. For example, if there is a difference between the partners' holding periods in their partnership interests and the partnership's holding period in its asset, the form would determine whether the partners have long-term or short-term capital gain. But practitioners should consider the application of the "sale of a going business" doctrine and related case law. *Barran v. Commissioner*, 334 F.2d 58 (5th Cir. 1964) (holding that in substance, the sale of assets of the partnership was a sale of partnership interests). For further discussion of this issue, see McKee et al., *supra* note 167, at para. 16.03 (Transfers of Partnership Interests: Transfers of Partnership Assets Compared).

[180] *See Metz v. Medford Fur Foods Inc.*, 90 N.W.2d 106 (Wis. 1958) (hold harmless clause found unenforceable when the underlying act was criminal).

[181] *See* reg. section 1.7704-1(h)(1).

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amount that would be distributed in respect of such partnership interest if an amount equal to the value of one hundred percent (100 percent) of the equity of the partnership implied by the consideration to be paid by the proposed purchaser were distributed to the partners in accordance with [the normal distribution or liquidation provisions] at such time.[182]

If desired, the parties can elaborate on how to determine the value of the partnership's equity. For example, you can say that it assumes that the purchase price does or does not reflect premiums or discounts for control or marketability or require the partnership to retain an appraisal firm to make the determination. If the drag-along right arises only on a sale of 100 percent of the company, this will unlikely be a concern, but if the drag-along is triggered at a lower threshold, there may be some disagreement on what value is ''implied.''

Another issue to consider is that in any case, this would result in no consideration being allocated to a profits interest that would not be entitled to any amount on a hypothetical distribution. Given that the applicable threshold for participation has not been met, it would be reasonable to provide that those profits interests do not participate in the sale proceeds and are (1) automatically dragged along, (2) automatically canceled, or (3) simply remain outstanding. If one of the first two alternatives is used, and there is a concern that the result is unfair or that there is inadequate consideration to bind those holders in the transaction, the parties can consider assigning a minimum amount to be allocated to those profits interests in the transaction.[183] Choosing the alternative (3), however, will mean that the dragging partners cannot sell 100 percent of the partnership's equity to a buyer using the drag-along rights.

Related to the purchase price allocation is the determination of how much of each holder's profits interests are ''dragged'' if less than all of the partnership is sold. Again, there is no right answer, but a reasonable approach would be to make the allocation based on relative liquidation values:

''Dragged Interests'' means with respect to each partner, a portion of that partner's partnership interests with an aggregate Liquidation Value equal to (i) the aggregate Liquidation Value of all of the partnership interests held by such partner at such time, multiplied by (ii) (A) the value of the aggregate consideration to be paid in connection with the proposed transaction, divided by (B) the aggregate Liquidation Value of all outstanding partnership interests at such time. In the event such partner has partnership interests with differing economics, the Dragged Interests shall be a proportionate amount of each of such partner's partnership interests, determined based on their respective Liquidation Values.

''Liquidation Value'' means in connection with a proposed transaction and with respect to each partnership interest a value equal to the amount that would be distributed in respect of such partnership interest if an amount equal to the value of one hundred percent (100 percent) of the equity of the partnership implied by the consideration to be paid by the proposed purchaser in the proposed transaction were distributed to the partners in accordance with [the normal distribution or liquidation provisions] at such time.

That language does not clearly delineate what happens with any profits interest that has a liquidation value of zero. So again, the parties should specify what happens to them.

A concern in the drag-along context that is unique to holders of profits interests is the risk associated with the two-year requirement for safe harbor treatment. If the drag-along is exercised before the holder has held the profits interest for two years, the interest will no longer qualify for the safe harbor. As seen above, the holder may still be able to rely on case law to avoid having the grant be taxable, but this does create added risk.[184] While this is a legitimate concern for the holder, it is normally not something the holder will receive protection from, as the investor partners do not want their ability to sell the business hindered. If a recipient of a profits interest has the leverage to extract a guarantee that there will not be a drag-along right exercised within two years of grant, it would still be wise for the partnership to memorialize that in a side letter of some kind rather than in the partnership agreement to avoid it applying to all other holders of profits interests.[185]

[182]Whether the distribution waterfall or liquidation waterfall is used is purely a business decision.

[183]That an interest would receive a minimum amount of consideration on that drag-along transaction generally should not jeopardize the safe harbor status of the interest (since it still does not guarantee any amount on a hypothetical liquidation of the partnership), unless the interest were granted in contemplation of such a transaction.

