

Profits Interests in Partnerships and LLCs: A Special Type of Equity Compensation (or Don't Try This with Your S Corporation!)

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January 31, 2015

Fundamentals

- Corporations and Partnerships
- LLCs as Partnerships for Tax Purposes
- Shareholder Equity
- Partner Equity
- Capital Accounts

Balance Sheet of a Corporation:

<u>Assets</u>	<u>Liabilities</u>
\$100	---
	<u>Equity</u>
	\$100
\$100	\$100

Balance Sheet of a Partnership:

<u>Assets</u>	<u>Liabilities</u>
\$100	---
	<u>Equity</u>
	Walter \$ 75
	Kim \$ 25
\$100	\$100

Legal Background:

- §61 of the Internal Revenue Code
- §83 of the Internal Revenue Code
- Treasury Regulation §1.721-1(b)(1)

§61

- Income includes compensation for services
- If compensation paid in property, compensation income is fair market value of property

§83

- If property is transferred to a provider of services, the fair market value of the property, at the first time the property is transferable or is not subject to a substantial risk of forfeiture, less whatever the provider of services paid for the property, must be included as income in the first year in which the property is transferable or not subject to a substantial risk of forfeiture.
- 83(b) election is provided for property subject to vesting requirements.

Treas. Reg. §1.721-1(b)(1)

Receipt of a share of partnership capital in exchange for services is taxable income but receipt of a share in partnership profits is not?

Diamond: Receipt of a partnership profits interest in exchange for services is a taxable event.

Campbell: Partnership profits interest had only speculative value so no amount needed to be included in income.

IRS Response: Rev. Procs. 93-27 and 2001-43

Rev. Proc. 93-27

- Profits Interests
- Capital Interests
- Liquidation Test

- Abbie, Bob and Connie create ABC, LLC, in which they are all equal partners.
- Each of Abbie and Bob contributes \$100 and plans to be a silent partner.
- Connie does not make a contribution but will manage the LLC.

Assets	Liabilities	
\$200	---	
	Equity	Profit Sharing Percentage
	A \$100	33.3%
	B \$100	33.3%
	C \$0	33.3%
\$200	\$200	100%

Rev. Proc. 93-27: Other Requirements

- There must be a partnership.
- The recipient of the profits interest must provide the services to, or for the benefit of, the partnership.
- The recipient of the profits interest must provide the services in a partner capacity or in anticipation of becoming a partner.

Rev. Proc. 93-27: Exceptions

- Interest relates to a substantially certain and predictable stream of income
- Partner disposes of the interest within two years of receipt
- Interest is a limited partnership interest in a “publicly-traded partnership”

Rev. Proc. 2001-43: Profits Interests Subject to Vesting Requirements

Clarifications:

- Determination of profits interest is made at time interest is granted (not when interest vests)
- Neither grant of profits interest nor vesting of profits interest is taxable event
- No need for 83(b) election

Rev. Proc. 2001-43: Profits Interests Subject to Vesting Requirements

Limitations:

- Must be profits interest under Rev. Proc. 93-27
- Recipient of profits interest must be treated as partner from date profits interest granted
- Partnership must not take compensation deduction

Summary from Rev. Proc. 93-27 and 2001-43

- Recipient of profits interest (described in Rev. Proc. 93-27) has no taxable income upon receipt or upon vesting.
- Partnership has no compensation deduction
- Recipient of profits interest is treated as partner from date of receipt of profits interest
 - Allocation of partnership's taxable income
 - Not an employee

Grant of a Capital Interest in Partnership

- Recipient subject to income tax on fair market value of interest
- Vesting requirements may delay taxable event
- 83(b) election
- Compensation deduction for partnership

No Profits Interests In Corporations

Options Distinguished

- Immediate interests (profits interest)
- Right to acquire interest in future (option)
- Uncertain tax treatment of compensatory partnership options

Benefits of Profits Interests

- Immediate ownership interest without tax cost
- No cash cost to LLC
- Deferral of taxable income
- Character of income is character of LLC's income – not compensation – possible long-term capital gain income for the provision of services

Profits Interests Are Described in the LLC's Operating Agreement

Operating Agreement's Description of Profits Interests

1. Profits interests issued upon LLC's formation
2. Profits interests to be issued from time to time during LLC's operation
3. Both 1 and 2 in same LLC

- Abbie and Bob create an LLC in which they are equal partners.
- Each contributes \$100, which is used by the LLC to buy real estate (raw land).
- Years later they recruit Connie to develop the land and offer a 25% profit sharing percentage in the LLC at a time when the land has appreciated to \$300.

