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PARTNERSHIP-RELATED RELATEDNESS: MEASURING PARTNERS' CAPITAL INTERESTS AND PROFITS INTERESTS

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Professor Borden has worked as a consultant to The Joint Committee on Taxation, Congress of the United States and often serves as an expert witness or consultant on major litigation matters that relate to real estate, flow-through taxation or legal malpractice. Before entering academia, he practiced tax law in the San Antonio, Texas law firm of Oppenheimer, Blend, Harrison & Tate, Inc. He is active in the American Bar Association Section of Taxation, is a past chair of its Sales, Exchanges & Basis Committee, and is a fellow of the American College of Tax Counsel.

Internal Revenue Code ("Code") Section 1031(f)(3) incorporates the Code Section 707(b)(1) definition of related party into the Code Section 1031 related-party rules. Code Section 707(b)(1)(A) provides that a partnership is related to a person who owns more than 50 percent of the capital interests or profits interests of the partnership, and Code Section 707(b)(1)(B) provides that two partnerships are related if the same persons own more than 50 percent of the partnership's capital interests or profits interests. Although other commentary has explored other aspects of related-party exchanges in significant depth,[1] the commentary on partnership-related relatedness is sparse.[2]

The lack of attention paid to partnership-related relatedness is surprising because numerous provisions of the Code incorporate the Code Section 707(b)(1) definition of related party or its concepts, including Code Section 108(e)(4) (treating acquisitions of indebtedness by a party related to the debtor as an acquisition of indebtedness by the debtor); Code Section 197(f)(9)(C)(i)(I) (applying the anti-churning rule to intangible amortization, using a 20 percent threshold); Code Section 267(e)(2)(1)(D), (e)(5)(A)(ii), (e)(5)(B) (relating to the general related-party loss disallowance rules); Code Section 355(d)(7)(A) and (g)(2)(B)(ii)(III) (governing corporate divisions); Code Section 453(g)(3) (governing installment sales with related parties); Code Section 465(b)(3)(C) (governing at-risk limitations); Code Section 512(b)(18)(J) (defining related person for the purpose of the rules governing unrelated business taxable income); Code Section 707(b)(1) (disallowing losses on transactions between a partnership and related partner and between two related partnerships); Code Section 707(b)(2) (ordinary-income characterization on sale to related dealer partnership); Code Section 1033(i)(3) (requiring acquisition of replacement property from an unrelated party in the case of involuntarily converted property); Code Section 1239(c) (adopting a similar test without referencing Code Section 707(b)(1)); Code Section 1397(a)(2)(B) (relating to the empowerment zone employment credit); Code Section 1400Z-2(d)(2)(D)(i)(I) (restricting qualified opportunity zone business property to property acquired by purchase) via Code Section 179(d)(2) (defining purchase to exclude acquisitions from a related person) and Code Section 1400Z-2(e)(2) (applying a 20 percent threshold); Code Section

7704 via Reg. § 1.7704-1(e) (relating to the definition of readily tradable partnership interests); and Code Section 7874(a)(2)(A)(ii) (defining expatriated entity).

Despite the frequent reference to Code Section 707(b)(1) and other uses of capital interests and profits interests in tax law, relatively little guidance and commentary consider how to measure partners' capital interests and profits interests. This column examines some of the complexities that arise in measuring partners' capital interests and profits interests. Even though measuring capital interests poses some challenges, the focus inevitably turns to profits interests because it raises some of the thorniest measurement issues, particularly with respect to partnerships that adopt distribution-dependent equity structures.

For partnerships that have complex equity structures (e.g., disproportionate sharing of profits and losses from various sources, distribution waterfalls, and other arrangements that do not allocate profits and losses in proportion to contributions), measuring the partners' profits interests is challenging. A partnership with a relatively simple distribution waterfall provides the backdrop for examining challenges of measuring partners' capital interests and profits interests.

Situation: Promo and Investo formed Prosto LP, a partnership for federal tax purposes, with Promo contributing $200,000 and Investo contributing $9,800,000. The distribution waterfall in the Prosto LP agreement requires Prosto LP to distribute available cash as follows:

- First, to provide the partners a simple 10 percent return.
- Second, to return contributed capital in proportion to the partners' contributions.
- Third, 50 percent to Promo until Promo has received 15 percent of all profits (catch-up distribution[3]) and 50 percent among the partners with 15 percent to Promo and 85 percent to the other partners.
- Fourth, 75 percent to Investo and Promo in proportion to their contributions and 25 percent to Promo.

After formation, Prosto LP purchases a single asset, Investment Property, for $10,000,000. Promo projects the Investment Property will be worth the following values at the end of the following years and that Prosto LP will have no other assets:

- Year 5: $14,500,000
- Year 6: $17,500,000
- Year 7: $19,000,000
- Year 9: $30,000,000
- Year 11: $40,000,000
- Year 25: $1,000,000,000 (max-out scenario)

Table 1 presents the manner in which Prosto LP would make distributions if it were to sell Investment Property for its projected fair value and distribute the proceeds to Promo and Investo at the various times.

