# Profits interest grants – basics

An easy and tax-efficient way for a partnership (or limited liability company, or LLC) to grant equity interests to key employees or service providers to motivate and reward them to grow the business involves the grant of something called a "profits interest." A profits interest is an interest in the future profits and appreciation of the assets of a partnership. A profits interest should be distinguished from a "capital interest," which is an interest where, if the partnership were to liquidate immediately after granting the capital interest, the holder would receive his or her proportionate share of the partnership's assets in the liquidation. The grant of the profits interest should not result in any taxable income to the recipient. A profits interest may be initially granted as a fully vested or may vest based on continued service or the achievement of business benchmarks related to the partnership's operations.

A profits interest may be structured similarly to a stock option but may be more attractive to the recipient because a profits interest grant, in some cases, can provide that all appreciation in value be taxed as long-term capital gains rather than ordinary income.[1] Unlike an option, a profits interest holder need not pay an exercise price to obtain the equity interest represented by the profits interest because the recipient is already viewed as a partner under the law. A profits interest holder also may fully participate in the partnership in a manner similar to other partners (or in a lesser role if that is what is decided) while the original members retain their full value of the partnership created prior to the grant of the profits interest.

As noted above, the receipt of a profits interest should not be taxable to the recipient – to achieve that end, the tax law provides safe harbors where purported profits interests will be respected as such if certain conditions are met.

*Vested profits interest*. The receipt of a profits interest in exchange for past or future services will not be treated as a taxable event for the recipient or the partnership if the following conditions are met:

- the recipient must receive the profits interest in his or her capacity as a partner, or in anticipation of becoming a partner, in exchange for the provision of services to or for the benefit of the partnership granting the interest
- the interest must not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease
- the recipient must not dispose of the profits interest within two years of receipt and
- the profits interest must not be a limited partnership interest in a "publicly traded partnership."

*Unvested profits interest*. Additional IRS safe harbor guidance provides that neither the granting of a profits interest nor the vesting of a profits interest will be treated as a taxable event. In order for the recipient to be treated as receiving the interest on the date of its grant, the following conditions must be satisfied:

- Both the partnership and the profits interest recipient must treat the recipient as a "real" partner for tax purposes with respect to the entire profits interest granted beginning on the date of grant (meaning, among other things, that the partnership must provide the recipient with a Form K-1, and the recipient must pay his or her share of the taxes on the partnership's taxable income, to the extent there is any)
- neither the partnership nor the recipient may take any compensation deduction in connection with the profits interest and
- all of the above requirements for vested interests must be satisfied.

Under the safe harbors referenced above, no "Section 83(b) election" need be made upon the grant of a profits interest. In effect, the partnership and the recipient are treated as if a Section 83(b) election was made by the recipient and assessed the fair market value of the profits interest at zero. Despite this protection, it is still advisable to file a "protective" Section 83(b) election upon receipt of a profits interest in the event any of the safe harbor requirements are not satisfied (*eg*, there is a disposition of the interest within two years). Any downside to filing an 83(b) election is generally considered minimal.

It is important to note that if an employee receives a profits interest, he or she can no longer be an "employee" of the partnership for tax purposes – the IRS position is that one cannot be both a partner and an employee of the same partnership. This means that any payment for services is subject to self-employment tax and certain benefits offered to partnership employees may no longer be available (*eg*, participation in cafeteria plans). Additionally, because the recipient of a profits interest is considered a partner of the partnership under the tax law, the profits interest holder will be required to report and pay tax on any income passed through from the partnership (whether or not the holder receives cash distributions from the partnership).

[1] Under current law, long-term capital gains rates are lower than ordinary income rates.

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