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Navigating LLC Waters

Rewarding employees with LLC partnerships may stir up some whirlpools if tax implications haven't been carefully considered.

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WITH THE ADVENT OF LIMITED liability companies in the 1990s, more and more business transactions are being conducted through LLCs taxed as partnerships than through corporations. Compared to state corporate laws, LLC statutes are extremely flexible, readily lending themselves to complicated business transactions. With LLCs more often than not being the entity of choice, the issue that commonly arises is how to properly incentivize key employees with LLC membership interests.

In contrast to grants of stock and stock options, the rules for which have been around for decades and are well entrenched in the tax law, how the Internal Revenue Service treats the award of membership interests in LLCs is far from clear, and this lack of clarity can lead to some rather unintended consequences. The absence of any precise tax rules on the grant of non-corporate equity interests to key employees has in the past lead to unpleasant litigation with the IRS.

Yet, after seeing its theory on the proper taxation of the receipt of a partnership profits interest in exchange for services being rejected by the courts, the IRS called a truce to the litigation in 1993 when it issued Rev. Proc. 93-27, 1993-2 CB 343, as clarified by Rev. Proc. 2001-43, 2001-2 CB 191.

Together, these revenue procedures provide taxpayers some comfort that if they receive a service-connected profits interest they will not have to battle the IRS over the proper taxation of those interests.

Although change is in the wind (see sidebar), it pays to understand how these two revenue

Safe Harbor Reg in The Works

On May 24, 2005, the IRS published a set of proposed regulations that clearly reject the theory that the receipt of a profits interest in connection with the performance of services is not a taxable event.

Concurrently, it issued Notice 2005-43, which includes a proposed revenue procedure that will implement an elective safe harbor contained in the proposed regulations. Generally, under the proposed regulations, an employee receiving a service-connected profits interest will be protected against taxation only if the partnership and all of its partners make a safe-harbor election to treat the fair-market value of the profits interest as being equal to its liquidation value.

In addition, an employee who receives a substantially non-vested profits interest must make a timely § 83(b) election to ensure that no income is recognized when the profits interest vests.

The proposed regulations and new revenue procedure, if finalized, would completely supplant Rev. Proc. 93-27 and Rev. Proc. 2001-43. However, until that time, Rev. Proc. 93-27 and Rev. Proc. 2001-43 remain good law, and taxpayers can rely on them. The proposed regulations and new revenue procedure would only apply on a prospective basis to transfers of partnership interests occurring on or after the date the proposed regulations are promulgated as final regulations.

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procedures work so when LLCs consider awarding membership interests to key employees, both the LLC and the employee can have some assurance that neither will be surprised by an IRS challenge.

Profit Plays

Before delving into these revenue procedures, a little historical background is helpful. Section 721(a) of the Internal Revenue Code of 1986 provides that no gain or loss shall be recognized by the partnership or any of its partners upon the contribution of property to the partnership. Reg. § 1.721-1(b) states that:

> To the extent that any of the partners gives up any part of his right to be repaid his *contributions* (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services … section 721 does not apply. The value of an interest in such partnership *capital* so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in *capital* so transferred. (Emphasis added.)

The precise scope of this regulation is unclear. By distinguishing between shifts in partner "contributions" from a "share in partnership profits," there is the implication that a transfer of an interest in partnership profits in exchange for services is a non-taxable event.

Highlighting this uncertainty are two conflicting U.S Appeals Court cases, one of which held that the receipt of a partnership profits interest is a taxable event, while the other held it is not.

Here's an example of how this situation might be encountered: a cable television venture is conducted through an LLC, and there are certain key employees to whom the LLC wants to grant participating equity interests. If the LLC grants them membership interests composed of an interest in LLC capital and profits, the employees will have ordinary income to report equal to the fair market value of the capital transferred to the employees.

If a three-member LLC has total capital of $100 and awards an employee a 25% interest in capital and profits, $25 of existing capital is transferred to the employee's capital account from the existing members' capital accounts, thereby generating $25 of ordinary compensation income to the employee.

In contrast, if all that the employee receives is a 25% interest in future LLC profits, no capital is transferred to the employee, and arguably the receipt of the profits interest is a non-taxable event.

Transferred Property

Complicating this area of the law even further is Code § 83. It governs the taxation of property transferred in connection with the performance of services. While Code § 83 was enacted primarily to deal with the award of restricted stock, it nevertheless applies to all service-connected property transfers, regardless of whether or not the property is restricted.