Opening Balance Sheet

Assets	Liabilities	
Land \$200	---	
	Equity	Profit Sharing Percentage
	A \$100	50%
	B \$100	50%
\$200	\$200	100%

Balance Sheet when Connie joins

Assets	Liabilities	
Land \$200	---	
(Now worth \$300)	Equity	Profit Sharing Percentage
	A \$100	37.5%
	B \$100	37.5%
	C \$0	25.0%
\$200	\$200	100%

(from Operating Agreement)

Class P Units [profits interests] issued hereunder are intended to qualify and shall be treated as “profits interests” within the meaning of Revenue Procedure 93-27, as clarified by Revenue Procedure 2001-43 (the “Revenue Procedures”). The parties agree and acknowledge that (A) no Person issued Class P Units shall be obligated to make Capital Contributions in respect of any Class P Units, (B) the Company shall treat such Members as holding “profits interests” for all purposes, and (C) if the Company were liquidated immediately after issuance of the Class P Units pursuant to this Agreement, before the Company made any earnings and before any appreciation occurred in the value of the Company’s assets, the Company’s assets were sold at fair market value and the proceeds were immediately distributed in a Liquidation Event, the holders of Class P Units would not be entitled to receive any share of the proceeds of such Liquidation Event in respect of such Units.

(from Operating Agreement)

Each time that a Class P Unit is issued, the Company shall determine the fair market value of the Company's assets, net of any liabilities of the Company as of such issuance (the "Applicable Pre-Issuance Company Value"). As of the date of this Agreement, the Applicable Pre-Issuance Company Value is \$5,000,000. Notwithstanding anything to the contrary in this Agreement, (i) a Person who receives a Class P Unit shall not be allocated any portion of the Applicable Pre-Issuance Company Value that is ultimately realized by the Company from the sale or exchange of assets that were owned directly or indirectly by the Company on the date such Person received such Class P Unit and (ii) the amount of distributions made by the Company to a Person with respect to such Class P Unit shall be no greater than the sum of (A) such Person's interest in net income and net loss arising from the ordinary operations of the Company after the date such Class P Unit was issued and (B) such Person's interest in any appreciation in the fair market value of the Company's assets, net of any liabilities of the Company, in excess of the Applicable Pre-Issuance Company Value.

Operating Agreement's Distribution Provisions

- Operating distributions
- Liquidating distributions
- Distribution “waterfalls”

Operating Agreement's Allocation Provisions

- Traditional allocations
- Targeted allocations

Variety in Profits Interests—Vested or Nonvested

(from Operating Agreement)

Allocations of net income or net loss for tax purposes shall be made with respect to Class P Units, whether vested or unvested. Any distributions with respect to unvested Class P Units shall not be distributed to the holders of such unvested Class P Units (each distribution not made pursuant to this Section a “Suspended Class P Distribution”), provided, however, that holders of unvested Class P Units shall still be entitled to any [tax distributions] payable with respect to such Units. Suspended Class P Distributions may be retained by the Company or distributed to the other holders of Units.

To the extent that any Class P Units did not participate in any distribution by reason of [suspension of distributions with respect to unvested interests], any subsequent distributions with respect to which Class P Units are not precluded from participating in by reason of [suspension of distributions with respect to vested interests] or [threshold requirements for distributions to holders of profits interests] shall first be made among the holders of such Class P Units in such amounts and ratios as may be necessary or appropriate to eliminate as quickly as possible any Suspended Class P Distributions.

Variety in Profits Interests – Ways to Describe Profits Interest

- Fixed percentage of Future Profits
- Catch-up allocations of Future Profits
- Participation in Future Profits subject to a cap
- Participation only in Future Profits from a liquidating event

Related Operating Agreement Provisions

- Required 83(b) elections
- Forfeiture of nonvested profits interests
- Tax distributions to holders of profits interests
- Subject to redemption upon happening of certain events

2005 Proposed Regulations

- Application of §83 to profits interests
– need for 83(b) elections
- Revenue Procedures 93-27 and 2001-43 obsolete
- Election to treat liquidation value as value of partnership interest
- New forfeiture allocations

*** The End ***