PARTNERSHIP AND LLC PROFITS INTERESTS

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Granting a profits interest to key executives of a partnership or limited liability company makes them partners or members with real ownership rights that are parallel and equal to those of other owners with respect to future profits and future growth in value of the company. Existing owners retain the full right to existing value. Revenue Procedure 2001-43 significantly simplifies the process of providing unvested profits interests to the service providers of a partnership or limited liability company.

I. Background

A. Structure of an Unvested Profits Interest. The grant of a profits interest in a partnership or limited liability company (an “LLC” or “Company”) will entitle the employee (“Employee”) to participate in all value of the Company in excess of the initial base value. For example, assuming a base value for the Company of $90X, all future profits and growth in value above $90X would be shared by the Employee as owner on the same basis as other owners share. If the Employee had a 2% profits interest, he or she would participate in 2% of all future profits and any growth in value. If the value increased to $190X as of a “liquidity event” (see below), the Employee would be entitled to $2X ($190X - $90X = $100X x 2% = $2X). A typical unvested LLC interest might carry the following rights and features (other variations are discussed in the last section of this outline):

Vesting. The interest would vest one-third each year for three years, so long as the Employee is employed. Any interest that was not vested upon termination of employment would be forfeited. The entire interest would be forfeited if the Employee were terminated for cause (or violated restrictive covenants, or upon any other agreed forfeiture events).

Ownership Rights. The Employee’s ownership rights would be limited to a right to a distribution of current profits sufficient to enable the Employee to pay any incremental income taxes he or she incurs with respect to the share of current profits, and, upon liquidity events, to receive his percentage of the growth in value.

Liquidity Events. The Employee would have a right to receive the value of the profits interest (subject to vesting) upon a sale of the Company. If the entire Company were sold, and the Employee had a 2% profits interest, he or she would receive 2% of the growth in value. If a portion of the Company were sold or distributed, the Employee would participate in distribution of the sales proceeds pro rata on the same basis (to the extent of the growth in value) as all other owners.

Other Features. Upon the Employee’s termination of employment before a “liquidity event,” the Company would have a right to call or redeem the Executive’s vested interest based upon the growth in value from the date of grant to date of call. The call value could be established by appraisal by an independent appraiser selected by the Company. The profits interest would typically be a non-voting interest.

B. Basic Tax Consequences. In general, the transfer of property, including the grant of a partnership or LLC interest as well as the transfer of employer stock, is governed by the rules dealing with transfers of property (Internal Revenue Code (“Code”) Section 83 and Treas. Reg. §§ 1.83-1 through 1.83-8). Those rules establish the following general tax treatment of property transfers:
1. **General Rule.** If property is transferred to a person in connection with the performance of services to the service provider, an amount equal to the fair market value of the property transferred reduced by the amount, if any, paid for such property is includable in gross income in the first taxable year in which the transferee’s rights are first either transferable or not subject to a substantial risk of forfeiture. (Code § 83(a)). Thus, the date of taxation essentially is when the property is, in the ordinary parlance, vested.

2. **Section 83(b) Election.** The recipient of property may elect to be taxed immediately on its grant, notwithstanding the fact the transfer is not vested by making a Section 83(b) election. (Code § 83(b) & Treas. Reg. § 1.832).

3. **Company’s Deduction.** The employer is entitled to a deduction with respect to the transfer of property at the time the transfer is taxable to the employee. (See generally Code Section 83(h) & Treas. Reg. § 1.83-6.) The amount of the employer’s deduction is equal to the amount included in the Employee’s taxable income.

4. **Capital Gain and Holding Period.** On sale of the profits interest, the Employee would be taxed at capital gains rates (assuming he or she meets the holding period requirements) on the sales proceeds in excess of the tax basis. For these purposes, tax basis would include any amount paid for the unit and any amount of undistributed income of the partnership previously taxed to the employee. The Employee’s holding period for purposes of long-term capital gains commences as of the date on which the employee is taxed. (See generally Code Section 83(f) & Treas. Reg. § 1.834.)

