Say you own one-half of an LLC that is taxed as a partnership. You and your partner invested the initial capital that was necessary to get the business up and running, and you both built the business with the help of a few key employees. With the business still in the growth phase, you want to make sure that you motivate and retain these key employees who are helping you grow your company. What should you do? You and your partner might want to consider causing the LLC to issue the key employees a profits interest in the LLC.

What is a Profits Interest?

From a tax standpoint, an LLC can issue two basic types of membership interests: capital interests and profits interests. A capital interest is an interest in a partnership or LLC taxed as a partnership that entitles the recipient to share immediately in the proceeds of liquidation. A capital interest normally results from a capital investment and provides recipients with participation in current and future equity value, a share of income, and distributions. When someone receives a capital interest in an LLC in exchange for a corresponding capital contribution, this is typically a tax-free event. When someone receives a capital interest in exchange for services, this is taxable compensation to the service provider.

Profits interests are distinct from capital interests, providing no current right to share in the proceeds of liquidation as of the date of grant. Instead, they typically only provide a holder with the right to share in those profits of the business that arise after the recipient acquires the interest. The primary goal of issuing profits interests is typically to give a service provider the ability to participate in the growth of the enterprise without incurring tax on the receipt of the interest, and to enjoy at least some long-term capital gain treatment (instead of ordinary income treatment) on proceeds they receive on a sale of the LLC or similar liquidity event.

Structuring a Profits Interests

Usually, as long as the profits interest is structured properly and capital accounts are booked up on entrance of the profits interest member, the IRS should not treat the grant of a vested or unvested profits interest as a
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taxable event. Most practitioners design profits interests so that they meet IRS safe harbor standards for ensuring profits interest treatment. These standards include:

1. The profits interest must not relate to a substantially certain and predictable stream of income from the entity's assets, such as income from high quality debt securities or a net lease,

2. The recipient of the profits interest must not dispose of it within two years of receipt, and

3. The profits interest may not be a limited partnership interest in a publically traded partnership.

The issuing entity's partnership or operating agreement should be closely examined upon the issuance of a profits interest. Things to consider with respect to newly issued profits interests include whether such recipients should have voting rights similar to that of members who contributed capital to the enterprise. Additionally, the agreement should be updated to clearly define how the profits interests will be valued relative to capital interests under current buyout or redemption provisions. Oftentimes, practitioners ensure that a profits interest has no right to share in liquidation proceeds on the grant date by valuing the company as of that date, and providing that a profits interest holder will not share in distributions except to the extent a threshold established based on the value is exceeded. Also, booking up capital accounts is generally critical to ensuring that the profits interest does not entitle the recipient to any proceeds of liquidation if the entity was liquidated on the grant date.

To the extent the profits interest issued is unvested at the time of issuance, most practitioners opt to make an 83(b) election to ensure tax-free treatment upon receipt. When a profits interest is issued, it has no value. If the profits interest is vested, there is no question that it is taxed at the time of receipt, at $0. Unvested property is taxed at the time of vesting, on the property's value at the time of vesting. Hence, if the profits interest has appreciated in value since the time of grant, then there would be ordinary income at the time of vesting. To avoid this treatment, recipients of profits interests can make an 83(b) election, which is an election to treat the profits interest as vested for tax purposes at the time of grant and to be taxed on the value of the profits interest at the time of grant. There is some IRS guidance that states that an 83(b) election is not necessary. However, that issue is beyond the scope of this article and a so-called “protective 83(b) election” is usually still made to assist in easing the minds of profits interest holders who want to ensure that the interest is not taxable when it vests.
Tax Consequences of a Profits Interest

The recipient of a properly structured profits interest is not taxed on receipt because the IRS views the profits interest's value as $0. Because the profits interest is treated as having no value, there is no deduction that corresponds to the issuance of the profits interest for the entity. The profits interest will be treated as having a $0 basis, and no capital account. Going forward, the recipient should be treated as an equity owner under the terms of the governing partnership or operating agreement for the entity starting on the date on which the profits interest was granted. The recipient should receive a K-1 and pay taxes on income that is passed through from the entity. Capital accounts should be adjusted accordingly, just as is the case for any other member.

The Future of Profits Interests

The history of how profits interests are taxed is riddled with controversy. In addition, politicians continue to discuss the desirability of profits interests (also sometimes called “carried interests”), in the context of private equity and hedge funds. However, the foregoing analysis reflects the IRS’ stated position on profits interests based on several Revenue Procedures that were issued to address the topic pending additional guidance. Until the IRS or Department of Treasury issues additional guidance, the current rules will generally remain applicable to small businesses and startups who are issuing profits interests.

Overall, profits interests are a unique and creative way to give people who are rendering services to the LLC or partnership a stake in the enterprise. They can generally be viewed as similar to options, except that they also provide the holder with a stake in the losses of the entity. With the increasing use of LLCs for startup operations, the use of profits interests as an incentive compensation mechanism has grown in the past years. If you are interested in learning more about profits interests and the complications that must be navigated when profits interests are issued to service providers, please contact our office.