CORPORATE MATTERS: PROFITS INTEREST BASICS

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INTRODUCTION

In previous articles we have discussed the relative flexibility of limited liability companies ("L.L.C.'s"), which are generally taxed as partnerships, and their desirability for use in many instances, including joint ventures. Another demonstration of the flexibility of L.L.C.'s is in the area of incentive ownership interests. Often, when people think of incentive awards, it is in the context of C-corporations and stock option grants. We have found that in many instances, upon the formation of an L.L.C. to be used as a joint venture entity, the members (partners) want to set aside certain interests to be awarded to service providers or employees as incentives.

Business entities that are treated as partnerships for U.S. Federal income tax purposes do not qualify for certain statutory benefits that are available only to C-corporations and S-corporations; a business entity that is treated as a partnership for tax purposes cannot issue incentive stock options. However, a business entity that is treated as a partnership for tax purposes can often use a profits interest (*i.e.*, a share of future profits and appreciation but none of the existing value of the partnership) to achieve the same or better tax result for its holders.

WHAT IS A PROFITS INTEREST?

Partnership interests can be divided into capital interests and profits interests. A capital interest is a partnership interest that gives the owner the right to a share of proceeds if the partnership assets were sold at their fair market value and the proceeds distributed in a complete liquidation of the partnership. A profits interest is a partnership interest that gives the owner the right to receive a percentage of future profits (but not existing capital) from the partnership.

Most commonly, a profits interest is granted to a partner in exchange for a contribution of services. By contrast, a capital interest is typically granted to a partner in exchange for a contribution of cash or other property. Because some investor partners are also executives or senior managers, an investor partner may also be granted a separate profits interest in exchange for a contribution of services.

Unlike the owner of a capital interest, the owner of a profits interest has no current capital at risk in the venture and, usually, has no obligation to contribute funds in the future. Therefore, all that can be lost by the owner of a profits interest are profits earned after the grant date of the profits interest.

A profits interest can arise in many contexts, but its most common application is to align a service partner's economic interest with that of the business entity for which the services are provided. In the corporate context, stock options, restricted stock, statutory incentive stock options and phantom stock plans can be used to

incentivize a service provider. In the partnership context a profits interest is by far the most common device.

WHO CAN GRANT A PROFITS INTEREST?

A profits interest can be granted by any entity that is treated as a partnership for U.S. Federal income tax purposes. This includes every business entity having two or more owners and not taxable as a corporation. These entities include general partnerships, limited partnerships, limited liability partnerships, limited liability limited partnerships and L.L.C.'s that have not made an election to be treated as a corporation for tax purposes.

If a limited liability company has a single owner, it is treated as a disregarded entity for U.S. Federal income tax purposes, unless it elects to be treated as a corporation for tax purposes. If a service provider is granted a profits interest in a disregarded entity, the creation of the profits interest automatically converts the disregarded entity into a partnership (for tax purposes) by virtue of the second ownership interest.

POSSIBLE ADVERSE CONSEQUENCES FOR EMPLOYEES

In addition to profits interests being granted to service providers, another common use for a profits interest is to grant a small profits interest in the partnership to a valued employee. The owner of a partnership interest cannot simultaneously be treated as an employee of the partnership. Therefore, if a profits interest is granted to an existing employee, what formerly was salary is converted into self-employment income. If the profits interest is small compared with the employee's annual salary, the burdens and costs of the profits interest grant may exceed the benefits. In such cases, alternate forms of compensation or alternate structures such as a tiered structure should be considered.

In a common tiered structure, a new partnership is formed, and it is given an ownership interest in the operating partnership. Profits interests in the upper-tier partnership are granted to employees or partners of the operating partnership. This tiered structure creates a formal division between the partnership for which the employee works and the partnership in which the employee is given a profits interest and so avoids potential adverse tax consequences for the employee. In addition, the owner of the profits interest does not necessarily have access to the operating partnership's records and in certain circumstances, this may be a desired result.

RIGHTS AND OBLIGATIONS OF OWNERS

It is important to remember that a profits interest is a partnership interest and therefore has all the rights and obligations that flow from having an ownership interest in the partnership. For example, if the partnership is formed as a general partnership, the owner of a profits interest is a general partner under applicable state law and is liable to creditors of the partnership despite anything in the partnership agreement to the contrary. For this reason, it is common to see profits interests limited to business entities offering limited liability protection.

In addition, the owner of a profits interest has whatever rights are provided by applicable state law to members of the partnership including, in many cases, the right to inspect the books and tax returns of the partnership. In the case of a small profits interest granted to incentivize a service partner, these ancillary rights can be more than the partnership wishes to grant. However, a tiered structure, referred to above, can be used to limit access to the records of the operating partnership.

TAX-FREE GRANTS

If structured properly, the I.R.S. has ruled that the contribution of services to a partnership in exchange for a profits interest is tax-free to the service partner and to the partnership at the time of grant and as it vests provided the following four requirements are satisfied:

1. The service partner must receive only a profits interest in the partnership in exchange for the contribution of services (*i.e.*, the service partner cannot be given a share of current capital in exchange for the contribution of services).

2. The profits interest must not relate to a "substantially certain and predictable stream of income" such as high-quality debt securities or a high-quality net lease of the partnership.

3. The service partner must not dispose of the partnership interest within two years of receipt of the interest.

4. The partnership must not be a "publicly traded partnership."[1]

Note that the first requirement (no interest in the partnership's current capital) means that if the partnership is liquidated immediately after the profits interest is granted, the owner of the profits interest would receive nothing. If, however, the partnership remains in existence and then turns a profit, the owner of the profits interest is entitled to a share of the profit earned since the date of grant.

If a service partner is granted a capital interest in exchange for a contribution of services, the service partner is taxed on the fair market value of the capital interest and there may also be tax consequences to the other partners and the partnership. For this reason, it is more common to grant a profits interest to a service partner.

Recent tax legislation has changed the treatment of certain profits interests. Prior to the change, recipients of profits interests generally realized long-term capital gain income. Under the new Code §1061, applicable to certain investment and real estate partnerships, a three-year holding period is now required to be eligible for long-term capital gains treatment.

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[1] Rev. Proc. 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43, 2001-2 C.B. 191.

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