Explaining Profits Interests and Their Tax Consequences

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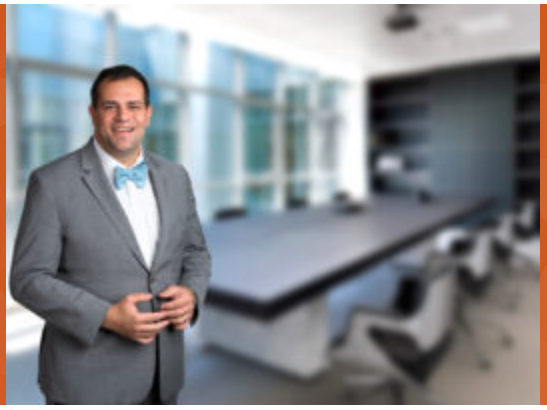

Equity incentives are an important form of compensation in many types of businesses and are especially important at the start-up phase when only limited funds may be available to pay cash compensation. Entrepreneurs familiar with the corporate form of business likely have received equity incentives themselves, possibly in the form of restricted stock, stock options or stock appreciation rights (SARs). Now that limited liability companies (LLCs) have become a popular choice of entity, more service providers are receiving LLC equity incentives. One such LLC equity incentive is a "profits interest." This article answers three questions of importance to both the recipient and grantor of a profits interest: (1) what exactly is a "profits interest," (2) what are the tax consequences to the recipient, and (3) what are some tax consequences to the LLC?

Q: My employer, an LLC, promised me equity incentives. I just received documentation indicating I have a "profits interest." I was expecting restricted stock, stock options or, perhaps, stock appreciation rights. What is a "profits interest?"

A: An LLC with more than a single member is classified as a partnership for US federal tax purposes unless it elects to be classified as a corporation. There are two types of equity in an LLC taxed as a partnership – "capital interests" and "profits interests." A capital interest, like a share of stock in an entity taxed as a corporation, represents a slice of existing company value; this means that if the LLC were to liquidate immediately after the grant by selling its assets, paying off its debts, and distributing out the remaining proceeds, the recipient of a capital interest would be entitled to receive a share of the liquidation proceeds or capital. On the other hand, a profits interest represents only a right to share in the future growth of the entity; that is, income and/or appreciation that is generated after the date of grant. In other words, if the company were to liquidate immediately after the grant by selling its assets, paying off its debts, and distributing out the remaining proceeds, the current LLC equity holders would receive all of the liquidation proceeds and the profits interest recipient would not be entitled to share in any of the existing value of the company.

While an LLC could issue restricted capital interests in the LLC, options to buy interests, or interest appreciation rights (akin to restricted stock, stock options and stock appreciation rights, respectively, in a corporation), profits interests are unique to tax partnerships and carry some tax advantages over these other forms of equity incentive.

Q: What are the possible tax consequences to a recipient of a profits interest?

A: From a tax perspective, and under current Treasury Regulations[1], the primary reason employers issue profits interests is that the grant of a profits interest does not result in taxable income to the recipient. This is because by its very nature a profits interest is worth nothing upon receipt and represents only a right to a share of future value of the LLC. This treatment differs from the grant of a capital interest where, upon the grant of the capital interest, the recipient has ordinary compensation income and is subject to tax in an amount equal to the then value of the capital interest minus the amount the recipient paid for the capital interest. Receipt

of a capital interest may cause a liquidity issue for the recipient since she must come up with either the funds to pay the purchase price or the taxes on the capital interest.

A second reason to issue a profits interest is that since the profits interest represents equity in the LLC, the later sale or redemption of the equity interest generally generates income taxable at more favorable capital gains rates. Certain partnership tax rules, applicable also to capital interests, may re-characterize some of the capital gain income as ordinary income. As mentioned above, an LLC taxed as a partnership can also issue options to purchase partnership interests; however, these options would likely be treated in a similar manner to non-qualified stock options in a corporate setting, meaning that while there are generally no tax consequences to either the recipient or the LLC upon the grant of the LLC option, at exercise of the option the recipient would recognize ordinary income and pay tax on the spread between the fair market value of the equity interest acquired and the amount paid by the recipient. Not only would the value attributable to these forms of equity incentives be treated as ordinary income taxed at higher ordinary income tax rates, it may also be subject to Social Security and Medicare taxes. Any future appreciation would benefit from capital gains treatment; however, given the varying tax consequences, the profits interest could produce better long-term tax results to the recipient.

