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Tax Court Decision Interprets Profits Interest “Safe Harbor” under IRS Rev. Proc. 93-27

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The Tax Court’s May 3, 2023, decision in *ES NPA Holding, LLC v. Commissioner* (T.C. Memo 2023?55), upholding a taxpayer’s position to characterize a partnership interest as a profits interest under the “safe harbor” of IRS Revenue Procedure 93-27 (as clarified by IRS Revenue Procedure 2001-43), provides helpful guidance to issuers of profits interests, including private equity funds and other investment partnerships and their portfolio companies.

As background, Revenue Procedure 93-27 provides a “safe harbor” definition of a profits interest. Specifically, it defines a “profits interest” as a partnership interest other than a “capital interest,” meaning “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation” at the time of receipt of the partnership interest. It further provides that the receipt of a profits interest in exchange for services “to or for the benefit of” a partnership in the recipient’s capacity of a partner or in anticipation of becoming a partner is not a taxable event to the recipient so long as the profits interest (1) does not relate to a “substantially certain and predictable stream of income,” (2) is held for at least two years prior to disposition, and (3) and is not granted by a “publicly traded partnership.”

In this case, the IRS took the position that (a) the partnership interest received by the taxpayer did not qualify for the Revenue Procedure 93-27 “safe harbor” and further did not qualify as a “profits interest” because the taxpayer did not directly provide services to the issuing partnership of the partnership interest and (b) the partnership interest was a capital interest rather than a profits interest because the taxpayer would be entitled to a share of the partnership’s proceeds in a hypothetical liquidation on the day the taxpayer received the partnership interest.

In its decision, the Tax Court—interpreting Revenue Procedure 93-27 expansively rather than literally—held in favor of the taxpayer with respect to both of the IRS's positions and provided that (1) a taxpayer who receives a profits interest issued out of one partnership in consideration of services that were, among other things, to or for the benefit of another related partnership—may, under the appropriate facts, qualify for the "safe harbor" and (2) a contemporaneous arm's-length transaction was acceptable evidence of value for purposes of determining that the profits interest entitled the taxpayer to distributions out of post-grant profits only, and the partnership interest was therefore a profits interest rather than a capital interest. The Tax Court further stated that "[it does] not view Revenue Procedure 93-27 in such a restricted manner, but rather view[s] [Revenue Procedure 93-27] as administrative guidance on the treatment of the receipt of a partnership profits interest for services."

While the Tax Court's decision can be interpreted as being generally consistent with market practice, there are meaningful nuances to the Tax Court's decision. In light of these nuances, and the general lack of interpretive guidance regarding profits interests, it remains important for issuers of profits interests to discuss their specific circumstances with their legal and tax advisors.

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