by Thomas O. Wells and Samantha B. Carter

Profits Interest – Converting Compensation to Capital Gains and Other Planning Ideas

A "profits interest" (also referred to as a "carried interest") is generally a right to receive a percentage of profits from a partnership without any obligation to contribute capital to the partnership and is awarded to the general partner, investment manager, or other service provider to the partnership. Profits interest has recently come under great scrutiny by members of Congress due to certain senior managers of hedge funds that have gone public generating significant value for themselves in exchange for investment services and advice to such funds. For example, Blackstone co-founders Stephen Schwarzman and Peter Peterson received $684 million and $1.9 billion, respectively, from the $4.7 billion Blackstone IPO in June 2007 — all taxed at the 15 percent long-term capital gains rate instead of the 35 percent federal ordinary income tax rate and the 2.9 percent Medicare tax rate typically imposed on compensatory pay. This preferential tax treatment is based on established tax law and the rationale that this "risk" capital should be taxed in a manner similar to other entrepreneurial returns.

The purpose of this article is not to debate whether hedge fund managers should be taxed at a lower rate than other executives. Rather, this article focuses on an explanation of the tax treatment of a profits interest. It sets forth the potential uses of a profits interest in structuring executive compensation packages by entrepreneurial ventures, in estate planning to transfer wealth to younger generations, as a bail-out from the double tax regime for potential appreciating property owned by a C corporation and as a restructuring of contingency fees for personal physical injuries. Finally, this article reviews one of the proposed Congressional changes to the taxation of a profits interest.

Introduction and Terminology

As background, hedge funds typically have a two percent management fee and a 20 percent carried interest. Alfred W. Jones is credited as launching the first hedge fund in 1949 and establishing the practice of awarding the general partner with a 20 percent carried interest.[1] The carried interest may be subject to a "hurdle rate" in which the profits interest is only paid after the fund has returned its capital or a specified rate to its investors. The carried interest may also be subject to a "clawback" under which the profits interest recipient must repay amounts previously paid if in a later year the agreed profit targets of the fund are not satisfied. A fund may use a "high water mark" provision in which a profits interest is suspended if the cumulative profitability of the fund at any point drops below a hurdle rate.

Explanation of Tax Treatment of Profits Interest

In analyzing a profits interest, a threshold question is whether the person who receives a profits interest is a partner. The Internal Revenue Code does not specifically address the issue of the tax treatment with respect to the issuance of a profits interest in exchange for services, and only a handful of cases have attempted to resolve this issue. Generally, assuming the profits interest is held by the recipient over a period of years and does not have other characteristics of compensation, the recipient should be recognized as a partner.

• *Treasury Regulation §1.721-1(b)(1).* The confusion and ambiguity surrounding the treatment of a profits interest begins with Code §721, which provides for nonrecognition of gain or loss on a contribution of property in exchange for a partnership interest. There is no mention of a contribution of "services" in Code §721. The first mention of a profits interest is found in Treas. Reg. §1.721-1(b)(1), which provides that the nonrecognition treatment of Code §721 does not apply to the issuance of a capital interest as compensation for services, but specifically states that such exclusion from the nonrecognition treatment of Code §721 does not apply to a "share in partnership profits."[2] Without further guidance from the Code or the Regulations, the courts were left to decipher the tax implications of this phrase as it applies to a variety of situations.

• *The* Diamond *Case* — The *Diamond* case, 492 F.2d 286 (7th Cir. 1974), *aff'g*, 56 T.C. 530 (1971), stood for the rule that in certain circumstances, a profits interest is taxable upon receipt. Diamond provided services to a real estate project by securing the financing for such project resulting in his receipt of a 60 percent profits interest in the partnership formed to own the real estate project. Less than three weeks after the formation of the partnership, Diamond sold the profits interest for $40,000. Diamond treated the granting of the profits interest as

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a nonrecognition event and reported a short-term capital gain from the sale on his tax return to offset a capital loss. The Tax Court and the Seventh Circuit both found that the grant of the 60 percent profits interest was a taxable event. The Seventh Circuit deferred to the Internal Revenue Service and treated the profits interest as having an ascertainable market value upon grant. This holding was based upon the purchase of such interest for $40,000 less than three weeks after the interest was awarded. Thus, Diamond incurred ordinary income at the time of grant in the amount of $40,000 and no capital gains upon the subsequent sale of such interest.

This ruling offers the notion that there could be double taxation to a profits interest partner. The first taxation event is the issuance of the profits interest with ordinary income recognized equal to the fair market value of the profits interest which may ultimately be offset at some time in the future by a capital loss upon disposition of the profits interest due to the increase in the adjusted basis of the profits interest for such income recognition. The second taxation event is the subsequent allocation of gain by the partnership to the profits interest holder.