Table 1: Financial Situation of Prosto LP at Various Times Throughout Its Life				
		Amount	Promo	Investo
Formation				
Contribution		$10,000,000		
Tier 1	10 percent Preferred	$0		
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$0	$0	$0
	Residual (15/85)	$0	$0	$0
Tier 4	Promote (25/75)			
Total			$200,000	$9,800,000
Share of Total			2.00 percent	98.00 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$0	$0
Cumulative Share of Profits			0.00 percent	0.00 percent
Year 5				
Projected		$14,500,000		
Tier 1	10 percent Preferred	$5,000,000	$100,000	$4,900,000
Tier 2	Return of Contribution	$9,500,000	$190,000	$9,310,000
Tier 3	Catch-Up	$0	$0	$0
	Residual (15/85)	$0	$0	$0
Tier 4	Promote (25/75)	$0	$0	$0
Total			$290,000	$14,210,000
Share of Total			2.00 percent	98.00 percent
Return of Capital			$190,000	$9,310,000
Return on Capital			$100,000	$4,900,000
Cumulative Share of Profits			2.00 percent	98.00 percent
Year 6				
Projected		$17,500,000		
Tier 1	10 percent Preferred	$6,000,000	$120,000	$5,880,000
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$750,000	$750,000	$0
	Residual (15/85)	$750,000	$112,500	$637,500
Tier 4	Promote (25/75)	$0	$0	$0
Total			$1,182,500	$16,317,500
Share of Total			6.76 percent	93.24 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$982,500	$6,517,500
Cumulative Share of Profits			13.10 percent	86.90 percent

Table 1: Financial Situation of Prosto LP at Various Times Throughout Its Life				
		Amount	Promo	Investo
Year 7				
Projected		$19,000,000		
Tier 1	10 percent Preferred	$7,000,000	$140,000	$6,860,000
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$1,000,000	$1,000,000	$0
	Residual (15/85)	$1,000,000	$150,000	$850,000
Tier 4	Promote (25/75)	$0	$0	$0
Total			$1,490,000	$17,510,000
Share of Total			7.84 percent	92.16 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$1,290,000	$7,710,000
Cumulative Share of Profits			14.33 percent	85.67 percent
Year 9				
Projected		$30,000,000		
Tier 1	10 percent Preferred	$9,000,000	$180,000	$8,820,000
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$1,376,471	$1,376,471	$0
	Residual (15/85)	$1,376,471	$206,471	$1,170,000
Tier 4	Promote (25/75)	$8,247,059	$2,061,765	$6,185,294
Total			$4,024,706	$25,975,294
Share of Total			13.42 percent	86.58 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$3,824,706	$16,175,294
Cumulative Share of Profits			19.12 percent	80.88 percent
Year 11				
Projected		$40,000,000		
Tier 1	10 percent Preferred	$11,000,000	$220,000	$10,780,000
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$1,682,353	$1,682,353	$0
	Residual (15/85)	$1,682,353	$252,353	$1,430,000
Tier 4	Promote (25/75)	$15,635,294	$3,908,824	$11,726,471
Total			$6,263,529	$33,736,471
Share of Total			15.66 percent	84.34 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$6,063,529	$23,936,471
Cumulative Share of Profits			20.21 percent	79.79 percent

Table 1: Financial Situation of Prosto LP at Various Times Throughout Its Life				
		Amount	Promo	Investo
Year 25				
Max-Out Scenario	$1,000,000,000			
Tier 1	10 percent Preferred	$25,000,000	$500,000	$24,500,000
Tier 2	Return of Contribution	$10,000,000	$200,000	$9,800,000
Tier 3	Catch-Up	$3,823,529	$3,823,529	$0
	Residual (15/85)	$3,823,529	$573,529	$3,250,000
Tier 4	Promote (25/75)	$957,352,941	$239,338,235	$718,014,706
Total			$244,435,294	$755,564,706
Share of Total			24.44 percent	75.56 percent
Return of Capital			$200,000	$9,800,000
Return on Capital			$244,235,294	$745,764,706
Cumulative Share of Profits			24.67 percent	75.33 percent

The presentation in Table 1 provides the basis for analyzing the possible measurements of partners' interests in profits and capital. Table 1 also elucidates several foundational issues that arise in attempting to measure interests in profits and capital.

1. The timing of the measurement may affect the outcome of the measurement. For instance, measuring on the date of formation may return one result and measuring in a later year may return a different result.
2. The performance of the partnership appears to affect the measurement of the partners' capital interests and profits interests. To illustrate, Promo's share of total profits increases as Prosto LP's profits increase.
3. The perspective may also affect the outcome. For example, a snapshot approach will likely return a result that will differ from an accumulated-profits or projected-profits approach.
4. The measurement apparatus may also affect the outcome. To demonstrate, a liquidation approach could treat all amounts to which a partner is entitled at the time of the measurement as capital interests and only rights in projected profits as profits interests. Such a liquidation approach will crystalize all profits accrued up to the time of measurement as capital interests.

These considerations and the information in Table 1 reveal that one of several different approaches, including the following, could apply in measuring the partners' capital interests and profits interests:

1. **Max-Out Approach:** determine the partners' profits interests based upon the partnership's profits becoming very large;
2. **Capital-Only Liquidation Approach:** determine the partners' capital interests and profits interests based upon a hypothetical fair-value liquidation at the time of measurement, with all hypothetical distributions representing capital interests;
3. **Capital-Plus Liquidation Approach:** determine the partners' capital interests and profits interests based upon a hypothetical fair-value liquidation of the partnership at the time of measurement, with all contributed capital representing capital interests and any excess distributions representing profits interests;
4. **Current-Profits Approach:** determine the partners' profits interests based upon the partnership's distributions of profits for the current period;
5. **Projected-Profits Approach:** determine the partners' profits interests based upon the partnership's projected profits.

