PROFITS, INTERESTS, CAPITAL INTERESTS, AND THE HOLDER AS A PARTNER

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On 12/3/13, the Tax Court decided Crescent Holdings LLC, which involved a $1.6 billion transaction. The Tax Court’s opinion (1) underlines the fact that the exact language in an operating agreement does matter and (2) clearly demonstrates that compensatory partnership/LLC interests are technically complicated and require the active role of tax counsel.

Facts

Duke Energy Corp., a publicly traded corporation, owned 100% of Crescent Resources LLC (“Crescent Resources”) through its subsidiaries. In turn, Crescent Resources owned, developed, and managed extensive real estate holdings primarily in the southeastern and southwestern United States. Duke Energy desired to monetize its interest in Crescent Resources’ extensive real estate holdings. To that end, Duke Energy’s subsidiaries and various hedge funds affiliated with Morgan Stanley in 2006. They formed Crescent Holdings LLC (“Crescent Holdings”), which was classified as a partnership for federal tax purposes. Crescent Holdings then owned 100% of Crescent Resources, which owned the real estate.

As part of the transaction, Crescent Resources was recapitalized. It borrowed $1.25 billion, $1,187,000,000 of which was distributed to Duke Energy. Duke Energy (or its subsidiaries) sold 49% of Crescent Holdings to the Morgan Stanley hedge funds for another $415 million. As another part of the restructuring, Arthur Fields (“the CEO”), who had been president of Crescent Resources, entered into a new arrangement (the “Fields Agreement”) to be president and chief executive officer of Crescent Resources going forward. Certainly this series of complex, large-dollar real estate and related transactions was extensively lawyered and presumably had a heavy involvement by the applicable accounting firms.

In connection with the Fields Agreement and the change of ownership of Crescent Resources, the Tax Court’s statement of facts reads in part:

As an inducement for petitioner [the CEO] to forgo his rights from his previous employment agreement, the Fields Agreement provided that: (1) Duke Energy would credit petitioner with $37,796,000 to an unfunded bookkeeping account to be administered as if maintained under Duke Energy’s nonqualified executive retirement plan; and (2) Crescent Holdings would grant petitioner a 2% restricted

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membership interest in Crescent Holdings subject to section 83 of the Code and in accordance with the terms stated in Exhibit A to the Fields Agreement. Exhibit A stated that petitioner’s membership interests in Crescent Holdings would be forfeited if he terminated his employment with Crescent Resources before the third anniversary of the formation of Crescent Holdings. Exhibit A also stated that petitioner’s “[i]nterests are nontransferable unless and until the forfeiture restrictions shall have lapsed.” Exhibit A required petitioner to pay Crescent Resources an amount sufficient to satisfy all withholding for employment taxes and other applicable taxes before the forfeiture restrictions would lapse. Exhibit A provided that petitioner is entitled to the same distributions as other holders of member interests and that any distributions he received are not subject to forfeiture.5

The CEO did not make a Section 83(b) election. For 2006 and 2007 the CEO, while his interest was unvested, received allocations of taxable income in excess of $4 million. The CEO was not amused by the allocations of income and the requirement that he pay tax on such income without cash distributions. He was allegedly told that the first year’s allocation was a mistake. Later, after the second year’s allocation of an additional $3,608,218 of ordinary income, the shocked CEO was told that the accountants believed that the economic substance of the transaction indicated that the CEO was a partner. As a result of “conversations” with the board of Crescent Holdings and the management of Duke Energy’s LLC, which was a member of Crescent Holdings, an agreement was reached whereby Crescent Resources paid the CEO $2,242,540 to cover his 2006, 2007, and 2008 income tax liabilities resulting from his distributive share of income of Crescent Holdings.3 This was a payment from Crescent Resources, not a distribution from Crescent Holdings!4

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Late in May 2009, the CEO resigned his position at Crescent Resources as its bankruptcy was imminent. In early June, the CEO sent a letter abandoning whatever interest he may have had in Crescent Holdings. The next day Crescent Holdings and Crescent Resources both filed for bankruptcy.