• *The* Campbell *Case* — In *Campbell,* 492 F.2d 286 (7th Cir. 1974), *aff'g,* 56 T.C. 530 (1971), the taxpayer had an agreement with his real estate employer wherein he received a small partnership interest in each real estate partnership he helped to form and finance. Campbell did not report income upon the receipt of any of these interests. The Tax Court followed the *Diamond* case and determined that Campbell had received ordinary income upon the grant of each partnership interest. On appeal, Campbell argued that a service provider who receives an interest in the partnership's profits and losses, and not in the capital, has no realized income upon the receipt of the profits interest. In an interesting turn of events, and despite the fact that the *Diamond* court was the only appeals court at that time to reach a decision on the same issue, the Internal Revenue Service conceded that the Tax Court erred in holding that the receipt of a profits interest in exchange for services to a partnership results in ordinary income to the service provider. The Eighth Circuit in *Campbell* reversed the Tax Court and held that the issuance of a profits interest did not generate taxable income in the year it was issued because the profits interest had no fair market value at the time it was issued to Campbell. The court stressed the fact that the services Campbell provided were for his employer and not for the individual partnerships. Campbell was not considered to have contributed services to each partnership in which he held a profits interest.

• *Revenue Procedure 93-27*[3] — Sensing the confusion with the courts as well as the taxpayers on the particular issue of the taxation of profits interests, the Service issued Rev. Proc. 93-27 to formally publish its position. Rev. Proc. 93-27 states that if a person provides services to a partnership in exchange for a profits interest in that partnership, the Service will treat the receipt of such interest as a nontaxable event for that person and for the partnership. A profits interest is merely defined as a partnership interest that is not a capital interest, with a capital interest being one in which the holder receives a share of the proceeds of the partnership in liquidation. However, there are three specific instances where this nonrecognition rule does not apply to the receipt of a profits interest: (i) if the profits interest has an ascertainable value based on a predictable stream of income from the partnership; (ii) if the recipient partner disposes of the profits interest within two years after receiving it; or (iii) if the profits interest is a limited partnership interest in a publicly traded partnership as defined in Code §7704(b). The underlying principal of Rev. Proc. 93-27 is that the partner will only be taxed on his allocable share of the income as it is earned by the partnership.

The frustration many have found in Rev. Proc. 93-27 is that it does not adequately describe the tax consequences of falling within one of the three exclusions. For example, if a partner sells a profits interest within two years after receiving it, but after the year of receipt, Rev. Proc. 93-27 is silent on the issue of double taxation in the year of receipt and the year of sale. Furthermore, Rev. Proc. 93-27 does not state that Code §83 will apply with regard to whether the partner has a vested or nonvested profits interest or whether such interest could be taxable at grant or subject to a Code §83(b) election. In addition, there is no guidance as to when a profits interest is related to a predictable stream of income from the partnership, how to determine whether a stream of income is "predictable" and under what circumstances this type of valuation is to occur.

Nearly 10 years later, the Service released Rev. Proc. 2001-43,[4] which was intended to clarify Rev. Proc. 93-27. Rev. Proc. 2001-43 states that the determination of whether an interest granted to a service provider is a profits interest occurs at the time the interest is granted even if the interest is substantially nonvested under Treas. Reg. §1.83-3(b). Under Rev. Proc. 2001-43, the Service will treat the profits interest as received on the date of grant by the service partner only if: (i) the partnership and the partner treat the partner as the owner of the interest from the date of grant, and the partner computes his tax liability taking into account his allocable share of partnership income, gain, loss, deduction, and credit; and (ii) upon grant of the interest to the

partner, neither the partnership nor any other partner takes a deduction for compensation with respect to the issuance of such profits interest. If the profits interest meets all of the requirements in both Rev. Proc. 93-27 and 2001-43, there is no taxable event at the time of the grant of a profits interest.

Uses of a Profits Interest

• *Executive Compensation* — Profits interests can be used in several scenarios. As with hedge fund managers, it can be used to compensate executives. Unlike stock grants that are taxable upon the issuance and vesting under Code §83, a profits interest is not subject to income taxation to the recipient executive upon issuance or vesting. In addition, as with Blackstone's President Hamilton James who received a value of $148 million from his profits interest after a few years of employment with Blackstone due to its IPO (and retained a five percent interest in Blackstone with an IPO value of over $2 billion), the value is generally subject to a 15 percent long-term capital gains rate and not a 35 percent ordinary income tax rate and a 2.9 percent Medicare tax rate. Finally, the deferred compensation from a profits interest is not subject to the excise tax and interest penalties under Code §409A as are other deferred compensatory arrangements.[5]