Under the Capital-Only Liquidation Approach, the partners' capital interests will be something other than the amount of capital they have contributed. By contrast, the Current-Profits Approach measures profits interests but does not account for capital interests. Under the approaches that assume capital interests equal contributions, the focus is on analyzing the partners' profits interests. The following application and analysis of the different approaches relies upon the information in the Table 1, and, as appropriate for the analysis assumes the information reflects projected performance or actual performance. The preference for one approach over another may depend upon the party who is faced with dealing with the Code Section 707(b)(1) thresholds. For instance, one approach may return a value that is higher for one partner and lower for another as determined under another approach. To illustrate, Promo may prefer a measurement that will not result in his profits interests moving above the Code Section 707(b)(1) threshold while Investo may prefer another approach that reduces her profits interests below the threshold. The sum of their profits interests should equal 100 percent, so their stakes could differ with respect to their preferred measurements. A measurement that shows a reduction of Investo's profits interests will show an increase in Promo's profits interests, so the partners could have conflicting preferences.

Max-Out Approach

Under the Max-Out Approach, the analysis assumes that the partnership's profits become very large. The analysis could assume that the profits will approach infinity, but such an extreme is unnecessary. As the numbers in the Year 25 Max-Out Scenario demonstrates, when Prosto LP's profits start to approach $1,000,000,000, Promo's share of profits approaches 25 percent and Investo's share of profits approaches 75 percent. These are the percentages in the Tier 4 promote. The outcome is expected because as the Prosto LP's profits become very large, most of the profits are shared in Tier 4. Under this Max-Out Approach, Promo's profits interests will approach, but never reach 25 percent.

An analysis based upon the largest potential partnership profits provides the limits of the partners' interests in the partnership's profits, but a measurement based upon such a scenario, which in most situations is highly unlikely to occur, risks grossly misidentifying the partners' profits interests. Despite this potential, the situation may make this the preferred approach for some partners at particular times. For Investo, as profits become very large, Investo's profits interests decrease. In this example, Investo's share of profits approaches but does not go below 75 percent. If Investo's wishes to show that her share of profits interests is below 80 percent, she could benefit from the Max-Out Approach. On the other hand, if Promo wishes to show that his share of profits is less than 20 percent, he would not prefer the Max-Out Approach.

Capital-Only Liquidation Approach

The Capital-Only Liquidation Approach adopts the definition of capital interests and profits interests in Rev. Proc. 93-27.[4] Under the Rev. Proc. 93-27 definition, a partner's share of capital equals the amount that the partner would receive in a fair-value liquidation at the time the interests are measured. Under the Capital-Only Liquidation Approach, partners would never have interests in profits because any amounts they would receive under a fair-value liquidation would be capital interests. The point in time at which the analysis occurs typically will affect the partners' capital interests under the Capital-Only Liquidation Approach, and the partners' profits interests will always be zero. Table 2 presents the amount of distribution to which each of Promo and Investor would be entitled to at the points in time for which information is available based upon the Capital-Only Liquidation Approach.

Table 2: Application of the Capital-Only Liquidation Approach			
		Promo	Investo
Formation			
	Distribution Amount	$200,000	$9,800,000
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 5			
	Distribution Amount	$290,000	$14,210,000
	Return of Capital	$290,000	$14,210,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 6			
	Distribution Amount	$1,182,500	$16,317,500
	Return of Capital	$1,182,500	$16,317,500
	Percentage of Total (Share of Capital)	6.76 percent	93.24 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 7			
	Distribution Amount	$1,490,000	$17,510,000
	Return of Capital	$1,490,000	$17,510,000
	Percentage of Total (Share of Capital)	7.84 percent	92.16 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 9			
	Distribution Amount	$4,024,706	$25,975,294
	Return of Capital	$4,024,706	$25,975,294
	Percentage of Total (Share of Capital)	13.42 percent	86.58 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 11			

Table 2: Application of the Capital-Only Liquidation Approach		
	Promo	Investo
Distribution Amount	$6,263,529	$33,736,471
Return of Capital	$6,263,529	$33,736,471
Percentage of Total (Share of Capital)	15.66 percent	84.34 percent
Profits	$0	$0
Share of Profits	0.00 percent	0.00 percent
Year 25		
Distribution Amount	$244,435,294	$755,564,706
Return of Capital	$244,435,294	$755,564,706
Percentage of Total (Share of Capital)	24.44 percent	75.56 percent
Profits	$0	$0
Share of Profits	0.00 percent	0.00 percent

Other areas of partnership tax law adopt this approach. For instance, the regulations governing the determination of a partnership's taxable year adopt a version of the Capital-Only Liquidation Approach. Code Section 706 provides that a partnership's taxable year generally is to be the majority interest taxable year.[5] The majority interest taxable year is the taxable year that, on each testing day, is the taxable year of one or more partners having an aggregate interest in the partnership profits and capital of more than 50 percent.[6] The testing day is typically the first day of the partnership's taxable year.[7] Determining the majority interest taxable year requires measuring the partners' capital interests and profits interests. The regulations under Code Section 706 guide the measurement of partners' interests in both profits and capital.