Crescent Holdings filed an adversary complaint against the CEO in bankruptcy court to recover the $2,242,540 that Crescent Resources had paid him. The complaint in part stated: “Before the interest vested, however, Fields chose to terminate his employment, forfeiting any interest in Crescent Holdings and negating his income tax liability arising out of the forfeited interest.”6 Creditors of Crescent Holdings intervened, claiming the amounts were due to them. The CEO made a payment of $600,000 to the creditors and agreed to turn over any federal tax refund he received for 2006-2008. Interesting procedural events took place, but the bottom line is the IRS audited Crescent Holdings, asserted additional adjustments for 2006 and 2007,7 issued a final partnership administrative adjustment (FPAA) against Crescent Holdings, and asserted that the CEO was a partner of Crescent Holdings for 2006 and 2007.

The CEO filed petition for readjustment of partnership items under Section 6226, taking the position that he was not a partner for federal income tax purposes in those years (or ever) and should not be allocated undistributed income. In court, however, the IRS changed its position concerning the CEO in the FPAA and argued that the CEO had an

1 141 TC No. 15 (2013).
2 Id. at 265 (footnote by the court omitted).
3 The CEO presumably reported the payments as compensation and paid tax on such payments.
4 Crescent Holdings was a disregarded entity for federal income tax purposes because it was a single member LLC that did not elect to be classified as an association taxable as a corporation.
5 The Tax Court did not discuss the issue, but since Crescent Resources was disregarded for federal income tax purposes, the payment from Crescent Resources was, for tax purposes, a payment by Crescent Holdings. Presumably this was a guaranteed payment as opposed to a simple distribution.
6 It appears that tax counsel for Crescent Holdings was not involved at this point, as the forfeiture of the interest would not negate the prior years’ tax liability of the CEO. This framing of the adversary complaint was commented on by the Tax Court a footnote as follows: “It is inconsistent for the intervenor [the tax matters partner on behalf of the LLC] to have argued to the bankruptcy court that petitioner’s [CEO] tax liability for the allocations to his forfeited interest was negated and then argue to this Court that the petitioner should be liable to pay tax on the income allocated to his forfeited interest.” Note 1, supra at 217, fn 27. The CEO’s counsel raised estoppel in his argument. The court did not rule on that because it determined that the interest was a capital interest and no income was allocable to the CEO. The degree to which this inconsistency colored the court’s decision that the interest was a capital interest is unknown.
7 The IRS asserted that the income of Crescent Holdings was increased by $11,177,727 for 2006 and decreased by $5,998,986 for 2007, for a net increase in income of $5,177,759. Since the Tax Court opinion does not deal with the adjustment, it appears to have been accepted by Crescent Holdings, or administratively resolved.
unvested capital interest, would not be treated as a partner in the years in question, and should not be allocated income. Crescent Holdings disagreed and maintained the position that the CEO was a partner for federal income tax purposes.

The decision involved other interesting tax and procedural issues that are beyond the scope of this article. Substantively, at the end of the day, the CEO and the IRS agreed that whether the CEO had a profits interest or a capital interest would determine (1) whether the CEO was a partner for tax purposes and (2) whether the allocation of partnership income by Crescent Holdings to the CEO was proper or whether the CEO was not a partner for tax purposes and the income should be allocated to the other members.8

The CEO was not amused by the requirement that he pay tax on a $4 million allocation without cash distributions.

The tax matters partner of Crescent Holdings intervened and took the position that the CEO had a profits interest subject to Rev. Proc. 93-27 and 2001-43,10 which treat the unvested holder as a partner receiving allocations of partnership income. Alternatively, the tax matters partner argued that if, for some reason, the CEO is deemed to have acquired a capital interest, Reg. 1.721-1(b)(1) and not Section 83 nevertheless controls, and the CEO should have the share of partnership income allocated to him.11

