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When Reality Collides With Legality: Profits Interests in Practice

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In this article, Norman and Chasteen review the legal requirements, common practices, and resulting tax consequences of, or relating to, profits interests. They also discuss best practices that companies should consider when granting profits interests prospectively.

Passthrough entities — limited liability partnerships and limited liability companies, most commonly — are increasingly taking center stage for both operating businesses and investment structures. While business owners and investors welcome the tax advantages that partnerships[1] offer, they may be more reluctant to let go of familiar features and terms of corporations. In many ways, partnerships (and especially LLCs) are flexible enough to accommodate corporate concepts. In others, however, the differences between partnerships and corporations, and their respective tax treatment, cannot be bridged so easily, such as how to incentivize key service providers. Partnerships offer tax-efficient alternatives for equity compensation that corporations cannot — namely, profits interests — with attendant legal requirements that remain unintuitive to business teams and investors. This article explores the resulting tension between what tax law requires and what is often done in practice, discusses the key tax consequences (intended and otherwise), and suggests best practices for partnerships that plan to offer profits interests in the future.

Much has been written regarding the policies and politics of profits interests, and rather than reprise these excellent commentaries,[2] we will discuss how profits interests are understood, used, and misused from a practice-oriented perspective. Because clients often struggle to grasp the concept of "profits interests" when presented in detail, the simplest explanation is generally more effective — a profits interest is simply an ownership interest in a partnership that gives the owner the right to share in the profits of the partnership in the future. While the owner of a profits interest has no rights regarding partnership *capital*, he will be able to benefit from the partnership's future success — and do so with beneficial tax treatment (at capital gains rates, rather than the ordinary income rates that apply to compensation).

[1]We use the terms "partnership" and "partner" to also refer to other passthrough entities (such as LLCs) and their members.

[2]For a discussion of history as well as additional analysis of profits interests, see Afshin Beyzaee, "Practical Considerations for Issuing Profits Interests, Part 1," *Tax Notes*, June 9, 2014, p. 1157.

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I. Beyond the Boilerplate

The tax efficiency of profits interests does not come without cost. Profits interests are attractive because of their beneficial tax treatment, and thus ensuring that profits interests will be respected by the IRS is (or should be) vital. Generally, practitioners advise that profits interests be structured to comply with the safe harbor rules the IRS set forth in Rev. Proc. 93-27[3] and the additional clarifying guidance provided in Rev. Proc. 2001-43.[4] The form this advice takes, however, is often limited to a boilerplate provision in the partnership operating agreement that cites the revenue procedures and states (in more or less detail) that all profits interests will comply with the rules set forth therein. That is not to diminish the importance of tax boilerplate and savings clauses in agreements, because they are essential to effective drafting — but simply including a paragraph stating that profits interests will comply with specific IRS authority is insufficient. Rather, it is crucial that both partnerships and partners understand the meaning behind these boilerplate clauses as well as the resulting requirements and tax consequences. While most tax lawyers acknowledge that standard tax provisions fall somewhere short of immortal prose, it is best to assume that everyone else skips over them completely.

Both of the above-mentioned revenue procedures offer practical guidance that is crucial for clients who are considering incentivizing service providers with profits interests. For instance, Rev. Proc. 93-27 established the general rule 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 Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership."[5] Rev. Proc. 93-27 further provided that the general rule would not apply to profits interests that: (1) relate "to a substantially certain and predictable stream of income"; (2) are disposed of within two years of receipt; or (3) relate to an interest in a "publicly traded partnership" within the meaning of section 7704(b).[6] Moreover, Rev. Proc. 93-27 helpfully defined the terms "capital interest" and "profits interest."[7]

Although Rev. Proc. 93-27 provided partners and partnerships with much-needed guidance on the tax treatment of profits interests, many were still left to wonder how such treatment would vary if the profits interest was granted with vesting conditions, and even more, grappled with whether the beneficial tax treatment of profits interests required the holder to make an election in accordance with section 83(b). Many of those questions were answered when the IRS issued Rev. Proc. 2001-43. The key takeaways of Rev. Proc. 2001-43 are that (1) it is acceptable to impose vesting conditions on the grant of a profits interest because neither the grant nor subsequent event of a profits interest will give rise to a taxable event, and (2) taxpayers need not file a section 83(b) election for any profits interests satisfying the requirements of Rev. Proc. 2001-43.[8] To ensure this treatment would follow, the following conditions must be met: (1) the parties must treat the recipient of the profits interest as the owner of the partnership interest from the date of its grant (that is, taking into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest for the entire period during which the service provider has the interest); (2) neither the partnership nor any of the partners take a deduction for the FMV of the profits interest (either at grant or vesting); and (3) all conditions of Rev. Proc. 93-27 are satisfied.[9] Despite the additional guidance set forth in Rev.