• *Use in Estate Planning* — Profits interests can also be used in estate planning to transfer wealth and cashflow to a younger generation while reducing the retained value of the older generation for estate, gift, and generation-skipping tax purposes. Although not yet addressed by tax laws or IRS promulgations, Code §2701 does not appear to apply to the grant of a profits interest. If Code §2701 did apply, then the transfer of a profits interest to a family member could result in a gift tax based upon the value of the transferring partner's aggregate interest in the partnership determined prior to the transfer of the profits interest. Code §2701 does not apply when there is only one class of partnership interest outstanding (*e.g.*, allocation of profits based on capital accounts).[6] A profits interest results in the crediting of allocable partnership income to the profits interest holder's capital account followed by a distribution to the profits interest and capital interest partners based upon their respective capital account balances — so there is only one class of partnership interest. The issuance of a profits interest to a younger generation that is providing commensurate services to the family partnership (*e.g.*, a son or daughter running a family office/partnership) can facilitate two important estate planning goals: (a) a gift-tax and income tax-free transfer of value to a younger generation; and (b) a corresponding reduction in the older generation's retained partnership interest. In addition, with an established rule in hedge funds of a management fee of two percent of the partnership's value and a 20 percent carried interest, such profits interest could transfer significant value to a

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younger generation.

• *Bail-out from C Corporation's Double Tax Regime* — C corporations operating in Florida are subject to an effective federal and Florida income tax rate of 38 percent (C corporations are not allowed to use the 15 percent long-term capital gains tax rate). Dividend distributions to shareholders constituting "qualified dividend income" are subject to another 15 percent tax to its shareholders. If a corporation owned property (*e.g.*, real estate) that has potential appreciation, the corporation could contribute such property to a LLC, taxable as a partnership for federal income tax purposes and retain a capital interest based on the fair market value of such property. The LLC could issue a profits interest to the C corporation's shareholder/executive and allocate a portion of the gain to such shareholder/executive. When the LLC sells the contributed property, the gain allocated to such shareholder/executive is long-term capital gain if the C corporation and/or LLC have owned the contributed property for more than 12 months prior to such sale. This structure is better than the shareholder/executive purchasing the property because such purchase triggers immediate gain recognition to the C corporation and would commence a new 12-month holding period for capital gains. A contribution of the property to the LLC defers recognition of the gain and allows the LLC to acquire the prior holding period of the C corporation under Code §1223(2). The gain allocated to the profits interest holder is long-term capital gain even if he or she owned the LLC profits interest for less than one year.[7]

• *Restructuring Contingency Fee Payments* — Attorneys receiving contingency fees applicable to personal physical injuries are subject to ordinary income taxes on such fees even though the plaintiff's recovery is excluded from income tax under Code §104(a)(2).[8] Rule 4-1.8(i), Rules Regulating The Florida Bar, suggests that a client may assign an interest in the claim in connection with a fee contingency contract. If a client assigned his or her claim to a partnership at a time when recovery was still doubtful and awarded the attorney a 25 percent profits interest in lieu of a 33 percent contingency fee contract, both the client and the attorney would receive greater after-tax proceeds.[9]

Under the 33 percent contingency fee contract, the client retains 67 percent of the award and the attorney retains 21.45 percent of the award after taxes. With a profits interest structure, the client is allocated 75 percent of the tax-free award and the attorney is allocated 25 percent of the tax-free award. As with hedge fund managers converting a fee for compensatory services to a long-term capital gain, an attorney could likely use a profits interest in a partnership that owns the personal injury claim that is excluded from income taxes under Code §104(a)(2) to convert ordinary income for services to tax-free income. There is judicial precedent of analogizing a contingency fee arrangement to a partnership.[10]

Status of Profits Interest

• *Notice 2005-43*[11] — In a further attempt to clarify the issue of the taxation of a profits interest, the Service has proposed a procedure in Notice 2005-43 to apply the rules of Code §83 to all transfers of partnership interests for services, without making any distinction between capital interests and profits interests. Under the proposed Treasury Regulations contained in Notice 2005-43, if a partnership interest is transferred to a service provider in connection with his or her performance of services, such interest is treated as "property" for purposes of Code §83 and could result in ordinary income to the recipient either upon vesting or upon a Code §83(b) election. Notice 2005-43 contains a safe harbor under which the fair market value of the profits interest is equal to the liquidation value of that interest at its issuance. If the profits interest is not entitled to any liquidation value, then no income is recognized to the profits interest recipient upon its issuance.