[184]*See* Section II.F.1 (Part 1 of report).

[185]If the partnership is continually granting profits interests (at least once every two years), this kind of provision in the partnership agreement would effectively remove the ability to sell 100 percent of the partnership using the drag-along right. So the parties should be very careful about putting such a provision in the partnership agreement.

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H. Tag-Along Provisions

Although drag-along provisions typically apply to profits interests, holders of profits interest usually do not receive the benefit of tag-along provisions. But if the parties wish to give them these rights, some of the same concerns as in drag-along provisions apply. The consideration must be properly allocated, and there should be a mechanism for determining the portion of the holder's interest that can participate in the sale. Provisions similar to those set forth in the previous section can be used for these purposes. There are, however, a couple of meaningful differences that arise with tag-alongs.

The first distinction is the application of the two-year rule. Here the holder is the one that would be deciding to sell the interest. So a provision preventing participation in the sale within two years is necessary only if the partnership believes it is important to satisfy the safe harbor requirements.

Secondly, and probably more importantly, if a holder of profits interests exercises a tag-along right, the purchaser is getting a different set of rights and economics than if the holder had not participated. As we have seen in various places already, profits interests rarely are given the same kind of voting or other rights as other partnership interests. This means that if a purchaser were looking to purchase 75 percent of the voting rights of the partnership, the participation of holders of any nonvoting profits interests would reduce the voting power the purchaser ends up with. Likewise, as a holder of profits interests, the purchaser may find itself subject to drag-along obligations that non-profits-interests may not be.

On the flip side, however, the participation of a profits interest will ordinarily increase the purchaser's share of later profits. This is because any profits interests will normally have much less capital value associated with a given percentage of future profits than the other interests have. For every dollar spent for a profits interest, the purchaser will get a larger share of profits. A purchaser expecting to purchase 50 percent of the value of the company may end up with 60 percent of the profits.

Example 20: Partnership *AB* has 4,000 common units, each with a liquidation value of $10, and 1,000 profits interest units, each with a liquidation value of $1. Each unit (common or profits) is entitled to 0.02 percent of the profits of the partnership. *AB* has tag-along provisions similar to the sample drag-along provisions in Section IV.G. A purchaser offers to purchase 2,500 common units, constituting 50 percent of the profits, for $25,000, and all the holders of the profits interests try to tag along. Each class of interests will effectively be entitled to sell around 61 percent ($25,000/$41,000) of its units. So the common unit holders will sell about 2,439 common units for $24,390, and the profits interest unit holders will sell about 610 profits interest units for $610. This would give the purchaser 3,049 units, constituting about 61 percent of the profits of *AB*.

The purchaser may be happy with this, but the other partners may think the purchaser is getting too good of a deal.

Because the decision to pull the profits interests into the transaction is in the hands of the selling partners in the drag-along situation, these concerns are not really an issue there. But to prevent these results in the tag-along situation, the partnership agreement could cause any profits interests to automatically convert into "normal" interests on the basis of liquidation values.

Example 21: The facts are the same as in Example 20, but the 610 purchased profits interests automatically convert into 61 common units, thereby giving the purchaser 50 percent of the value of *AB* and 50 percent of the profits of *AB*.

Or the agreement could require the profits interest holders to sell the interests to the selling partners and allow them to decide whether the profits interests or the selling partners' existing interests are sold to the purchaser.[186]

I. Valuation of Partnership and Assets

It must be readily apparent by now that valuations play an important role in the granting of profits interests. Even for an issuance of the most basic profits interest, the parties must determine the value of the partnership. Depending on the type of profits interest granted, individual assets of the partnership may also need to be valued.[187] And unless the profits interest is issued near the time of an event that clearly establishes the value of the partnership (such as the issuance of new equity for capital or the sale of equity between unrelated parties), it is often difficult to establish that value. What are the parties to do? Does this mean the

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[186]This mechanism could create tax hazards or opportunities. Because partners generally are treated as having a unified basis in their partnership interest (see Rev. Rul. 84-53, 1984-1 C.B. 159) and a divided (weighted average) holding period (see reg. section 1.1223-3(b)), a purchase and resale of partnership interests could leave the selling partners with a net taxable gain or loss if the form of those transactions is respected. And if a section 754 election is in place (or will be made for that tax year), the partnership's basis in partnership property could differ as a result of two transfers instead of one. Of course, the two transfers could be joined together under the step transaction doctrine and treated simply as a sale of the interests from the profit interest holders to the ultimate purchaser.