[3] 1993-2 C.B. 343.

[4] 2001-2 C.B. 191.

[5] Rev. Proc. 93-27, section 4.01.

[6] *Id.* at section 4.02.

[7] *Id.* at sections 2.01 and 2.02.

[8] *Id.* at section 3.

[9] *Id.* at section 4.

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Proc. 2001-43, the authors continue to advise taxpayers to file protective section 83(b) elections as a best practice.[10]

II. Profits Interests Gone Awry

Despite the guidance provided in the revenue procedures described above, several traps for the unwary that pose consistent challenges for businesses are noted below.

A. Compensatory Grants of Partnership Interests

An award of partnership equity can be called a profits interest, and it can look like a profits interest, but if it entitles the recipient to any part of the existing capital of the partnership, it isn't a profits interest — or at least not a "pure" profits interest. The FMV of the "built-in" interest in partnership capital is taxed as compensation income (at ordinary rates) to the recipient.[11] Under section 83, the capital (that is, the equity) granted to the service provider as part of the profits interest is treated as a cash bonus paid by the partnership, which the service provider is then deemed to contribute back to the partnership as purchase price for the equity.[12]

B. Confusing Profits Interests, Options, Stock

Many clients have worked with equity incentive awards in the corporate context and try to conceptualize profits interests — unique to partnerships — within the more familiar framework of traditional corporate equity incentive awards. The confusion is understandable, especially regarding traditional corporate options and restricted stock, but the tax treatment of these awards can be strikingly different. For instance, the grant of a restricted membership interest is an immediate transfer of a "capital interest" in the partnership subject to a substantial risk of forfeiture, which is generally not taxed upon the grant date. It is important that the recipient becomes a partner as of the grant date. Restricted membership interests are generally subject to ordinary income tax rates upon the date the interest first becomes nonforfeitable, or upon the partner's section 83(b) election.[13] A proper section 83(b) election starts the clock on the underlying membership interest for capital gains tax purposes.

Alternatively, the grant of an option to purchase a capital interest does not result in the immediate transfer of property, but rather the partner's right to purchase a capital interest at a specified exercise price at a later date (generally after specific vesting conditions are satisfied). Unlike a restricted membership interest, the recipient of an option does not become a partner on the grant date, and no taxation occurs upon vesting. Rather, once the option vests and is exercised, the recipient would become a partner and would be taxed at ordinary income tax rates on the excess of the FMV of the membership interests at the time of exercise over the exercise price.[14] Before granting any options to purchase membership interests, partnerships should be mindful of a complex set of rules governing nonqualified deferred compensation, known as section 409A.[15] That is because if the options were not structured to meet requirements ensuring exemption from section 409A, they would likely be subject to serious and unintended adverse tax consequences.[16] Finally, as noted above, the grant of a profits interest is the transfer to the recipient of the right to share in the profits of the partnership prospectively. Like restricted membership interests, the recipient of a profits interest becomes a partner as of the grant date (even if subject to a substantial risk of forfeiture).[17] It is important to note that if the recipient is not treated as a partner as of the date of grant of the profits

[10] While it is clear that a section 83(b) election is not required if the requirements of Rev. Proc. 2001-43 (and Rev. Proc. 93-27) are satisfied, many practitioners recommend that recipients of profits interest awards file timely section 83(b) elections as a "belt-and-suspenders" protection. Given that some requirements are prospective (and thus uncertain at the time of grant), such as the two-year holding period, it makes sense to file protective section 83(b) elections when possible.

[11] *See Diamond v. Commissioner*, 429 F.2d 286 (7th Cir. 1974), *aff'g* 56 T.C. 530 (1971).

[12] This parallels with the tax treatment that would result when the service recipient is a corporation. *See, e.g.*, reg. section 1.1032-(a).