The Tax Court's opinion

The first issue the Tax Court had to determine was whether the interest received by the CEO was a capital or a profits interest.12 To do this, the court looked at the language of Crescent Holdings’ operating agreement and its associated exhibits and appendices. This included examining an agreement and acknowledgment with Crescent Resources and Duke Energy to determine if the CEO would have received a share of the proceeds in a hypothetical liquidation of Crescent Holdings on the day of the grant.13

The tax matters partner argued that the CEO (1) did not contribute any money to receive his interest, (2) was not credited with a beginning capital account balance, (3) would have a zero balance in his capital account if a liquidation occurred on such date, and (4) therefore, would not have received a distribution under section 602(c) of the operating agreement. The tax matters partner therefore argued that section 602(a) required the distribution of the unreturned capital prior to the CEO's receiving

8 The Tax Court noted that treaties seem to assume that a service provider who receives an unvested partnership interest can be recognized as a partner from the time such person receives the interest. It cited Mckeever et al., Federal Taxation of Partnerships and Partners (Wesren, Gorham & Lambert, 2007), ¶ 5.03 at 5-47.
9 1993-2 CB. 343.
10 2001-2 CB. 209.
11 Although not germane to the importance of clear drafting but substantively very important, Crescent Holdings is the first case to address who is taxable on income attributable to an unvested capital interest. Reg. 1.83-16(e)(1) provides that distributed income represents additional compensation to the holder of a profits interest, but does not address whether recognition of undistributed income attributable to an unvested interest is allocable to the transferor or transferee. The Tax Court found undistributed income was allocable to the transferee, which in this case was Crescent Holdings, and therefore would be recognized by the other members.
12 The IRS did not argue that Rev. Proc. 93-27, as clarified by Rev. Proc. 2001-43, was invalid, but did argue in the Tax Court proceeding that the CEO had a capital interest and that Section 83 controlled. The tax matters partner did not argue that Rev. Proc. 93-27 and Rev. Proc. 2001-43 were not correct, but did argue that the interest was a profits interest. Alternatively, the tax matters partner argued that if the interest was a capital interest, Reg. 1.721-1(b) applied, requiring the undistributed income associated with the interest to be reportable by the CEO.
15 Note 1, supra at 270.
16 Id.
17 Id. at 271.
18 Id.
19 The Service's opening brief requested as a proposed fact that no priority capital contributions to Crescent Holdings prior to the date the interest was awarded the CEO. The tax matters partner did not object and no contrary proof was provided, and the court so determined.
20 It appears that the court considered the unreturned capital of Crescent Holdings as the capital invested by Crescent Holdings in Crescent Resources. However, the author has no idea as to what that amount may be and whether it is determined by tax capital accounts or by some valuation process. The court's opinion did not elaborate. If there was not an event that gave rise to a "book up" under Reg. 1.704-1(b)(2)(iv)(b), or if the book up was not made, the capital account of Crescent Holdings in Crescent Resources was probably highly negative following the distribution of almost $1.2 billion of borrowed funds and there may be no "unreturned capital" with respect to Crescent Holdings' investment in Crescent Resources. The court appears to have decided that since unreturned capital was that of Crescent Holdings, it did not give a distribution preference to anyone and what constituted the amount of unreturned capital, if any, was irrelevant.
distributions. Thus, under Rev. Proc. 93-27 and 2001-43, the CEO received a profits interest because he would not have received anything on liquidation. As a result, the tax matters partner argued, under Rev. Proc. 93-27 and Rev. Proc. 2001-43, he was a partner for federal tax purposes even though the interest was unvested and should receive an allocation of undistributed income.14

The court's opinion reported that section 6.03 is entitled "Distributions in Liquidation," and provides that upon dissolution of Crescent Holdings, "the proceeds of sale and other assets of the Company distributable to the Members under section 12.02(c)(ii) shall be distributed ... to the Members in accordance with Section 6.02."15 Section 6.02(c) of the operating agreement states in part: "The Members acknowledge and agree that, unless the Executive Committee determines otherwise and except as otherwise provided in Section 6.8(d) of the Formation Agreement, the Company shall make annual distributions." The Tax Court then goes on to say that section 6.02(c) "provides that the amount of the annual distributions will be the lesser of: (1) the maximum amount permitted under the Delaware Limited Liability Company Act and under loan and other credit agreements; and (2) an amount that is based on the unreturned capital of Crescent Holdings and priority capital contributions."16 Section 6.02(c)(v) is quoted to the effect that "the Executive Committee shall authorize for distribution to the Members in accordance with Section 6.02(a) an aggregate amount."17