[187]For example, a valuation of individual assets might be necessary if the profits interest permits the holder to participate in the gross increase in the value of partnership assets or specific assets.

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partnership or the recipient must obtain a third-party appraisal each time a profits interest is granted?

Fortunately, a third-party appraisal is not required. Indeed, there is no requirement at all that anyone do anything at the time of the grant to establish the value. If the interest had a zero liquidation value at grant, it would satisfy that requirement, even if it were by accident — there is no intent requirement. That said, if the IRS challenges the treatment of the interest as a profits interest on the basis that the interest had a positive liquidation value, it becomes a battle over the support each party has for its valuation.

In a dispute, an independent appraisal obtained at the time of the grant of the interest, while not required, would obviously carry significant weight in that analysis.[188] But given the costs associated with getting that appraisal, this will likely be impractical except in unusual situations. So what are the alternatives?

A good approach would be for the partnership to make a good-faith estimate of the value at the time of the grant and prepare a contemporaneous internal memorandum with the analysis and support for the estimate. The more rigorous the analysis and documentation, the more weight it will carry in a challenge. It is up to the parties to balance the resources dedicated to such an analysis with the risk of the value being challenged. If the parties do nothing, they will be in the unenviable position of relying on an after-the-fact appraisal or analysis, which would likely carry much less weight.

J. Revaluation of Partnership Assets

Most partnership agreements permit, but do not necessarily require, the partnership to revalue its assets for book purposes at the times permitted under reg. section 1.704-1(b)(2)(iv)(f)(5). One time revaluation is permitted under that regulation is ''in connection with the grant of an interest in the partnership (other than a *de minimis* interest) . . . as consideration for the provision of services to or for the benefit of the partnership.'' Clearly, the grant of any profits interest that is not de mimimis for services for a partnership would satisfy this and permit a revaluation.[189] But is that a good idea?

As with most things, it depends. Revaluing the assets of the partnership should bring the partners' capital accounts in line with their economic rights to the partnership assets at that time. This will generally make future allocations more intuitive and probably more closely align them with the economics from a timing perspective. And it will link any existing built-in gain or loss and the associated tax consequences with the existing partners.[190]

Example 22: Assume A and B are each 50 percent partners in partnership AB. Each has a capital account of $10, the partnership's assets have a book value of $20, and the partnership agreement provides for target allocations. When it is worth $100, AB issues a profits interest to C giving C 10 percent of all distributions after the first $100 of distributions. AB revalues its assets, giving each of A and B a new capital account of $50.

In Example 22, if AB has $100 of subsequent net income, that income would be allocated $45-$45-$10 among A, B, and C, respectively. If AB thereafter sold all its assets and liquidated, the tax gain arising from the existing $80 of built-in gain would be allocated $40 to A and $40 to B to match the amounts allocated to each on the revaluation event.

What if the assets are not revalued? First, any built-in gain or loss will not be tied to the existing partners under reverse 704(c) principles. This is an important result if the parties are trying to use an approach in which they let the profits interest holder share in existing built-in gain.[191] It is hard to justify allowing the holder of the profits interest to participate in any of the built-in gain if it is being allocated for tax purposes to the other partners because of a revaluation.

Second, the existing partners' capital accounts will unlikely be matched up with their economic rights. In most cases, this would have the effect of allocating a larger share of current income (for built-in gain) or current loss (for built-in loss) to the existing partners.

Example 23: Assume the same facts as in Example 22, except that the assets are not revalued upon the grant of the profits interest to C.

Here, if AB has $100 of subsequent net income before liquidating, that income will be allocated among A, B, and C on a $49-$49-$2 basis.[192] Then, if AB sells its assets and liquidates, the $80 book and tax gain would be allocated among A, B, and C on

[188] *See, e.g., Pittsburgh Plate Glass Co. v. Commissioner*, T.C. Memo. 1965-159.

[189] *Cf.* LTR 200329001 (taxpayer represents that the partnership will revalue its assets and adjust its existing partners' capital accounts); REG-139796-02, 68 F.R. 39498, 39499 (July 3, 2003).

[190] *See* reg. section 1.704-3(a)(6)(i).

[191] *See* Section III.A.6.

