Grant of Profits Interest
In Upper-Tier Partnership

To the Editor:

ES NPA Holding\(^1\) has received significant attention, including in an article by Lee A. Sheppard in the May 15 issue of Tax Notes\(^2\). Commentators agree with its holding that a person providing services for the benefit of a lower-tier partnership can receive a valid profits interest in the upper-tier partnership. However, there has been little or no commentary about some of the services in ES NPA Holding being solely for the benefit of a corporation that owned an interest in the upper-tier partnership.

In preparing for the sale of an interest in its business, NPA Inc. formed two limited liability companies, IDS and NPA LLC. NPA Inc. contributed essentially all its assets to NPA LLC. NPA Inc. owned IDS, which in turn owned NPA LLC. Another entity, NPA Investors, purchased all of NPA LLC’s A units from IDS. At the same time, ES NPA acquired from NPA Inc. all of the C units (profits interests) in IDS. ES NPA acquired the profits interest by exercising an option for $100,000. The C units in IDS held by ES NPA mirrored the C units in NPA LLC held by IDS.

The court held that Rev. Proc. 93-27, 1993-2 C.B. 343, applied to ES NPA’s receipt of an interest in IDS. ES NPA acquired the profits interest by exercising an option for $100,000. The C units in IDS held by ES NPA mirrored the C units in NPA LLC held by IDS.

It seems obvious that a service provider can receive a valid profits interest in an upper-tier partnership due to providing services to or for the benefit of the lower-tier partnership. That is consistent with the “for the benefit of” language in Rev. Proc. 93-27 and with business practice and tax attorneys’ views.

Little of the commentary about ES NPA Holding discusses the type of services provided by the recipient of the profits interest in the upper-tier partnership. ES NPA provided (1) strategic advice for the purpose of enhancing the performance of NPA’s business and (2) advice to assemble an investor group to purchase 40 percent of NPA Inc.’s business for approximately $21 million. It is appropriate for ES NPA to receive a tax-free profits interest in the upper-tier partnership in return for providing advice to enhance the business that was soon to be owned by the lower-tier partnership. However, enabling the parent corporation (NPA Inc.) to sell a significant portion of its business and retain the cash does not seem to be for the benefit of the upper- or lower-tier partnership within the meaning of Rev. Proc. 93-27. Only the portion of the partnership interest received by ES NPA allocable to its advice to enhance the performance of NPA’s business should be a true profits interest.

Another unusual feature is that the profits interest was purchased for $100,000 upon the exercise of an option granted to ES NPA for its services. It is appropriate to bifurcate a partnership interest in a transaction of that type. A portion of ES NPA’s interest with a value of $100,000 should be treated as purchased. The portion allocable to ES NPA’s advice to enhance the performance of NPA’s business should be a valid profits interest. The portion allocable to ES NPA’s advice to assemble an investor group to purchase 40 percent of NPA Inc.’s business should be taxable compensation for services.

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Aug. 7, 2023

\(^1\)ES NPA Holding LLC v. Commissioner, T.C. Memo. 2023-55.