Code § 83(a) applies to any transfer of "property" in connection with the performance of services. The employee's income is equal to the excess of the fair market value of the transferred property, over the amount (if any) paid for such property.

Sample Scenario

For example, a key media executive is granted the right to purchase a share of stock for $1 at a time when the fair market value of the stock is $3. Upon purchase, the executive would have $2 of ordinary compensation income to report (i.e., the difference between the stock's value of $3 and the $1 paid by the executive).

This income is recognized, and the fair market value of the property is determined at the time the property is transferred so long as it is freely transferable by the employee and not subject to forfeiture. However, where the property is not transferable and is forfeitable, the taxable event and value determination occurs at the time the property first becomes either freely transferable or no longer subject to forfeiture.

In other words, the property becomes substantially vested. If the property is not substantially vested at time of issuance, the employee can make what is known as a "§ 83(b) election" to take the unrestricted value of the property into income in the year of receipt, so long as such election is filed with the IRS within 30 days of the property's transfer.

For Code § 83 purposes, the term "property" includes real or personal property other than either money or

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an unfunded and unsecured promise to pay money or property in the future.

Under state law, an LLC membership interest (whether an interest in LLC capital or profits) is characterized as intangible personal property. Hence, such interest does not appear to constitute an unfunded and unsecured promise to pay money or property in the future.

Nevertheless, this conclusion is obfuscated by Reg. § 1.721-1(b), which seems to draw a distinction between an interest in capital, which is clearly property, and an interest in future profits, which arguably is not property for Code § 83 purposes, since an interest in future LLC profits can be likened to an unfunded and unsecured promise to pay money or property in the future.

Incongruent Law

Against this backdrop, now consider the incongruent case law that evolved over the years. Until 1971, there was a general consensus that the IRS would not treat the receipt of an interest in future partnership profits as an income-recognition event. Then there was *Sol Diamond*, 56 TC 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974), where it was held that the receipt of a percentage interest in future partnership profits was a taxable event and that the profits interest apparently had value upon receipt, because the taxpayer sold the interest less than three weeks later for $40,000.

Over the ensuing two decades before the Eighth Circuit's decision in *Campbell*, 59 TCM 236 (1990), rev'd, 943 F2d 815 (8th Cir. 1991), only four cases dealt with the profits interest for services issue. The most important of these cases is *St. John*, 84-1 USTC ¶ 9158 (CD IL 1983).

There the court held that the receipt of a profits interest was a taxable event subject to Code § 83; therefore, the court had to determine the fair-market value of the profits interest as of the day it became substantially vested. In making this determination, the court looked to the amount the taxpayer would receive upon a hypothetical liquidation of the partnership on that date.

In doing so, it found that the values of the partnership's assets (e.g., $155,000) were worth less than the other partners' capital accounts (e.g., $170,000), so the taxpayer's profits interest had a value of zero when it vested.

Two of the other three cases were decid-

ed in favor of the taxpayers: one on grounds similar to *St. John*, the other based on a concession by the IRS that receipt of a profits interest was <u>not</u> a taxable event. In the fourth case, the taxpayer tried using *Diamond* offensively in arguing for a tax-recognition event upon receipt. The court did not accept that argument, because the taxpayer's profits interest had only speculative value upon receipt. Only where an interest has a determinable value at time of receipt does a taxpayer have income to report pursuant to Code § 721.

Finally, came *Campbell*, wherein the Eighth Circuit held that the profits interest received by Mr. Campbell had only speculative, if any, value, thereby concluding that receipt of a difficult-to-value profits interest is not taxable upon receipt.

Until the proposed regulations are finalized, taxpayers can continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

The facts in *Campbell* are not atypical of a structure that could be employed in a cable television venture where key employees desire participating equity interests.

In *Campbell*, the taxpayer received a special class of limited-partner interest in exchange for his services in organizing and financing several real estate limited partnerships. These special interests provided the taxpayer with no immediate capital, but afforded him the right to share in future partnership profits following distribution of a priority return to the capital investing limited partners.

Faced with yet another litigation defeat, the IRS reconsidered its views on the tax consequences of transferring a profits interest in exchange for services. The result was Rev. Proc. 93-27.

However, this revenue procedure should not be mistaken as the IRS's views on the substance of the law. It is merely meant to provide assurance to taxpayers that the IRS will not challenge the grant of service-connected profit interests in most, but not all, typical situations.