[192] After the $100 of income is earned, the partnership will have an aggregate book value of $120 (the existing $20 plus the $100 of income). On a liquidation basis, this would be distributed $59 to each of A and B (50 percent of the initial $100, plus 45 percent of the subsequent $20) and $2 to C. To bring the existing $10-$10-$0 capital accounts of A, B, and C, respectively, up to these hypothetical liquidation amounts, the income would be allocated $49-$49-$2.

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a $36-$36-$8 basis. As you can see, this will, in the aggregate, give the partners the same overall $85-$85-$10 allocations, but A and B will have a larger share of the current income. If the built-in gain were capital gain and the current income were tax-exempt income, A and B might prefer this result. However, if the built-in gain were capital gain and the current income were ordinary income, A and B may dislike this result.

That said, even when the current income is subject to tax at a higher rate than the built-in gain is expected to have, there may be reasons the existing partners want to avoid a revaluation. The parties may want to reduce the taxable income allocated to the holders of profits interests in the early years. This could reduce the self-employment tax exposure in the early years (if the other partners are not actively involved in the business) and avoid tax distributions to the holders of profits interests.[193] If any of the profits interests are unvested, this might also avoid some of the difficulties arising with an unvested interest that is forfeited while it has a capital account.[194]

K. Top-Up Profits Interests

Sometimes in business, as in life, things do not go as well as planned. If a partnership's prospects deteriorate after the grant of a profits interest, then, as with options, the holder may find itself so far out of the money that the incentive associated with the profits interest is not meaningful. Sometimes a partnership in this situation will look for a way to reestablish that incentive.

An intuitive response might be to cancel the original profits interest and grant a new profits interest with a lower participation threshold. But the form of this transaction raises some concerns if it is done within two years of the grant of the original profits interest. Remember that the two-year test does not on its face provide much guidance about what constitutes a disposition of the interest.[195] The IRS might argue that the cancellation of the original interest is a disposition that disqualifies the original grant from the safe harbor treatment. Moreover, the holder would now likely also be treated as having a profits interest entirely subject to a new two-year holding period for the safe harbor treatment, not to mention a new holding period for determining long-term capital gain treatment.

What if, instead, the original profits interest is simply amended to provide for a lower participation threshold? Unlike the cancellation and reissuance, this is not in form a disposition of the original profits interest. Nevertheless, the IRS might argue that it is an exchange that similarly disqualifies the original grant. Or the IRS might argue that the amendment is a taxable event because it is not in form a grant of a profits interest.

In substance, both of those approaches are simply an attempt to grant the holder a new top-up profits interest that allows it to participate in profits from the new, lower participation threshold up to the original, higher participation threshold.[196] The holder will, of course, have a split holding period for the holder's partnership interest, but it would not jeopardize the original grant.[197]

Given that the cancellation/reissuance and amendment routes would yield the same substantive result as just granting a top-up profits interest, there really should be no difference in the tax treatment. That said, occasionally the form of a transaction matters, and taxpayers are typically held to the form they select.[198] So unless there is an important nontax reason to use another form, the parties should probably stick to granting a top-up profits interest to accomplish this goal.

L. Grants Not From Partnership

There is no requirement that the grant of the profits interest come from the partnership itself. Instead, the profits interest can come from an existing partner in the partnership.

Example 24: Partnership AB consists of partners A and B, each of whom has a 50 percent interest in all capital, distributions, and allocations of the partnership. For services performed for the partnership by C, A assigns to C a portion of its partnership interest representing 10 percent of the partnership's gains and profits.

The interest granted to C can qualify as a safe harbor profits interest if all the other requirements are satisfied, since the revenue procedures nowhere require that the interest be transferred or granted by the partnership or any other particular person.

The partner assigning the interest should first ensure that there are no transfer restrictions in the agreement that would prevent the assignment. If it is permitted, the assignor should then address the

[193] *See* Section IV.E.
[194] *See* Section II.E.5.a (Part 1 of report).
[195] *See* Section II.F.1 (Part 1 of report).
[196] This could be accomplished using the capped participation approach discussed above in Section III.A.4.
[197] *See* Section III.A.4.
[198] *See, e.g.*, *United States v. Morris & Essex R. Co.*, 135 F.2d 711, 713 (2d Cir. 1943) ("It is true that the Treasury may take a taxpayer at his word, so to say; when that serves its purpose, it may treat his corporation as a different person from himself; but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue"), citing *Higgins v. Smith*, 308 U.S. 473 (1940).

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fact that it probably has no easily separable interest representing these rights that it can simply assign to the service provider. One approach would be to amend the partnership agreement to accommodate the interest being assigned.

