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Business Briefs
Legal Update

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Protect The Interest In What You've Built and Prepare for the Future

Many business owners favor the limited liability company structure (taxed as a partnership) over a corporation formation when starting their business. Due to the benefits of flow-through taxation and increased flexibility, the LLC provides many advantages that a corporation cannot provide.

After years of growing the business into a profitable organization, business owners often face the problem of retaining talented employees to take their business to the next level. In order to resolve this issue, an attractive option to business owners is to incentivize their employees with equity in the company. By giving the employee an ownership interest, the employee feels tied to the success of the business and will, in theory, work harder and stay at the company.

However, granting ownership in the company via capital interest creates an issue that the owner may not have intended. A capital interest is an interest that entitles the holder to share in the proceeds if the LLC's assets are sold at a fair market value and the proceeds are then distributed in a complete liquidation of the LLC after the interest is granted. For example, let's say an LLC, taxed as a partnership, granted an employee a 10% capital interest in the company. If the company is then sold the following day for $10 million, the employee (now partner) would be entitled to one million dollars, even though he has only been a partner for one day. The owners' profits for the years of hard work have now been minimized.

In order to resolve this issue, a business owner can offer a "profits interest." A profits interest is an interest that upon liquidation of the LLC, the recipient only has a share in the future profits and appreciation in value of the LLC following the date of grant.

Going back to the hypothetical, the employee is granted a 10% profits interest in the company. The value of the company on the date of issuance is $10 million. Two years later, the company is sold for $12 million. The liquidation distribution would result in $11.8 million to the original owners ($10 million prior to the date of issuance of the profits interest to the employee + 90% of the $2 million from the date of issuance) and $200,000.00

to the employee (10% of the value of the company from the date of issuance).

Current IRS regulations provide that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of the interest as a taxable event for the partner or the partnership if certain requirements are met.

To accomplish this:

- The profits interest must not relate to a substantially certain and predictable streams of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
- Within two years of receipt, the partner cannot dispose of the profits interest; or
- The profits interest is not a limited partnership interest in a "publicly traded partnership" within the meaning of the Internal Revenue Code.

It is advisable that your Operating Agreement is amended in order to allow for granting profits interest. If not, this can result in significant tax consequences because most Operating Agreements only account for capital interests. Rendigs is able to assist should you want to review this important document.

Issuing Unvested Profits Interests

Many employers worry that if an employee is given a profits interest, he or she will not perform at the same level as he or she did prior to having a profits interest. However, if structured properly, a business owner can set up certain milestones (dollar amount in sales, length of employment, etc.) that the employee must reach in order to obtain a profits interest. Once the employee meets these milestones, the employee will gain ownership of the profits interest. This is called a vested interest.

While a number of tax issues arise when profits interests are issued, but not yet vested, the primary question is "**when does the ownership transfer for tax purposes?**"

Most commentators suggest a service provider who receives a non-vested partnership profits interest can be recognized as a partner from the time he or she receives the interest. In order to pass IRS muster, the following conditions must be satisfied so that the receipt of such profits interest is not treated as a taxable event for the recipient or the company:

- Adhere to the three requirements for profits interest laid out above.
- Both the LLC and the recipient must treat the recipient as a "real" member for tax purposes with respect to the entire profits interest granted beginning on the date of grant (i.e., the LLC must provide the recipient with a K-1, and the recipient must pay his or her share of the taxes on the LLC's income); and
- Neither the LLC nor the recipient may take any compensation deduction in connection with the profits interest.

Careful drafting of the Operating Agreement must take place in order to account for the granting of a profits interest that is substantially unvested. If not, there is a significant likelihood that the intended profits interest will actually be treated as a capital interest. This opens a whole new can of worms for both the recipient and company in regards to potential adverse tax consequences.

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