For computing partners' capital interests, the Code Section 706 regulations provide that "[g]enerally, a partner's interest in partnership capital is determined by reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon liquidation of the partnership."[8] As discussed below, the Code Section 706 regulations adopt a version of the Current-Profits Approach using the projected current-year profits to measure the partners' interests in partnership profits. Thus, the Code Section 706 regulations divide capital interests from profits interests using a temporal metric—all profits accrued prior to the testing day are included in the partners' interests in capital; profits projected for the current year following the testing day are included in the computation of partners' profits interests. The rules therefore combine a version of the Capital-Only Liquidation Approach with a prospective version of the Current-Profits Approach. The measure of capital interests for purposes of Code Section 706 does not, however, adopt a fair-value liquidation. Instead, it uses capital account balances,[9] which would include profits allocated to the partners prior to the measurement date, to determine partners' capital interests but would not take into account the unrealized appreciation in the value of the partnership's property. That practice most likely reflects a practical necessity and recognition of the administrative complexity of using fair values, but the practice does not accurately reflect the partners' interests in unrealized profits, or rights in existing partnership property.

Capital-Plus Liquidation Approach

The Capital-Plus Liquidation Approach also uses a fair-value liquidation to determine the amount to

which each partner would be entitled upon a fair-value liquidation when the measurement occurs. The portion of that distribution that equals an interest in capital would equal the amount of capital that the partner had contributed (or the amount contributed, adjusted to reflect any capital shifts or returns of capital). The portion of the distribution representing interests in profits would equal the amount of the distribution minus the portion of the distribution that represents an interest in capital. The time of the measurement typically will affect the partners' capital interests and profits interests under the Capital-Plus Liquidation Approach, as illustrated in Table 3.

Table 3: Application of the Capital-Plus Liquidation Approach			
		Promo	Investo
Formation			
	Distribution Amount	$200,000	$9,800,000
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$0	$0
	Share of Profits	0.00 percent	0.00 percent
Year 5			
	Distribution Amount	$290,000	$14,210,000
	Return of Capital	$190,000	$9,310,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$100,000	$4,900,000
	Share of Profits	2.00 percent	98.00 percent
Year 6			
	Distribution Amount	$1,182,500	$16,317,500
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$982,500	$6,517,500
	Share of Profits	13.10 percent	86.90 percent
Year 7			
	Distribution Amount	$1,490,000	$17,510,000
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$1,290,000	$7,710,000
	Share of Profits	14.33 percent	85.67 percent

Table 3: Application of the Capital-Plus Liquidation Approach			
		Promo	Investo
Year 9			
	Distribution Amount	$4,024,706	$25,975,294
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$3,824,706	$16,175,294
	Share of Profits	19.12 percent	80.88 percent
Year 11			
	Distribution Amount	$6,263,529	$33,736,471
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$6,063,529	$23,936,471
	Share of Profits	20.21 percent	79.79 percent
Year 25			
	Distribution Amount	$244,435,294	$755,564,706
	Return of Capital	$200,000	$9,800,000
	Percentage of Total (Share of Capital)	2.00 percent	98.00 percent
	Profits	$244,235,294	$745,764,706
	Share of Profits	24.67 percent	75.33 percent

In this example, the partners' capital interests do not change because the only capital events are the contributions. As the amounts to which the partners are entitled upon a hypothetical fair-value liquidation change, the partners' profits interests change. Based upon a Capital-Plus Liquidation Approach, Promo's share of profits exceeds the QOF 20 percent related-party threshold only in Year 11 and in Year 25 under the Max-Out Scenario. During any other year, Promo's snapshot profits interests under the Capital-Plus Liquidation Approach would be less than 20 percent.

Current-Profits Approach

An analysis based on current profits would consider the percentage of profits for the current year (or other time period) in question to which each partner has a right under the partnership's distribution structure. This analysis requires computing the current period's profits and determining how the partners would share those profits. Table 4 illustrates the computation of the partners' interests in current profits for three different years. The partners would share the $1,000,000 of Year 5 profits under Tier 1, and only under Tier 1, because the amount of profits through Year 5 are not sufficient to flow into Tier 3 and Tier 4.

Notice in Year 6, however, that the profits exceed the amount of Tier 1 distributions and begin to flow into Tier 3, being distributed equally between the 50 percent catch-up tranche and the 15/85 tranche. Because Promo is allocated more than 50 percent

of the Tier 3 amounts, his share of Year 5 profits approaches 30 percent. It does not, however, reach 50 percent because Investo's 98 percent share of profits under Tier 1 are so significant. The Year 6 profits significantly exceed the Year 6 Tier 1 distributions, so a significant percentage of the Year 6 profits end up in Tier 3, significantly increasing Promo's share of the Year 6 profits. The Year 7 profits only slightly exceed the Year 7 Tier 1 distributions, so only a small percentage of the Year 7 profits flow into Tier 3. Because Investo's share of Tier 1 profits is 98 percent, the amount flowing into Tier 3 must be significant to appreciably affect the partners' share of profits in a particular year. Thus, in Year 7, Promo's share of Year 7 profits is considerably less than Promo's share of Year 6 profits. This illustration demonstrates an interesting phenomenon of the partners' profits interests. If the distributions are sufficient to max out the Tier 3 distributions but not sufficient to make any Tier 4 distributions, Promo's profits interests would be 15 percent at that point. Promo's profits interests would therefore increase and then decrease as the amount of Tier 3 distributions increase from zero to the maximum amount.