The Tax Court concludes that section 6.02(c) determines only the amount of total distributions to the members, not which members receive what amount. According to the court, "[s]ection 6.02(a) clearly states that after an amount is distributed for the return of priority capital contributions, 'the remaining amount shall be distributed to the Members in proportion to their current Percentage Interests at the time of such distribution. Section 6.02(a) does not limit the remaining amount of the distribution to members that have contributed capital to Crescent Holdings."18 Priority capital was defined as any capital contribution made by a member pursuant to section 4.02 of the operating agreement, which provided that the members of Crescent Holdings may be requested to make additional capital contributions and that such had not happened at the time of the grant of the interest to the CEO.19

The court noted that Appendix A of the operating agreement defines unreturned capital in terms of the unreturned capital of Crescent Holdings,20 not in terms of the individual members. The court concluded that this amount is then distributed to the members in accordance with section 6.02(a). The court saw this as another reason why the tax matters partner's argument fails.

The court found collaborative support in other portions of the operating agreement and its attachments for the proposition that the
CEO was entitled to distributions prior to vesting and therefore would have been entitled to liquidation distributions on admission. Section 4 of Appendix E provides that the CEO is entitled to distributions from Crescent Holdings in proportion to his percentage interest and that any distributions he receives are not subject to forfeiture. Exhibit A to the Fields Agreement provides that the CEO's entitlement to distributions is the same as other members.

The testimony indicates that there had been no meeting of the minds between the parties at the outset as to the nature of the interest.

There is no discussion or indication in the Tax Court's opinion that the operating agreement required capital accounts to control the distribution of capital proceeds, although the logic of the tax matters partner's argument that the CEO had a zero balance capital account would be premised on capital accounts controlling the disposition of liquidation proceeds. It is common in partnership agreements today to attempt to force the capital accounts each year into balance based on a distribution waterfall using tax book values. Although not clear, there is no indication that the taxable income allocated to the CEO comprised all of the taxable income of Crescent Holdings in 2006 and 2007, which would be the result if the allocations were trying to force capital accounts into waterfall balance.

Analysis
There is apparently no reference in the documents characterizing the interest granted to the CEO as a profits interest or a capital interest. Although the documents are not perfectly clear, the Tax Court, for the reasons discussed above, construed them to find the existence of a capital interest. It appears that the CEO did not have a discussion with his tax advisors at the time of the award, nor did counsel or others involved in the transaction appear to have discussed the tax ramifications of the award of the interest to the CEO and whether the interest was capital or profits. It is hard to believe that the CEO realized that if he had a capital interest, and Crescent Holdings merely retained its value for three years (much less increased in value), he would owe more than $5 million of federal taxes in the year of vesting. From the record, it appears that the CEO did not understand that if he had a profits interest, he would have to pay tax on phantom income prior to vesting (perhaps even after vesting). There was no Section 83(b) election required or apparently discussed, even though the award references Section 83. It appears that the operating agreement did not provide for tax distributions to the members. This was probably because there was a mandatory distribution of the all cash available each year subject to the limitation of section 6.02(c), which includes restrictions imposed by the lenders. Usually, however, there is a specific tax distribution provided for and the limited liability company negotiates with the lenders for the specific tax distribution as an exception to any general restrictions on the distribution of cash by the borrower, at least so long as the borrower was not in default.

