Ballard Spahr LLP

Tax Geek Tips You Ought To Know

A PUBLICATION OF THE BALLARD SPAHR TAX GROUP SEPTEMBER 2014

SO YOU WANT TO ISSUE PROFITS INTERESTS?

Profits interests issued by partnerships and LLCs[1] are touted as the most amazing thing since sliced bread. And they are pretty amazing. Unlike corporate stock, they can be issued to an employee or service provider without triggering current income tax to the employee or service provider (provided certain tax requirements are met). Despite their popularity, a lot of people do not understand exactly what profits interests are. Generally and simply put, they provide the holder with a right to (1) *future* income of the LLC, and (2) *future* appreciation in the assets of the LLC, but not to any of the value of the assets of the LLC existing immediately before the profits interest is issued. In order for a holder of a profits interest to receive any distributions, the LLC must have income and/or appreciation in value in the future. If the LLC does not have any income or appreciation in value after the date of the issuance of the profits interest, the holder will not be entitled to anything.

Understanding that profits interests entitle holders to only future income is just the starting point in structuring them. There are many other aspects that have to be thought through in their structuring and, perhaps just as importantly, in drafting to ensure that the contemplated structure is implemented:

- **Straight percentage sharing.** The simplest profits interest arrangement provides that after the return of the value of the LLC existing immediately prior to the issuance of the profits interest ("preexisting value") to the persons that were members at such time ("preexisting members"), the owners of the profits interests will share in a straight/fixed percentage of distributions.

- **Catch-up profits right.** This type of profits interest attempts to achieve an economic right that is similar to the economic right that a holder of a share of corporate stock is entitled to. Generally, this type of right provides that after the return of the preexisting value of the LLC to the preexisting members, the owners of the profits interests will receive a "catch-up" distribution equaling the amount of distributions they would have been entitled to if they had been members of the LLC from day 1.

---

1 LLCs with two or more members are treated for U.S. federal income tax purposes as partnerships, unless they have made a tax election to be treated as corporations. This memorandum addresses only LLCs that are taxed as partnerships.

Only after the catch-up distribution is made will all members share in any remaining distributions. Thus, while the distributions to the holders of profits interests come out of only future income and profits of the LLC, the distributions are intended to catch up the holder economically to what the holder would have received if the holder had a capital and profits interest, and not just a profits interest. The difference between this approach and the one outlined above is best illustrated by a simple example.

> **Example:** *LLC has two members:* Capital Member and Profits Member. Capital Member contributes assets with a value of $1 million. Profits Member is issued a 10% profits interest. For the year, LLC has $1,200,000 of taxable income and distributable cash.
>
> *Straight percentage sharing:*
> Capital Member is first distributed $1,000,000 to return her capital.
> The remaining $200,000 is split 90/10, so that Capital Member gets $180,000 and Profits Member gets $20,000.
> Total distributions: Capital Member - $1,180,000; Profits Member - $20,000
>
> *Catch-up approach:*
> Capital Member is first distributed $1,000,000 to return her capital.
> Then, Profits Member is distributed $100,000 as the "catch-up."
> Then they share 90/10 so that Capital Member gets $90,000 and Profits Member gets $10,000.
> Total distributions: Capital Member - $1,090,000; Profits Member - $110,000

- **Fixed percentage or diluted over time?** Often, parties agree that a certain percentage of profits interests should be "set aside" for issuances to employees. However, they will not have identified all the recipients up front. A key point that many fail to adequately consider is to whom any profits are allocated, and any unrealized appreciation will accrue, until such time as the later profits interests are issued.

> **Example:** *On Day 1 of Year 1, X and Y form an LLC.* X and Y decide that they will set aside 10% for issuances to employees, anticipating that there will be five employees identified (each intended to have a 2% interest), and that X and Y will share the remainder of the profits equally. As of Day 1 of Year 1, they've identified one employee that will be issued a profits interest, A, but not any others. On Day 1 of Year 2, they identify that B, C, D, and E will also receive profits interests. During year 1, the LLC has $100,000 of income. For simplicity, assume that the value of the LLC's assets remains the same from Year 1 to Year 2.
>
> *Fixed percentage to employee:* During Year 1, A will receive $2,000, and X and Y will share the remaining profits ($49,000 each). During Year 2, however, since the full 10% of profits interests will have been issued, X and Y will each receive 45% of the profits, and the employees in the aggregate will receive 10%.
>
> *Dilution of employee over time.* During Year 1, X and Y will receive $45,000 each, and A will receive $10,000. Once B, C, D, and E are granted profits interests in Year 2, A's interest will go down to 2%, and each of B, C, D, and E will have an interest that entitles each to 2% of the profits.

While the difference between these results seems to be relatively obvious, this point is often lost on many drafters of agreements. This is particularly so in LLC Agreements that employ the concept of "profits units" rather than "profits interests."

- **Kick-in only on liquidation or other capital event.** A profits interest may be structured to allow a holder to a share of the proceeds only upon the sale of all the assets of the LLC, or other capital event or liquidation—but to none of the regular, operating income.

- **K-1s and net earnings from self-employment.** Employees that receive profits interests will get K-1s rather than W-2s. Their earnings will generally be considered subject to self-employment taxes, causing them to pay the employer's share (as well as the employee's share) of FICA and Medicare taxes. There may be planning strategies to address this that should be discussed.

- **Vested versus unvested interest.** While parties certainly have control over whether holders of unvested profits interests will be entitled to distributions or not, the IRS considers the holders of an unvested interest to be a partner of a partnership. Accordingly, K-1s are required to be issued to them, and depending on how the allocation provisions of the partnership or LLC agreement are drafted, taxable income may be allocated to them. If it is important to the parties that the holders of the profits interest not be allocated taxable income prior to vesting, then care should be taken in drafting the allocation provision to achieve this result. Further, consideration should be given to whether the holders of profits interests will be provided tax distributions and other tax and non-tax rights typically enjoyed by partners and LLC members.

- **Who makes the determination of preexisting value?** Immediately prior to the issuance of a profits interest, the preexisting value of the issuing partnership/LLC must be determined. (This is the value that the holder of the profits interest cannot participate in.) Obviously, the determination of this value is important, as it directly affects the amount of distributions that all members will receive. A key question is, who will make this determination, and by what process they will make the determination? Note that, with respect to LLCs/partnerships that plan to issue profits interests frequently (whether to new or existing members or partners), this determination will have to be made just as frequently.

It is surprising how often these seemingly simple points are not considered.

Please consult one of the members of Ballard Spahr's Tax Group for help in structuring profits interests.

Saba Ashraf
Partner
ashrafs@ballardspahr.com
Tel 678.420.9372
Atlanta

Christopher A. Jones
Associate
jonesc@ballardspahr.com
Tel 215.864.8424
Philadelphia

Wayne R. Strasbaugh
Partner
strasbaugh@ballardspahr.com
Tel 215.864.8328
Philadelphia

Jeffrey R. Davine
Partner
davine@ballardspahr.com
Tel 303.299.7312
Denver

Wendi L. Kotzen
Partner
kotzenw@ballardspahr.com
Tel 215.864.8305
Philadelphia