[13] Section 83(b); and reg. section 1.83-1, -2.

[14] Reg. section 1.83-7.

[15] *See, e.g.*, section 409A; reg. section 1.409A-1(b)(5); and prop. reg. section 1.409A-4.

[16] Prop. reg. section 1.409A-4(b)(6).

[17] *See* Rev. Proc. 2001-43, section 4.

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interest, the profits interest would likely not qualify for the safe harbor treatment of Rev. Proc. 2001-43 and would have to rely on prior case law and guidance other than the revenue procedures described above to determine the appropriate tax treatment. This could lead to a costly and uncertain path.

C. Navigating Dual Status as Employee & Partner

A profits interest is fundamentally an equity interest in the partnership. It follows that holders of profits interests are therefore *partners* of the partnership, and it is *as partners* that profits allocated are eligible for preferential capital gain treatment. Currently, tax law puts "partners" and "employees" into distinct categories, like apples and oranges. A partner simply is not an employee. However, this legal distinction ignores numerous practical realities — including that profits interests are most commonly awarded to key *employees*, and the purpose of the awards is to encourage employees to continue (and excel) in their current roles.

Safeguarding partner status is thus often at odds with practical realities. The profits interest holder must be treated as a partner under state law, and both the partnership and the holder should uphold the formalities of partner treatment.[18] Businesses often react by asking, "What's the problem? So what if my top employees are partners as well as employees?" And when tax advisers are retained (often for a future exit transaction), they confront a practical reality when profits interest recipients are also treated as employees for all material purposes.

Current federal tax law, however, provides that the recipient of a profits interest cannot be both a partner and an employee, and in the case of a properly granted profits interest, partner treatment trumps.[19] The practical consequences of this distinction are not trivial, and include those listed below.

Employees are subject to income and FICA tax withholding (and Form W-2 reporting) on wages. Partners, on the other hand, receive Forms K-1 from the partnership, and pay income and self-employment taxes on "wages" on a quarterly estimated tax basis.[20] Also, it may be surprising to some recipients of profits interests that they will experience an increase in the amount of employment taxes. Employment taxes for employees are split equally with the employer (with each party generally paying about 7.65 percent).[21] Partners do not receive similar treatment, and thus bear the full weight of self-employment taxes at a rate of about 15.3 percent.[22]

The values of some employer-provided health, welfare, and fringe benefits are generally nontaxable to employees, but are taxable (with offsetting deductions) to partners.[23]

Only employees are permitted to participate in cafeteria plans, including flexible spending arrangements, and permitting partners to participate in these arrangements could result in the disqualification of the plan or arrangement in its entirety, for all participants.[24]

As discussed above, the availability of the Rev. Proc. 2001-43 safe harbor for profits interests requires recipients to be treated as partners from the date of grant. Failure to do so would likely preclude application of the safe harbor treatment

[18] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[19] The IRS has consistently taken the position that partners may not be employees of the partnerships in which they hold membership interests. *See, e.g.*, GCM 34001 (Dec. 23, 1968); GCM 34173 (July 25, 1969); Rev. Rul. 69-184, 1969-1 C.B. 256; and Rev. Rul. 81-300, 1981-2 C.B. 143. More recently, Treasury and the IRS published temporary and final regulations providing guidance on the appropriate treatment of partners in a partnership that owns a disregarded entity. *See* reg. section 301.7701-2. These new regulations clarified, contrary to what some previously believed, that when a partnership is the sole owner of a disregarded entity, partners in that partnership might not be treated as employees of the disregarded entity.

[20] *See* section 1402(a); reg. section 1.1402-1(b). Payments that the partnership makes to limited partners *other than* guaranteed payments for services are not subject to self-employment tax (section 1402(a)).

[21] These estimates do not include the potential additional Medicare tax that may be imposed on some high earners.

[22] *Id.*

[23] *See, e.g.*, section 106.

[24] Prop. reg. section 1.125-1(g)(2).

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to the profits interest in question, leaving the individual left to navigate a path of uncertain tax consequences.

D. Practical Missteps at Time of Issuance

1. Understanding the implications of a defective profits interest.

While helpful, the guidance provided by Rev. Proc. 93-27 left areas of uncertainty. As noted, a debate continues about whether award recipients should file section 83(b) elections as a matter of course. Also, if a profits interest is not respected by the IRS and is instead taxable compensation, the partnership faces legal and practical problems. Reconciling the rules of subchapter K with those under section 83 is far from straightforward, and taxing service providers on the receipt of a defective profits interest affects the allocation of income and deductions (and partner capital accounts) at the partnership level.