In the court's view, based on the price the Morgan Stanley hedge funds paid, the CEO would have received almost $17 million dollars if Crescent Holdings liquidated immediately after the interest was awarded to the CEO. The author initially thought that such a result would have surprised Duke Energy and the Morgan Stanley hedge funds. However, two commentators who studied the briefs observe that the CEO was pre-transaction non-qualified retirement plan benefit was approximately $54 million and the new post-transaction non-qualified retirement plan benefit was approximately $37.8 million. If this is correct, it would appear that at least Duke Energy might not be surprised. Nevertheless, unless there are

21. It is possible that the income allocated to the executive was all of the income, since the Tax Court's opinion states only that the amount was calculated to represent his distributive share under Section 702. If 100% had been allocated to the CEO, however, the author expects that counsel for the CEO would have argued that the allocations reflect the intent to "fill up" the capital account and show the intent of the company to treat the interest as a capital interest.

22. The argument is that if the borrower was a corporation, it would be required to pay such taxes ahead of the lenders, and therefore distributions should be permitted to pay the tax imposed on the owners for the income of the borrower. In essence, the lenders are not disadvantaged by tax distributions. Generally the lenders agree to this line of argument.

23. The Morgan Stanley hedge funds as a willing buyer purchasing from a willing seller paid approximately $415 million for a 49% interest. On a liquidation basis, that would imply that 2% would receive $16.9 million.


25. Note 1, supra at 264.

relevant portions of the documents that the court failed to discuss, it appears that the operating agreement and related documents can reasonably be construed to dictate such a result. Therefore, the factual determination by the Tax Court is reasonable and the holding is unlikely to be overturned on appeal.

Although not discussed in the court’s explanation of why it determined that a capital interest was issued, the grant document quoted by the court states: "Crescent Holdings would grant petitioner a 2% restricted membership interest in Crescent Holdings subject to section 83..." This statement applying Section 83 is inconsistent with the application of Rev. Proc. 93-27 and Rev. Proc. 2001-43 if the interest was intended to be a profits interest, and is inconsistent with the arguments of counsel for the tax matters partner that Section 721 and its regulations control and that Section 83 is not applicable to this situation.

The prior case law discussed in the Tax Court’s opinion clearly provides that a capital interest is property for Section 83. It is hard for the author to understand why, if tax counsel was involved, a Section 83(b) election was not discussed as the original transaction progressed if the interest was to be a capital interest. The other members would receive a deduction for the value of the interest. The CEO would have an obligation to remit the withholding amount and the employee portion of the employment tax to Crescent Holdings either upon the grant (if a Section 83(b) election was made) or at vesting (if a Section 83(b) election was not made). From a business perspective, it is reasonable to expect an "upset" CEO when he unexpectedly receives a tax bill for several million dollars on vesting.

If a profits interest was intended, and if tax counsel was involved, it is hard to understand why Crescent Holdings did not make it clear to the CEO that his interest was subordinate to a threshold of approximately $830 million in the event of a sale or other disposition of the interests or assets of Crescent Holdings and that he would be taxable on the undistributed income from the date of grant.

The author expects that either (1) the draftsmen intended that the interest the CEO received would be a profits interest and that the CEO would not be taxable on receipt or vesting or (2) the draftsmen did not understand the tax consequences of the issuance of an unvested partnership interest and had no intention with respect to the characterization. The conduct of the parties by allocating income to the CEO each year, and the CEO reporting such income on his tax return, would ordinarily be an indication that a profits interest was involved. That, however, is belied by the testimony. The surprise of the CEO, the CFO’s assurances that the first year was a mistake and would not be repeated, and subsequent discussions leading to payments by Crescent Resources to pay the tax indicates that there had been no meeting of the minds between the parties at the outset as to the nature of the interest he received.

**Conclusion**

Less than clear restricted interest grant documents and less than clear operating agreements can lead to a great deal of confusion and surprise. The grant of a profits interest or a capital interest involves a great deal of tax complexity and should be carefully reviewed and drafted by a tax attorney. A profits interest is a unique and extremely powerful compensatory tool to attract and retain top talent in a partnership (or LLC taxable as a partnership), and is frequently used in real estate partnerships (LLCs and limited partnerships). However, as with other sophisticated and technically complex tax planning, tax expertise and clear drafting are required and it is highly preferable that the parties understand the tax ramifications of the business arrangement before the IRS brings it to their attention.