A third important difference for recipients and LLCs to consider is that upon receipt of a profits interest, the grantee recipient is no longer treated as an employee of the LLC. Instead, the recipient becomes a partner for tax purposes and will receive Forms K-1, reporting his or her share of the LLC's fiscal year profit and loss (if any) in accordance with the LLC's Operating Agreement and payments for services (i.e., formerly "salary"). The grantee will be solely responsible for paying periodically estimated taxes and self-employment taxes. If the profits interest is relatively small in comparison with the annual salary amounts, granting a profits interest to an employee may present a tax and compliance burden to the recipient that outweighs any benefit conferred. In those cases, an LLC should consider alternative forms of compensation such as cash bonuses.

However, if the change in employment status and added tax reporting burden are not deal-killers, the receipt of a profits interest has distinct advantages over other types of equity incentives of both no current taxation and a potential for capital gains treatment. Nonetheless, a grantee must be comfortable that the terms of the profits interest represent a meaningful incentive. Careful review of the terms governing the profits interest, which are typically contained in a Grant Agreement and the LLC's Operating Agreement, is necessary.

Q: What are some possible tax consequences to an LLC granting a profits interest?

A: From a tax perspective, if an LLC has a single owner, it is treated as a disregarded entity (DRE) for US federal income tax purposes, unless it makes an election to be taxed as a corporation. A DRE can grant a profits interest; however, the creation of the profits interest automatically converts the DRE into a partnership for US federal tax purposes by virtue of the issuance of the equity interest and obligates the LLC to file its own partnership tax returns.

In addition, since the grant of a profits interest represents only a right to a share of future value in the LLC and does not result in the recipient reporting taxable income in connection with the receipt of a profits interest, the LLC would not be entitled to a deduction for the transfer of the profits interest to the recipient.

From a tax compliance standpoint, since the recipient of a profits interest becomes a partner for tax purposes, the LLC will issue the new partner a Form K-1 reporting his or her share of the LLC's profit and loss, and should no longer report payments for services on a Form W-2 or withhold income and Social Security and Medicare taxes or pay the employer's share of such taxes.

The LLC should be aware of certain non-tax considerations as well, including the right of the equity holder to access the LLC's books and records, as well as potential obligations regarding

liability and capital contributions.

Important questions the recipient and grantor of a profits interest should consider when contemplating issuing profits interests include:

- What value has been set for the LLC upon grant of the profits interest? This value will be attributed to the existing LLC equity holders. If the value is too high, the profits interest may never share in any appreciation if the value cannot be reached and surpassed; if it is too low, the intended profits interest may instead be a capital interest, causing the recipient to have taxable income upon grant.
- Is the profits interest subject to vesting? If so, what is the vesting schedule and what will happen if the vesting is not met?
- What are the rights of the class or series of equity on which the profits interest has been granted? For example:
  - Will the class or series share in distributions of operating income, as well as liquidating distributions?
  - Is the class or series entitled to distributions to pay taxes on its allocable share of LLC income each year?
  - Does the class or series carry voting rights?
  - Is the class or series subject to other restrictions which do not apply to other LLC interests, such as transfer restrictions or restrictions on access to information about the LLC?

A company considering issuing profits interests to incentivize employees should review its structure, organizational documents, and determine whether the benefits outweigh the burdens to both the company as well as the intended recipient. As long as the profits interest is structured properly and capital accounts are booked up on admission of the profits interest recipient, the IRS should not treat the grant of a vested or unvested profits interest as a taxable event. For more information on the underlying mechanics or for assistance implementing a profits interest plan, please contact Joseph Hunt.

Footnotes

1. Note, in 2005 the Internal Revenue Service issued proposed regulations that would alter the procedural requirements that must be satisfied in order to achieve a tax-free result. These new proposed regulations would only be effective for profits interests granted on or after the date the final Treasury Regulations become effective, which has not occurred as of the publication date of this post.