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THE PROFITS-ONLY INTEREST: REWARDING SERVICE AND INCENTING PERFORMANCE IN AN LLC

Last August the *Minnesota Revised Uniform Limited Liability Company Act* became effective. The new laws, codified in Minnesota Statutes Chapter 322C, overhauled the prior framework governing LLCs in the state (Chapter 322B), and moved from a corporate model to a more flexible one based on partnership principles. The updated statutes apply to any LLC formed in Minnesota on or after August 1, 2015. Limited liability companies in existence before that date may opt in to Chapter 322C, though the new statutes will automatically apply to all LLCs in the state as of January 1, 2018.

An LLC is a popular choice for many business owners because it provides personal liability protection in a manner similar to corporations, but without the governance formalities that the latter must follow. Those features, combined with the option of pass-through taxation for an LLC, make it attractive for someone starting a new business.

However, one factor a new business should consider in choosing an entity is the extent to which it believes it will want to reward or compensate key service providers to the business with equity interests in the business. LLCs are typically taxed as partnerships (for reasons beyond the scope of this article). However, tax partnerships are not allowed to provide stock options to employees. If you believe your business will want to compensate employees with equity interests, you should reconsider whether an LLC is the correct choice of entity, and/or advise your employee to seek counsel as to the substantial tax consequences of being compensated with equity. Nonetheless, granting a “profits only” interest (sometimes referred to as simply a “profits interest”) is a tool that can be utilized by tax partnerships to compensate non-employee service providers and employee service providers (as long as the employee fully understands the tax consequences of receiving a profits-only interest).

A profits-only interest does not convey or create any ownership interest in the company’s existing assets. It only grants a defined interest in the future value of the LLC. If the company were liquidated immediately after a profits interest is granted, the recipient of a profits-only interest would receive nothing. If the company were liquidated at a later date, and profits had been allocated to the respective capital accounts, the profits only interest recipient will pay income tax on those profit allocations. A profits only interest recipient is not allowed to participate in operating losses that bring his or her capital account below zero.

Providing a profits interest can be an effective way to both compensate and *incent* a service provider because it creates an equity interest, tying the value of the award to both the performance of the company as well as to the length of time the recipient remains at the service of the company similar to the incentives corporations employ in the form of stock options. The terms of a profits-only grant can be flexible. They may, for example, include a vesting or forfeiture provision (e.g., to encourage a key service provider to remain a part of the company), restrict transfer of the interest, or be tied to personal performance criteria, completing specific projects, or the company's achievement of particular benchmarks.

Tax Implications of a Profits Interest Grant

Although flexible, the tax treatment of a profits interest are complex. Distilling the full constellation of tax implications is beyond the scope of this article. However, two important tax-related issues warrant mention.

- Under IRS Revenue Procedure 93-27, no taxation will occur at the time of the grant of a profits-only interest if the award meets the following "safe harbor" criteria:

    - the LLC does not have a predictable income stream from a lease or debt security;
    - the profits-only interest is held for two years; and
    - the interest is not a limited partner interest in a "publicly traded partnership" as defined in IRC §7704(b).

  The LLC would not receive a tax deduction for the profits-only interest if it is tax-free to the recipient. If the grant does not meet the above criteria, the fair market value of the interest at the time of the grant would be taxable to the grantee, and would be a tax deduction for the LLC. Additionally, an *unvested* profits interest grant will be non-taxable if the recipient is treated as the owner from the moment the grant is made, regardless of the vesting period.

- Section 83b of the Internal Revenue Code provides that if a service provider is compensated with property instead of cash, gain realized on the property is not reported as income until either: (i) the time the property is transferred (sold) by the service provider; or (ii) the time the property is no longer subject to forfeiture. Whichever of those events occurs earlier is the triggering event. An election must be filed with the IRS to take advantage of section 83b's tax deferring benefits. Since a profits only interest is worth nothing when granted, it makes sense to file a section 83b election because it can be an additional safeguard in the event the profits-only interest fails to meet the IRS safe harbor provisions discussed above.

In summary, a profits-only interest can be an effective method of rewarding key service providers to an LLC and incenting both their relationship with the company and continued high performance. Further, the terms and conditions of the grant may be tailored to meet the goals of the LLC and tied to a variety of benchmarks or other performance measures. They may also include a vesting period or a restrictions on transfer. However, this flexibility is tempered by the array of tax and related accounting implications that flow from an LLC's granting of such interests. Any company considering granting a profits only interest and any person offered one should obtain advice regarding the tax consequences of such a transaction from an experienced professional.