COMPENSATION VIA SHARE OF PROFITS DID NOT ESTABLISH A PARTNERSHIP

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Parties that jointly conduct a business or venture and share the profits and losses will typically meet the definition of a "partnership" for income tax purposes and be taxed accordingly. Such partnership treatment can arise, even though the parties did not intend to create a partnership and merely have some other type of contractual arrangement between them.

This issue often arises when an individual or an entity provides services to another that is conducting a venture or business, and is paid for its efforts in whole or in part with a percentage of the profits of the venture. Since there is a sharing of "profits," there is a reasonable risk that the IRS may find the arrangement to be a partnership, and not a non-partnership contractual arrangement.

The tax status of the relationship can have significant consequences for the parties, including whether the service provider is taxed immediately on a pass-through basis on the ventures profits, whether the provider can deduct venture losses, whether Section 1446 withholding on foreign participants may apply, and whether the service provider will be taxed on its receipts as ordinary income (nonpartner) vs. capital gain income (partner) if the shared profits are in the nature of capital gains.

It was whether such profits paid to a service provider were capital gains or ordinary income that was the issue in recent tax case. Interestingly, the court found that the service provider was NOT a partner even though it was paid with a 20% profits interest in the venture. While the court's examination was very fact specific, the factors looked at by the court and its view whether those facts supported a partnership or nonpartnership relationship can be useful when crafting contractual relationships when no partnership relationship is (or is not) desired. These factors included:

-the contract specifically declared that the relationship was not a partnership (this obviously was a factor against a partnership);

-the contract provider expended its own funds in performing its functions (this was considered by the court as a capital contribution and was a factor in favor of a partnership);

-the contract provider did not have authority to withdraw funds from the business, it could not increase the business owner’s capital commitment to assets, it could not enter into binding agreements in the name of the business, and it could not dispose of an asset without the owner's prior written approval. The court held that the service provider’s responsibilities, while numerous, did not extend into the key areas of acquiring and disposing of assets or drawing upon the business’ bank accounts that would indicate a partnership relationship (factor against partnership);

-the contract provider did not own title to any of the assets in the business, and apart from depositing checks did not share control with the business over the bank accounts that corresponded with the companies in the business portfolio and could only make business recommendations (factor against partnership); and

-the parties did not file partnership tax returns, and the contract provider did not hold itself out as a partner to third parties (factor against partnership).

Compensating employees or independent contractors with a profits share often makes good business sense to owners, as compared to actually making them part owners. Benefits to business owners include avoiding creating statutory rights in the recipients (such as voting rights and rights to examine books and records), and the ability to terminate the relationship without an obligation to repurchase shares or ownership interests, while gaining the incentive benefits of a profit participation. Sometimes, these interests are established as a share of gross profit instead of net profit, to avoid the partnership tax risk -with a gross profit interest, there is no sharing of expenses or losses, thus eliminating an important factor in the establishment of a partnership relationship for tax purposes. Thus, in addition to providing helpful factors to avoid partnership status, the case also provides some comfort that compensation via a net profit share will not, in and of itself, necessarily create a partnership relationship.

Rigas v U.S., 107 AFTR 2d 2011-788 (CD TX 5/2/7/2011)

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