Existing Partnerships Can Now Book Up Capital Accounts to Grant “Profits Interests” to Service Providers

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In a partnership (including a limited liability company which is taxed as a partnership), each partner has a separate capital account which generally tracks that partner's investment in the partnership. Because capital accounts are initially maintained using the historical cost, rather than the fair market value, of the partnership's assets, they do not take into account the appreciation or depreciation in the assets that may have occurred subsequent to the contribution of the assets to the partnership. If the interests in the partnership change (for example, as a result of a new partner buying into the partnership based on the fair market value of partnership assets and not historic capital contribution value), then, without an adjustment to the partners' capital accounts, the relative capital accounts may not reflect the actual economic deal among the partners, and adverse tax consequences may result as well.

Because of this problem, upon the occurrence of certain specified events, the Treasury Regulations permit the partners' capital accounts to be increased or decreased (i.e., "booked up" or "booked down," as the case may be) to reflect a revaluation of partnership property on the partnership's books. Such an adjustment has historically been permitted where a new or existing partner contributed money or property to a partnership in consideration for an interest in the partnership, and where money or property was distributed by the partnership to a partner in liquidation of all or part of his or her interest. However, the regulations did not contain any provision allowing an adjustment where a new or existing partner contributed services, rather than money or property, to the partnership in exchange for a partnership interest. A partnership interest granted to a service provider is often referred to as a "profits interest" or "carried interest" since it typically gives the service partner the right to participate in the future profits of the partnership as opposed to the existing partnership capital. While many practitioners believed that such an event was an appropriate occasion for an adjustment, no adjustment was
available under the literal language of the regulations.

On July 2, 2003, the IRS issued proposed regulations to expand the list of circumstances under which a partnership may elect to adjust the partners' capital accounts to include the grant of an interest in consideration of services performed to or for the benefit of a partnership by a new or existing partner. However, the proposed regulations provided that such an adjustment would only be allowed with respect to the grant of an interest on or after the date that final regulations are published. Therefore, the proposed regulations could not be relied upon.

On May 6, 2004, the IRS issued the much anticipated final regulations. The regulations now include, as one of the circumstances under which a partnership may elect to adjust capital accounts, the grant of an interest in the partnership (other than a "de minimis" interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.

These regulations are welcome news given the frequency with which we have seen profits interests in partnerships being granted to service providers. Now partnerships that grant these interests can "book up" capital accounts if advisable, which will usually be the case. In addition, clients with partnership and limited liability company agreements which recite the circumstances under which capital account adjustments are permitted may wish to amend their agreements to include the grant of an interest for services.