Rev. Proc. 93-27 starts off by adopting the following commonly accepted definitions of a "capital interest" and a "profits interest."

"Interest" Terminology

A capital interest is any partnership interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair-market value then distributed to the partners in complete liquidation of the partnership, all as determined at the time of receipt of the partnership interest.

By exclusion, any partnership interest that is not a capital interest is a profits interest. To illustrate, if the LLC in the above example liquidated on the day the employee received his or her 25% profits interest, with the $100 of liquidation proceeds going to the existing members, what the employee received by definition is a profits interest.

Having defined a profits interest, Rev. Proc. 93-27 announces that, generally, the IRS will not treat the receipt of a profits interest as a taxable event for the employee or the partnership if a person receives a profits interest in connection with the performance of services to or for the benefit of a partnership, and such person is acting in a partner capacity (or in anticipation of becoming a partner).

If a person performs services for an LLC conducting a cable television business, and this is the only entity to which these services are being provided, he or she is likely acting in a partner capacity (or in anticipation of becoming a partner). If this same person performs similar services for other cable television entities, he or she is probably not acting in a partner capacity.

The revenue procedure then notes three important exceptions. First, Rev. Proc. 93-27 does not apply if the profits interest relates to a substantially certain and predictable stream of income from partnership assets.

Exceptions to the Rule

Examples of this include income from high-quality debt securities or a high-quality net lease. Second, it would not apply if, within two years of receipt, the service partner disposes of his or her profits interest. Finally, the revenue procedure would also be inapplicable in situations where the profits interest is a limited partner interest in a "publicly traded partnership."

Code § 7704(b) defines the term "publicly traded partnership" as any partnership if: 1) interests in such partnership are traded on an established securities market, or 2) interests in such partnership are readily tradable on a secondary market (or

the substantial equivalent thereof). For federal tax purposes, publicly traded partnerships are treated as corporations; hence, a limited partner interest is characterized as stock rather than as a partnership interest.

The nature of these exceptions strongly suggests that the IRS has not completely acquiesced to the non-taxable theory, and where profits interests are easily valued at or about the time of receipt, the IRS may litigate the tax consequences of service-connected profit interests.

Moreover, Rev. Proc. 93-27 does not address the situation where a person receives a profits interest for services rendered to someone other than the partnership transferring the profits interest. An example of this would be where key employees of a corporation formed to organize and promote investment partnerships receive profits interests in those investment partnerships, whether they performed services for those partnerships or not.

What if, at time of receipt, the profits interest cannot be transferred to someone else and is forfeitable if the employee leaves within a set term of years or is unable to reach prescribed performance goals, i.e., it is substantially non-vested? To provide guidance in this situation to the employee and the partnership, the IRS issued Rev. Proc. 2001-43 clarifying Rev. Proc. 93-27. According to Rev. Proc. 2001-43, the determination of whether an interest is a profits interest is tested at the time it is granted, even if, at that time, the interest is substantially non-vested.

To benefit by this rule, the partnership and the employee must treat the employee as the owner of the profits interest from the date of its grant. And the employee must take into account his or her distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing his or her income tax liability for the entire period during which he or she has the interest.

In addition, upon grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of its partners deducts any amount of the fair-market value of the interest as wages, compensation or otherwise. Hence, assuming all the other conditions of Rev. Proc. 93-27 are satisfied, where a partnership grants a profits interest to an employee,

The IRS may litigate the tax consequences of service-connected profit interests if they are easily valued at or about the time of receipt.

the IRS will not treat the grant of the service-connected profits interest or the event that causes that interest to become substantially vested as a taxable event for the employee or the partnership.

Finally, Rev. Proc. 2001-43 states that the employee does not have to file a § 83(b) election with the IRS to obtain this favorable treatment. However, prudence dictates that the employee file this election anyway since there is no harm in filing the election with the IRS.

Until the proposed regulations mentioned in the sidebar story are finalized, taxpayers can continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43. The advantages offered by these revenue procedures can best be capitalized on by engaging tax counsel early on in the process. Through careful structuring and document drafting, LLC membership interests can be awarded to employees key to the venture's success without any untoward tax surprises.

It cannot be emphasized enough that little or no tax planning can have drastic tax consequences for the very employees whose services the LLC is trying to encourage and reward.

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