If the other partners are not interested in amending the partnership agreement — a likely situation — the assignor can consider remaining the record holder of the interest and contractually assigning a beneficial interest in the assignor's partnership interest to the service provider. Then the assignor can pass through the appropriate distributions to the service provider and pass through tax allocations in accordance with the nominee reporting rules.[199]

M. Disqualification Issues for Partnership

In thinking about many of these risks regarding the qualification of partnership interests as profits interests, there is a tendency to view them as concerns for the recipient but not the partnership or existing partners. That is a mistake. There are meaningful consequences to the partnership and, as a result, the other partners.

It is true that if the partnership interest turns out not to be a profits interest, the partnership may be entitled to a deduction for the value of the interest granted.[200] However, it may also be liable for failing to withhold income taxes for the grant and failing to withhold and pay payroll taxes for the grant.[201] Moreover, the deduction, which flows through to the partners, will not offset these withholding tax liabilities, which will fall on the partnership itself.[202] As a result, the partners may end up with a deduction that they cannot use, while the partnership will have real cash liabilities for the withholding taxes and any penalties and interest.

Accordingly, the partnership and the existing partners should not assume that the question of whether an interest qualifies as a profits interest is not relevant to them.

[199]Reg. section 1.6031(c)-1T.

[200]Section 83(h).

[201]*See* section 3102 (requirement to withhold employee share of payroll taxes), section 3111 (requirement to pay employer share of payroll taxes), and section 3402 (requirement to withhold income tax). While not entirely clear, the principles of Rev. Rul. 69-184 (which states that a partner is not an employee for employment tax purposes) likely would not apply if the recipient were not a partner before the receipt of the partnership interest. *But see* reg. section 1.721-1(b) (''To the extent that any of the partners gives up any part of his right to be repaid contributions (*as distinguished from a share in partnership profits*) in favor of *another partner* as compensation for services . . . it is a guaranteed payment for services under section 707(c)'') (emphasis added).

[202]Reg. sections 31.3401(d)-1(c), 31.3403-1, 31.3102-1, 31.3111-4.

N. Proposed Carried Interest Legislation

Over the past decade, the taxation of ''carried interests'' has received significant scrutiny from lawmakers. Several proposals for changing the taxation of carried interest have been made by the president and Congress.[203] Those proposals have taken various forms, but generally they would apply to profits interests granted in connection with the performance of services when the profits interest received is in a partnership whose assets primarily consist of investment assets. They are, in effect, primarily targeting interests granted in private equity funds, hedge funds, and real estate funds (sometimes called investment services partnership interests). Under the proposals, capital gain allocated to the holder of a profits interest or capital gain realized by the holder on the sale of the interest would generally be converted into ordinary income. It is difficult to predict whether this concept will be adopted or what form it would take if it is adopted, but the possibility of the change in law is something that people dealing with profits interests should keep in mind. And although profits interests in partnerships that operate an active trade or business would generally be unaffected by these proposals, practitioners should still continue to monitor proposed legislation in the area in case that changes.

V. Probably-Not-Final Thoughts

As this report illustrates, profits interests can be a great way to provide an equity incentive to people providing services to a partnership. The tax treatment to the recipient is very favorable, and there are almost endless possibilities in terms of how they are structured. But their use raises a host of issues both in implementation and administration that practitioners should be attuned to. And unfortunately, while they have been sanctioned by the IRS for some time, there remain many unanswered questions about their treatment.

[203]*See, e.g.*, Tax Reform Act of 2014 (as proposed by House Ways and Means Committee Chair Dave Camp, R-Mich.), section 3621; H.R. 4213 (111th Cong.), section 601; H.R. 1935 (111th Cong.); H.R. 2834 (110th Cong.); Office of Management and Budget, ''Fiscal Year 2015 Budget of the U.S. Government'' (Mar. 4, 2014); OMB, ''Fiscal Year 2014 Budget of the U.S. Government'' (Apr. 10, 2013); OMB, ''Fiscal Year 2013 Budget of the U.S. Government'' (Feb. 13, 2012); OMB, ''Fiscal Year 2012 Budget of the U.S. Government'' (Feb. 14, 2011); OMB, ''Fiscal Year 2011 Budget of the U.S. Government'' (Feb. 1, 2010); OMB, ''Fiscal Year 2010 Budget of the U.S. Government'' (Feb. 26, 2009).

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