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The Tax Advantages to Emerging Businesses of Utilizing Profits Interests as Equity Awards

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When granting equity-based compensation to service providers, pass-through entities, such as partnerships and limited liability companies, have opportunities that are unique when compared to corporations. The tax consequences to the recipient of a partnership or membership interest in exchange for services rendered depend, however, upon the characterization of the interest as a "capital interest" or a "profits interest."

As background, under Sections 61 and 83 of the Internal Revenue Code of 1986, as amended (the Code), a service provider receiving property, such as an equity interest in the service recipient, in lieu of cash in exchange for services rendered is generally required to include the value of such property in his or her gross income. The taxable event and determination of value of transferred property occur at the time of transfer if the interest in the property is vested (transferable and not subject to a substantial risk of forfeiture) or, if the interest in the property is unvested at the time of transfer, at the time the interest becomes vested. However, the recipient of an unvested interest in property may alter the general timing rule and elect under Code Section 83(b) to include the value of the property in his or her gross income at the time of grant rather than at the time at which the property becomes vested.

Capital Versus Profits Interests

When applying the above rules, a capital interest is an interest that gives a service provider a share of the proceeds if the partnership's or LLC's assets were to be sold and distributed in a complete liquidation. An award of a capital interest is similar to an award of corporate stock, and is includible in the recipient's taxable income based on the fair market value of the interest on the date of grant (or the date of vesting if the award of the interest remains subject to a substantial risk of forfeiture).

Conversely, a profits interest entitles the holder only to future profits and appreciation of the entity's assets but not an interest in any liquidating proceeds that would be distributed if the entity were to be liquidated at the time the profits interest is granted. This characterization of a profits interest as, in essence, an appreciation right provides emerging businesses that are established as pass-through entities with access to a tax-advantaged equity award, whether the profits interest is vested or subject to forfeiture when granted. This treatment is contrasted with the receipt of restricted stock and stock appreciation rights, which require an ordinary income inclusion event coupled with a potentially significant income and employment tax burden.

The Safe Harbor for Profits Interest Grants

To address significant disagreement amongst courts regarding whether a profits interest is property or merely a speculative award with no determinable value, the Internal Revenue Service (IRS) established a safe harbor under Revenue Procedure 93-27. This guidance provides that the grant of a profits interest in exchange for services rendered to a partnership is generally not a taxable event and does not result in taxable income to the service provider, provided:

- The grantee receives the interest in a partner capacity or in anticipation of being a partner;
- The profits interest does not relate to a substantially certain and predictable stream of income from partnership assets;
- The partner does not dispose of the profits interest within two years of receipt; and
- The profits interest is not a limited partnership interest in a "publicly traded partnership" within the meaning of Code Section 7704(b).

The guidance in Rev. Proc. 93-27 raised the question of whether the guidance applied equally in the case of the grant of a vested versus an unvested profits interest. Namely, whether the characterization of the type of interest granted would occur at the time of vesting, requiring an election under Code Section 83(b) to protect the grant date treatment under Rev. Proc. 93-27. In the absence of such an election, practitioners feared that a profits interest subject to a substantial risk of forfeiture would trigger significant ordinary income if the value of the partnership or membership interest appreciated in value after the date of grant.

The IRS responded in Revenue Procedure 2001-43 by clarifying that whether an interest granted to a service provider is a profits interest is determined at the time the interest is granted, even if, the interest is unvested at that time. This treatment under Rev. Proc. 2001-43 is conditioned on the following requirements being met:

- Both the service recipient and the service provider must treat the service provider as a partner/member from the date the profits interest is granted;
- The service provider must take into account the distributive share of partnership income, gain, loss, and deduction associated with the profits interest for the entire period the service provider holds the interest;
- No compensation deduction may be taken by the service recipient or any partner/member in connection with the grant of the profits interest; and
- The safe harbor rule of Rev. Proc. 93-27 must also be followed.

By following the safe harbor rules in Rev. Proc. 93-27 and 2001-43, a partnership or LLC may award a service provider with an equity interest without the value of such an award being included in the service provider's ordinary gross income. Although, once the service provider is a holder of the profits interest he or she must be treated as a partner or member, as applicable, for purposes of taking into account the distributable share of pass-through income and loss and the application of the tax on self-employment, the appreciation in the liquidation value of the entity will enjoy capital gains treatment upon a future disposition. This can provide a significant future tax benefit to founders, employees, and advisors of emerging businesses.

Continued Applicability of Elections Under Code Section 83(b)

Although the IRS has indicated that it is unnecessary to file an election under Code Section 83(b) for an unvested profits interest if the safe harbor requirements are met, it may be advisable for recipients of unvested profits interest to file such an election as a protective measure in the event the safe harbor requirements of the Revenue Procedures discussed above (e.g., the two-year holding period) are not satisfied.

For more information on the matters discussed in this *Locke Lord QuickStudy,* please contact the authors:

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