Table 4: Application of the Current-Profits Approach

Interests in Year 5 Profits

Year 5 Profits	$1,000,000			Line-Item Percentage	
		Promo	Investo	Investo	Promo
Year 5 Tier 1	$1,000,000	$20,000	$980,000	2.00 percent	98.00 percent
Tier 3 (50/50)	$0	$0	$0	0.00 percent	0.00 percent
Tier 3 (15/85)	$0	$0	$0	0.00 percent	0.00 percent
Tier 4	$0	$0	$0	0.00 percent	0.00 percent
Total		$20,000	$980,000		
Percentage of Total	2.00 percent	98.00 percent			

Interests in Year 6 Profits

Year 6 Profits	$3,000,000			Line-Item Percentage	
		Promo	Investo	Investo	Promo
Tier 1	$1,000,000	$20,000	$980,000	2.00 percent	98.00 percent
Tier 3 (50/50)	$750,000	$750,000	$0	100.00 percent	0.00 percent
Tier 3 (15/85)	$750,000	$112,500	$637,500	15.00 percent	85.00 percent
Tier 4	$0	$0	$0	0.00 percent	0.00 percent
Total		$882,500	$1,617,500		
Percentage of Total	29.42 percent	53.92 percent			

Interests in Year 7 Profits

Year 7 Profits	$1,500,000			Line-Item Percentage	
		Promo	Investo	Investo	Promo
Tier 1	$1,000,000	$20,000	$980,000	2.00 percent	98.00 percent
Tier 3 (50/50)	$250,000	$250,000	$0	100.00 percent	0.00 percent
Tier 3 (15/85)	$250,000	$37,500	$212,500	15.00 percent	85.00 percent
Tier 4	$0	$0	$0		
Total		$307,500	$1,192,500		
Percentage of Total	20.50 percent	79.50 percent			

The Code Section 706 regulations adopt a version of the Current-Profits Approach, providing that "[f] or purposes of section 706(b), a partner's interest in partnership profits is generally the partner's percentage share of partnership profits for the current partnership taxable year."[10] The focus on the profits of the current partnership taxable year, reflects a version of the Current-Profits Approach. As explained above, the testing day is typically the first day of the partnership's taxable year. Consequently, the application of the Current-Profits Approach must consider the partnership's projected profits for that year. Thus, the Current-Profits Approach described in the Code Section 706 regulations is different form the backward-looking Current-Profits Approach presented in this article.

A prospective Current-Profits Approach must consider how to measure interests in partnership profits, if projections show no profits for the current year. Regarding this issue, the Code Section 706 regulations provide that "[i]f the partnership does not expect to have net income for the current partnership taxable year, then a partner's interest in partnership profits instead must be the partner's percentage share of partnership net income for the first taxable year in which the partnership expects to have net income."[11] The IRS recognizes in this rule that a partnership may not have profits in every year for which a measurement of profits is needed and that partners' interests in profits may fluctuate from year to year, but it focuses on the profits of a single year. The partners' interests in profits could fluctuate due to transfers of partnership interests, changes in percentage interests resulting from capital events such as contributions or distributions, or, as illustrated in this column, from a combination of the application of the partnership's distribution waterfall and changes in the partnership's performance. The Code Section 706 regulations recognize that various factors can affect partners' interests in partnership profits.

The Code Section 706 regulations define a partner's percentage share of partnership net income for a partnership taxable year as "the ratio of: the partner's distributive share of partnership net income for the taxable year, to the partnership's net income for the year."[12] This rule reinforces that the regulations apply a version of the Current-Profits Approach for purposes of determining the majority interest taxable year and adopt net income as the measure of the partnership's profits. The regulations also explicitly acknowledge the fluctuations in partners' interests in partnership profits may depend "on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items)."[13] In such situations, "the partnership must make a reasonable estimate of the amount and nature of its income for the taxable year…based on all facts and circumstances known to the partnership as of the first day of the current partnership taxable year."[14] The Code Section 706 regulations are designed for the limited purpose of determining interests in partnership profits for a single taxable year. Because the rules require measuring the interests each taxable year, limiting the view to a single taxable year adequately addresses that purpose. The principles in the Code Section 706 regulations may, however, prove lacking for measuring interests in partnership profits, if the measurement period is greater than one year or for a purpose other than determining the majority interest taxable year. Partnership-related relatedness appears to require a different approach.

Projected-Profits Approach

Under the Projected-Profits Approach, the measurement of partners' profits interests considers the partners' expected profits interests over the life of the partnership. If the partners' shares of profits is not constant for each dollar of profits (e.g., Promo's share of profits increases as Prosto LP's profits cross various thresholds), an attempt to measure the partners' shares of lifetime profits will require determining the partnership's lifetime profits. For instance, Promo's share of lifetime profits could be 2 percent, if Prosto LP's profits do not exceed the Tier 1 distributions, such as would be anticipated for a Year 5 liquidation. If Prosto LP were to exist through Year 11, and perform according to projections, then Promo's share of projected lifetime profits would be slightly greater than 20 percent. If the

actual performance of Prosto LP deviates from those projections, then Promo's profits interests would be different at those different times. Thus, partners' profits interests change as the partnership's lifetime profits change. If the partners are attempting to measure their shares of the partnership's lifetime profits, they must first determine the amount of the partnership's lifetime profits. Except for the atypical partnership with a predictable lifetime with predictable profits, any measurement of lifetime profits will be speculative.

If the appropriate measure of profits depends upon projected lifetime profits, then partners face the same problem measuring their profits interests as they do measuring the value of profits-only interests. If the variable upon which the measurement depends is speculative, then the measurement is not accurate enough for tax purposes as a matter of law. The IRS and courts recognize this phenomenon as it relates to valuing profits-only interests,[15] and they recognize that measuring interests in profits raise identical issues.

