

Receiving partnership interest in exchange for services

Dear Reader:

You recently mentioned that you expect to receive a partnership interest in the firm in which you are currently employed in exchange for your services. This letter will explain the tax implications of the receipt of the partnership interest in exchange for your services.

A partnership interest can be divided between an interest in the capital of the partnership and an interest in the future profits of the partnership. The tax law provides that a person who receives an interest in a partnership's existing capital in exchange for services recognizes income at the time of the receipt of the interest. In contrast, IRS has announced that it will generally not treat the receipt of an interest in the future profits of a partnership (other than a publicly traded partnership) as taxable, unless the profits are substantially certain (e.g., the partnership holds treasury bonds on which it receives a predictable income stream) or the partner disposes of the profits interest within two years of the receipt of the interest.

You have informed me that the partnership will be giving you a profits interest and that you will have to "buy in" to get an interest in partnership capital by reducing the distributions you will receive. For instance, if your interest in partnership profits for next year will be \$150,000, you will receive distributions of \$125,000, and a \$25,000 interest in partnership capital. The reductions in the distributions you receive will continue until your percentage interest in partnership capital is equal to your profits percentage.

In this situation, you will not recognize any income as a result of your receiving the profits interest, since the profits are not substantially certain and you cannot dispose of the partnership interest. Accordingly, you will not be subject to tax as a result of your receipt of the profits interest. However, because your distributions will be reduced as a result of the "buy in," you will be subject to tax on profits that exceed your distributions.

We can discuss with you the implications of the "buy in" and help you negotiate terms with the partnership that would make it easier for you to avoid any cash flow problems resulting from the "buy in." If you would like our help in considering the terms of your entry into the partnership or would like to discuss this topic further, please give us a call.