C. **Rev. Proc. 93-27.** Revenue Procedure 93-27, 1993-27 C.B. 343, creates a special tax exception where the LLC interest is strictly a profits interest and not a capital interest. Rev. Proc. 93-27 defines a “capital interest” as an interest that would give the holder a share of the proceeds if the partnership’s or LLC’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership or LLC, as determined “generally” at the time of receipt of the partnership or LLC interest. It defines a “profits interest” as any interest other than a capital interest. It then holds that “if a person receives a profits interest for the provision of services to or for the benefit of a partnership [or LLC] in a partner capacity or anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.”

The revenue procedure does not apply in three circumstances: (1) where the profits interest relates to a substantially certain and predictable stream of income from partnership or LLC assets; (2) where the profits interest member disposes of the profits interest within two years of receipt; or (3) where the profits interest is in a publicly traded partnership.

II. **The Impact of Rev. Proc. 2001-43**

A. **The Issues.** For a number of purposes, federal tax law divides interests in partnerships or LLCs into “capital” and “profits” elements. When a service provider to a partnership or LLC is given a profits interest with no present capital value, but with a right to participate in future earnings or growth, the economic effect is similar to giving an employee a stock option with an exercise price equal to the current value of the stock.

Taxing the receipt of a profits interest by the service provider would distort the employee’s income. Since any income the employee will derive from the partnership or LLC has yet to be earned,
and since the partnership or LLC is a flow-through entity, an employee who must pay tax on all amounts
derived from the partnership or LLC as they are earned, and also pay an initial tax on the value of the
granted profits interest, will pay tax twice on the same earnings. (The employee would get a capital loss
when the partnership or LLC is later liquidated or the employee disposes of the interest, but the
employee may then be unable to utilize the a capital loss.) Rev. Proc. 93-27 recognized the illogic of
that result by providing that a service provider need not pay an initial tax on the value of the profits
interest when granted.

But Rev. Proc. 93-27 left some doubt whether its no-tax result applied to grant of an unvested
limited liability company interest. Taken literally, the rules of Section 83(a) might be viewed as imposing
a tax when the interest vested, by which time the profits interest might have increased in value and
might indeed have become a capital interest (by giving the holder a capital account interest in retained
profits earned after the initial grant). The risk of tax at the time of vesting could be eliminated by a
protective Section 83(b) election. However, the grant of an unvested profits interest could be thought to
be similar to an unfunded promise to pay money or transfer property in the future, which is not itself a
property interest governed by Section 83, and which may not be subject of a Section 83(b) election.
(See Treas. Reg. § 1.83-3(e).) Even if permissible, making a Section 83(b) election for a partnership or
LLC profits interest still generated some fear that the Service would then impose a tax at the time of the
election on the value of the profits interest at that time (less the amount that the Employee paid for the
grant, if anything).

provider is a profits interest is, in general, tested at the time the interest is granted even if the interest is
substantially nonvested (within the meaning of Treas. Reg. § 1.83-3(b)). Thus, neither the grant of the
interest nor its vesting will be taxable events for the partnership or LLC or the service provider, and the
service provider need not file a Section 83(b) election.

Two conditions must be satisfied for this treatment to apply. First, the partnership or LLC and
the service provider must treat the service provider as the owner of the partnership interest on the date
of its grant, and the service provider must take into account his or her distributive share of company
income, gain loss, deductions, and credit associated with that interest. This makes it important for the
partnership or LLC to distribute enough from its profits to enable the service provider to pay the tax on
those profits -- at least to the extent that other members of the partnership or LLC have a right to
distributions to pay taxes.

Second, upon the grant of the interest, or at the time the interest becomes substantially vested,
neither the partnership or LLC nor any of its members may deduct any amount (as wages,
compensation or otherwise) for the fair market value of the interest. The three generally applicable
conditions of Rev. Proc. 93-27, noted above, must also be satisfied.

C. Some Consequences of Rev. Proc. 2001-43. While a profits interest in a partnership
or LLC has some of the economic attributes of an option to purchase such interest, the tax
consequences may be different; and the greater certainty now available for partnership or LLC
unvested profits interests should reduce the number of situations in which options should be considered.
If an option is granted, Section 83 necessarily applies at the time of exercise; at which time the interest
is likely to be a capital interest even if it was a profits interest originally . Thus the service provider
would incur ordinary income (though the partnership or LLC would be entitled to a corresponding
deduction). Options for partnership or LLC interests should accordingly be limited to situations where