The IRS has also grappled with measuring interests in speculative profits in guidance issued with respect to the old Kintner regulations. Recall that the Kintner regulations adopted a fact-intensive multi-factor test to determine whether an arrangement was a tax partnership.[16]Under those rules, taxpayers frequently requested rulings regarding the tax classification of entities, and the IRS provided instruction related to the ruling requests. Relating to the claim that an entity lacked continuity of the life or free transferability of interests, the IRS provided that for it to issue a favorable ruling related to those factors, "the member-managers in the aggregate must own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC."[17] That guidance provided further that "if the taxpayer requests a ruling that the LLC lacks limited liability…, the assuming member or members must in the aggregate own, pursuant to the express terms of the operating agreement, at least a 1 percent interest in each material item of the LLC's income, gain, loss, deduction, or credit during the entire existence of the LLC." Because the guidance tracked the profits of the entire life of the LLC, it required some guidance regarding the speculative nature of profit interests over the life of the LLC.

The guidance provided some relief for allocations that temporarily cause "less than 1 percent of the LLC's income, gain, loss, deduction, or credit to be allocable to the party….[I]n these cases, the ruling request must describe any required allocations and explain why the allocation is required….Any other temporary allocation causing less than 1 percent of any material item…will be considered a violation of this [requirement], unless the LLC clearly establishes in the ruling request that the member-managers or the assuming members (as the case may be) have a material interest in net profits and losses over the LLC's anticipated life." This rule requires a definition of material interest in future net profits and losses, which the guidance provides is met with respect to an interest only if the interest "substantially exceeds 1 percent and will be in effect for a substantial period of time during which the LLC reasonably expects to generate profits. For example, a 20 percent interest in profits that begins 4 years after the LLC's formation and continues for the life of the LLC generally would be considered material if the LLC is expected to generate profits for a substantial period of time beyond the initial 4-year period." The significant difference between the 20 percent in the example of material interest and the general 1 percent standard, suggests that the IRS recognized taxpayers needed to demonstrate that, due to the speculative nature of future profits, the member-managers' or assuming parties' interests in profits would not risk decreasing the profits interests to below the 1 percent threshold, if the speculation ended up not adequately representing future profits. The significant cushion the IRS required for measurements related to speculative profits confirms the IRS's general lack of trust in projections of future profits.

Evaluation of the Interest-Measurement Approaches

With no definitive guidance governing the measurement of partners' profits interests and capital interests, taxpayers and their advisors are left to guess which approach the IRS or courts might apply if the issue is contested. Taxpayers and their advisors in particular face a challenge because they often must plan in the face of uncertainty. In some situations, taxpayers may feel comfortable that they do not cross relatedness thresholds. For instance, Promo can feel comfortable that his share of profits does not exceed 50 percent because even if the Current-Profits Analysis applied, and he was in a year in which the distributions reached, but did not exceed, the Tier 3 catch-up distributions, his share of accumulated and current-year profits would not exceed 50 percent. Under the other analyses, his share of profits does not exceed 25 percent. Thus, Promo should be able to conclude that his profits interests do not exceed 50 percent.

The analysis is more complicated for Promo if the relatedness threshold is 20 percent. Under the right circumstances, the Current-Profits Analysis will return a result for Promo that places his share of profits above the 20 percent threshold. His share of cumulative profits under the Projected-Profits Approach also exceeds 20 percent based upon Prosto LP's performance through Year 11. Also, the Max-Out Analysis puts his interest at close to 25 percent. The Max-Out Analysis should return the same result regardless of the point in time at which Promo must measure it. Thus, under the Max-Out Analysis, Promo's share of profits will always exceed 20 percent, but will never reach 25 percent. If Promo has no tolerance for tax risk, the 20 percent threshold applies, and dealing with related partnerships could have significant adverse tax consequences, he will not transact business with two partnerships in which he owns the interests provided for in the Prosto LP agreement. Even if Promo is willing to accept tax risk related to the measurement of Promo's interest in Prosto LP's profits, Investo may not be willing to accept that risk.

To illustrate, Prosto LP may be a proposed venture in an opportunity zone that will acquire Investment Property from Promo. If Investo wants the property to be qualified opportunity zone business property, Prosto LP must purchase it, and Prosto LP cannot be related to Promo, based upon a 20 percent threshold.[18]xviii To attract Investo's investment, Promo may have to definitively establish that his profits interest in Prosto LP will not exceed 20 percent, which, in the face of uncertainty, may require him to show that his interest is not greater than 20 percent under any of the measurement approach.

Taxpayers who are in situations that dictate taking tax risk into account in taking a reporting positions will undoubtedly be interested in assessing the various interest-measurement approaches to determine whether a particular approach provides the requisite authority for a reporting position. As stated above, the preferred approach may differ from partner to partner. Partners may therefore find themselves taking different positions regarding their profits interests based upon the use of different approaches. The need for certainty in areas such as investments in qualified opportunity zones and the potential for partners taking disparate positions in the face of uncertainty suggests the IRS should consider providing guidance regarding the measurement of interests in profits. A process of elimination helps reject non-viable approaches, leading to the optimal approach.