2. Trying to 'do it all' in the operating agreement.

While it is essential that partnership agreements be drafted carefully and in contemplation of the issuance of profits interests, the details of each award (distribution threshold, vesting conditions, and any requirements for section 83(b) elections) can be segregated into a separate award agreement.

3. Setting the distribution threshold (the FMV of partnership capital) without deliberation.

As discussed above, to the extent that a profits interest entitles the recipient to a share of partnership capital, there will be compensation to the service provider (and attendant challenges to the partnership). While determining the FMV of partnership capital on a deemed-liquidation basis can be difficult, the valuation should not be made by tax lawyers (or their nontax colleagues). Rather, the deemed liquidation value should reflect business realities, such as the present value of the partnership's projected cash flows.

4. Forests and trees: Forgetting the business deal.

While profits interests are rife with advantages, they remain unfamiliar to many clients. Partnerships in general offer significant flexibility as well as tax-efficiency. For business owners and investors who have more experience using corporations, however, profits interests (among other aspects of partnership taxation) come with a steep learning curve. The challenge for advisers is to educate clients about how to properly structure and administer a profits interest award without becoming mired in legalities. Profits interests, for all of their complexities, offer real practical advantages to clients — not the least of which is giving employers and owners a highly tax-efficient method of providing service providers with equity incentives. The flexibility of profits interests allows employers and owners to accomplish their own business and economic objectives, whether with vesting restrictions, fixed profit shares or capped participation, or catch-up rights. Further, profits interests can provide recipients with a share of *current* operating profits (so that the distribution threshold is met on liquidation or other capital events), or they can be structured so that recipients only share in profits on liquidation. When clients become frustrated by the complexity of profits interests, the role of the tax adviser is to present the forest as well as the trees by reminding them that, with proper planning and education, profits interests can be used to advance and complement the clients' businesses.

III. Considerations for Future Grants

The practical pitfalls and challenges discussed above illustrate the importance of implementing best practices in navigating profits interests.

A. Revisiting the Operating Agreement

When profits interests are introduced in existing partnerships, the operating agreement must be amended. New provisions and terms must be added to reflect the new interests and provide authority for their issuance. While necessary, these changes alone are insufficient and can lead to confusion and conflict. Clients — and their advisers — should consider incorporating additional terms into the operating agreement such as voting rights, redemption, call and drag rights, and detailing how the distribution waterfall should be structured. (For example, will profits interest holders share in operating profits throughout the term of the agreement, or will the right to share in profits be triggered only upon liquidation? What method of valuation is both reasonable and practical for determining the "distribution threshold" for profits in either case?) While these are concepts that most businesses should

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regularly revisit, such consideration should definitely occur upon each issuance of partnership profits interests. Depending on the business terms and objectives, it is possible that the operating agreement will need to provide for tax distributions (for example, if profits interest holders are allocated profits while the interest is still unvested).

B. Tax Reporting and Classification

Clients will also benefit from knowing as early as possible that the receipt of a profits interest causes the recipient's tax status to change from an employee to a self-employed partner. This head start is often essential to give clients time to educate the award recipient about the implications of the status change and to allow sufficient time for shifts in reporting and administration. Initiating these discussions as soon as possible provides clients with opportunities to consider tax reporting obligations (that is, the additional Forms K-1), resulting logistical issues (for example, timing), and the effects the change in status will have on employee benefit plans and programs.

IV. Conclusion

Partnership taxation is rarely straightforward, and profits interests combine some of the best — and the most challenging — features of subchapter K. As a form of equity incentive, profits interests can be extremely attractive to both businesses and their service providers. Still, clients with corporate experience may not ask the right questions, and often assume that corporate principles that appear similar to profits interests apply in the same way in the partnership setting. The steep learning curve presents a range of challenges from basic principles to back-office implementation. Nonetheless, to the extent tax advisers can translate the applicable technical requirements — and attendant advantages of profits interests — into practical, real-world advice before the first award is ever granted, business operations (and service providers) will benefit tremendously without suffering unintended and adverse tax consequences. ■

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