• *H.R. 2834.* On September 6, 2007, the Committee on Ways and Means of the House of Representatives conducted a public hearing to specifically discuss the issue of a carried partnership interest, or profits interest.[12] The Congressional hearing resulted from the public criticism of Blackstone fund managers like Schwarzman and Peterson having enormous wealth derived, in part, from managerial services being taxed at the preferential long-term capital gains rate. A new bill entitled H.R. 2834 discusses income distributed from a partnership based on an "investment services partnership interest" held by such partner. Investment services partnership interest (ISPI) is defined as a partnership interest held by a person who provides a substantial amount of certain services to the partnership in its ordinary course of business. The types of services include 1) giving an opinion to the partnership of the value of a specified asset; 2) recommending to the partnership whether or not to invest in, purchase, or sell any specified assets; 3) the management, acquisition or disposing of a specified assets; 4) securing the financing with respect to the acquisition of a specified asset; and 5) any other activities that support one through five. Specified assets are defined to include securities, real estate or commodities.

Net income received by a partner based on an ISPI would be recharacterized as ordinary income regardless of whether the income would have been treated as capital gain. This income would be treated as compensation for services and taxed at ordinary income tax rates and be subject to self-employment taxes.

To the extent that the net income received with respect to the ISPI would be treated as ordinary, any net loss allocated to that interest would be an ordinary loss. If any such loss is not allowed for a particular partnership taxable year, it could be carried forward to a subsequent year with the partner's basis in his or her interest being reduced by such loss only in the year the loss is allowed.

If a partner disposes of an ISPI, any gain or loss would be treated as ordinary income. This rule would be completely contrary to the current rule in Code §741 which treats the gain or loss from the disposition of a partnership interest as capital. Loss on the disposition of an ISPI would be ordinary to the extent of the aggregate net income previously treated as ordinary exceeds the aggregate net loss allowed previously as ordinary.

The present rule of no gain or loss on the distribution of appreciated property would not apply and the partner would recognize gain as if the partnership had sold the property at its fair market value at the time of distribution.

Net income received by the holder of an ISPI would not only be ordinary, but would also be subject to a self-employment tax. The net income received that is derived from the sale or exchange of a capital asset, which would otherwise be characterized as capital gain, would be recharacterized as ordinary income and further subject to self-employment taxes.

Conclusion

The future tax treatment of a profits interest is not clear as Congress continues to scrutinize the application of long-term capital gains tax treatment to compensation paid to hedge fund managers for their carried interest. In addition, if the preferential long-term capital gains rate sunsets on December 31, 2010, there will be less incentive to issue profits interest. But until the tax law changes, executives, estate planners, and attorneys should take advantage of using profits interest to address numerous and varying tax issues. ❑

[1] A. W. Jones, History of the Firm, www.awjones.com/historyofthefirm.html.

[2] The full text of Treas. Reg. §1.721-1(b)(1) speaking to a profits interest reads: "To the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply." (Emphasis added.) In other words, Treas. Reg. §1.721-1(b)(1) implies that the issuance of a profits interest is a nonrecognition event under Code §721.

[3] 1993-2 C.B. 343.

[4] 2001-34 I.R.B. 191 (August 20, 2001).

[5] Notice 2005-1, Q&A 7, 2005-2 I.R.B. 274.

[6] Treasury Regulation §25.2701-1(c)(3).

[7] *See* Rev. Rul. 68-79, 1968-1 C.B. 310, in which a partner contributing cash for an interest in a continuing partnership is entitled to long-term capital gain on allocable share of gain on partnership long-term capital asset sold one month after admission. Under reverse Code §704(c) principles, the new partner should only share in gain attributable to appreciation after admission.

[8] For a good discussion on taxation of contingency fees in Florida, *see* Merritt A. Gardner, *Taxation of Contingent Fees*, 77 FLA. B. J. 41 (December 2003).

[9] *Cotnam v. Commissioner*, 263 F.2d 119, 126 (5th Cir. 1959), provides that the assignment of a claim pursuant to a contingency fee contract is not attributable to assignment of income principles because recovery is still speculative and absent the services of the attorney, there would have been no recovery.

[10] *Estate of Clarks v. U.S.*, 202 F.3d 854 (6th Cir. 2000). *See* Kalinka, *A.L. Clarks Est. and the Taxation of Contingent Fees Paid to an Attorney*, 78 TAXES 16 (2000).

[11] 2005-24 I.R.B. 1221.

[12] The materials for this hearing are entitled: Joint Committee on Taxation, *Present Law and Analysis Related to Tax Treatment of Partnership Carried Interests and Related Issues, Part I*, (JCX-62-07), September 4, 2007; *see also* Joint Committee on Taxation, *Present Law and Analysis Related to Tax Treatment of Partnership Carried Interests and Related Issues, Part II*, (JCX-63-07), September 4, 2007. Both are *available at* www.house.gov/jct.

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