Deficiency of Speculative Approaches

The measurement approaches that require speculative determinations of future profits should be rejected. Even if Promo is adverse to tax-reporting risk, he should be able to reject the Max-Out Approach. Taxpayers should be bound by projections that have little or no likelihood of occurring. Rejecting the Max-Out Approach would leave Promo to question the extent to which the measurement will allow for a speculation discount in computing his share of reasonably projected profits in Prosto LP. The law provides no clear authority on this issue, but Campbell does provide that projections in promotional materials do not require assigning value

to profits-only interests based upon those speculative projections. The ruling guidelines under the old Kintner regulations also discounted interests in projected future profits. Those guidelines suggest that, at a minimum, the law should discount interests in speculative profits. With such a discounting, Promo's projected 20 percent share in Prosto LP's profits through Year 11 would be discounted to some lesser percentage, if measured at any time before Year 11. Thus, if Promo is considering his interests in Prosto LP at the date of formation, he most certainly is not bound by the result of the Max-Out Analysis, and he most likely is not bound by the result of an optimistic projection of Prosto LP's performance through Year 11. In fact, under an analogous application of Campbell to the measurement of Promo's interests in Prosto LP's profits, Promo would not be required to consider future profits. Thus, Promo would use a snapshot approach (i.e., the Capital-Only Liquidation Approach, the Capital-Plus Liquidation Approach, or the Current-Profits Approach) that examines cumulative or current profits interests at a specific point in time to determine his shares of Prosto LP's profits.

Rejection of Capital-Only Liquidation Approach

The process of elimination helps narrow the field of snapshot tests. The Capital-Only Liquidation Approach is not viable because it does not allow for the partners to have a share of profits and would render the statutory reference to profits interests meaningless. Thus, the Capital-Only Liquidation Approach should be rejected.

Capital-Plus Liquidation Approach versus Current-Profits Approach

After eliminating the Max-Out Approach, the Projected-Profits approach, and the Capital-Only Approach, only the Capital-Plus Liquidation Approach and the Current-Profits Approach remain as viable tools for measuring partners' capital interests and profits interests.

As between the Capital-Plus Liquidation Approach and the Current-Profits Approach, the strongest argument can be made for adopting the Capital-Plus Liquidation Approach. The Capital-Plus Liquidation Approach has at least two redeeming features when compared to the Current-Profits Approach. First, the Capital-Plus Liquidation Approach provides a measure of the partners' interests in cumulative profits from inception until the point of measurement. The Current-Profits Approach looks only to the partner's profits interests that have accrued in the current measurement period. The Current-Profits Approach requires selecting an accrual period, which will require a start date. The end date of the accrual period should be the point of measurement. The start date will be subject to some arbitrariness. It could be the first day of the year during which the interests are being measured. It could be the date that is twelve months prior to the date of the measurement. The arbitrariness of fixing such a date makes the Current-Profits Approach less attractive than the Capital-Plus Liquidation Approach.

Second, the Capital-Plus Liquidation Approach recognizes that at any given point in time, the partners' interests in a partnership's assets can consist of interests in capital and interests in profits. If the partnership were to liquidate at the point of measurement, the distribution that the partners would receive would, assuming the partnership has been profitable, consist of capital and profits. The measurement has a particular definiteness to it that the other approaches lack.

Capital-Plus Liquidation Approach and Prior Distributions

An issue to address with the Capital-Plus Liquidation Approach is how to account for prior distributions. Once valid distributions have been made, they are no longer partnership assets, so arguably they should not factor into the computation of the partners' interests in the partnership's profits. A possible exception to this rule is distributions that are subject to a claw-back. For instance, the hypothetical fair-value liquidation of the partnership under the Capital-Plus Liquidation Approach might show that Promo could be required to recontribute distributions to ensure that Investo obtains the contracted-for distributions. Those claw-back amounts should factor into the computation of the partners'

interests in Prosto LP's profits. To ensure that Promo's profits interests is not negative and Investo's profits interests is not greater than 100 percent, the analysis should measure profits interests after taking into account the claw-back amount that would be required upon a hypothetical fair-value liquidation at that time. Other distributions should be disregarded. Granted, unauthorized distributions could be recovered by the partnership, but the analysis, absent any indication to the contrary, should assume that the prior distributions are valid.

Need for Uniform Application

The analysis in this column leads to the Capital-Plus Liquidation Approach as the most viable, policy-supported approach, but the law is yet to adopt an approach. Although the law does not provide guidance for measuring profits interests, the law should apply approaches fairly. A fair application would require that the same approach apply to both entities under consideration. A mix-and-match approach could be unfair to either the taxpayer or the IRS, depending upon whether the mix-and-match approach favored one party over the other. For instance, the analysis would be unfair, if it allowed the IRS to apply the Current-Profits Approach to one entity that resulted in the highest possible measure of profits interests in that entity for the affected partner and apply the Projected-Profits Approach to the other entity to obtain the highest possible measure of profits interests for the affected partner. Instead, a single measurement approach should apply to both entities under consideration.

An example illustrates the potential unfairness that results from applying a mix-and-match approach. In the opportunity zone context, property qualifies as a good fund asset only if the qualified opportunity fund (QOF) or its subsidiary qualified opportunity zone business (QOZB) acquires the property by purchase from an unrelated party. Relatedness in this context uses a 20 percent threshold. The issue of partnership relatedness could arise if the owners of opportunity zone property would like to sell the property to a QOF and be owners in the QOF entity. For instance, Prosto LP, which is in Year 6 of its existence, has property in an qualified opportunity zone, and wishes to sell the property. Investo would like to receive her share of the sale proceeds, but Promo would like to reinvest his share of the sale proceeds in the QOF. Assume Promo will have an interest in the QOF entity that is similar to the one he has in Prosto LP. The only difference between the measurement of the two interests is that Promo is in Year 6 of Prosto LP, but will be at formation of the new QOF entity. Under the Current-Profits Approach, Promo's interest in Prosto LP's profits exceeds 20 percent. Under that same analysis, Promo's interests in the QOF entity, which would be measured at formation, would be zero because the entity has no profits at that point. Thus, Prosto LP and the QOF would not be related under the Current-Profits Approach.

Under the Projected-Profits Approach, Promo's profits interest in Prosto LP in Year 6 should equal 0 percent (Prosto LP has not profits projected past Year 6 because it is liquidating) or 13 percent (the amount of cumulative profits he will receive upon liquidation). Under the Projected-Profits Approach, Promo's profits interests in the QOF should equal the 20.21 percent that Promo is projected to receive through Year 11, assuming the QOF plans to liquidate in Year 11. Thus, if the Projected-Profits Approach applies to measure Promo's profits interests in both Prosto LP at the time of its liquidation and his interest in the QOF at the time of its formation, Prosto LP would not be related to the QOF. If a single one of these two approaches applied, Prosto LP would not be related to the QOF under the QOF rules.

If the IRS were able to mix and match measurement approaches, it could claim that Promo's profits interests in Prosto LP is greater than 20 percent under the Current-Profits Approach and his profits interests in the QOF is greater than 20 percent under the Projected-Profits Approach. Based on that analysis, the IRS would argue the two entities are related. Promo, on the other hand, would argue the inverse, claiming his profits interests in the Prosto LP is less than 20 percent under the Projected-Profits Approach, and his profits interests in the QOF is less than 20 percent under the Current-Profits Approach, so

the two entities are not related. The arbitrariness of the outcomes based upon mixing and matching approaches, dictates that a single approach should apply to measuring partners' capital interests and profits interests.

CONCLUSION

The uncertainty regarding the measurement of capital interests and profits interests in partnerships is somewhat surprising considering how frequently tax law requires such a measurement. The commentary on this issue is also similarly sparse. This article considers some of the complexity that partners face in trying to determine their profits interests in partnerships that have distribution-dependent equity structures. The article suggests that the IRS could bring clarity to this issue by adopting the Capital-Plus Liquidation Approach. Adopting that approach would provide legal clarity. The approach would requiring valuing the partnership's assets at the time of measurement, which can be fraught with challenges, but by providing guidance with respect to the law, the IRS would remove one layer of uncertainty that plagues this area of the law.

Notes

1 See, e.g., Bradley T. Borden, Malulani and the Entrenchment of Mechanical Analysis of Related-Party Exchange Rules, 20 J. Passthrough Ent. 15 (May-June 2017); Bradley T. Borden, North Central and the Expansion of Code Sec. 1031(f) Related-Party Exchange Rules, 18 J. Passthrough Ent. 19 (May-June 2015); Kelly E. Alton, Bradley T. Borden & Alan S. Lederman, Are Related-Party Acquisitions in Anticipation of Exchange Technically and Theoretically Valid, 120 J. Tax'n No. 2014) 52); Kelly E. Alton, Bradley T. Borden & Alan S. Lederman, Related Party Like-Kind Exchanges: Teruya Brothers and Beyond, 111 J. Tax'n 324 (Dec. 2009); Kelly E. Alton, Bradley T. Borden & Alan S. Lederman, Related-Party Like-Kind Exchanges, 115 Tax Notes 467 (Apr. 2007 ,30); Bradley T. Borden, From the Ground Up: An In-Depth Analysis of Build-to-Suit and Related Party Exchanges, 44 Tax Mgmt. Memo. No. 19 (Jan. 2003 ,27).

2 Of course, Shelly Banoff has written in this space. See Sheldon I. Banoff, Indentifying Parnters' Interests in Profit and Capital: Uncertainties, Opportunities and Traps, Taxes—The Tax Magazine (Mar. 2007).

3 See 2-1993 C.B. 343.

4 See Code Section 706(b)(1)(B)(i).

5 See Code Section 706(b)(4)(A)(i).

6 See Code Section 706(b)(4)(A)(ii).

7 See Reg. § 1-1.706(b)(4)(iii).

8 See Id.

9 See Reg. § 1-1.706(b)(4)(ii)(A).

10 See Id.

11 See Reg. § 1-1.706(b)(4)(ii)(B).

12 See Id.

13 See Id.

14 See Reg. § 2-301.7701(a)(1) (as amended in 1996) ("There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divided [sic] the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."); see also United States v. Kintner, 216 F.2d 9) 24–421 ,418th Cir. 1954) (applying a six-characteristic test: (1) associates, (2) an objective to carry on a business and divide the profits therefrom, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests).

15 See Reg. § 2-301.7701(a)(1) (as amended in 1996) ("There are a number of major characteristics ordinarily found in a pure corporation which, taken together, distinguish it from other organizations. These are: (i) Associates, (ii) an objective to carry on business and divided [sic] the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests."); see also United States v. Kintner, 216 F.2d 9) 24–421 ,418th Cir. 1954) (applying a six-characteristic test: (1) associates, (2) an objective to carry on a business and divide the profits therefrom, (3) continuity of life, (4) centralized management, (5) limited liability, and (6) free transferability of interests).

16 See Rev. Proc. 1-1995 ,4.02 § ,10-95 C.B. 501, obsoleted by Rev. Rul. 2-2003 ,99-2003 C.B. 388.

17 See Code Section 1400Z2-(d)(2)(D)(i)(I) (restricting qualified opportunity zone business property to property acquired by purchase); Code Section 179(d)(2) (defining purchase to exclude acquisitions from a related person); Code Section 1400Z2-(e)(2) (applying a 20 percent threshold).