



PROFITS INTERESTS

LLC Equity Incentive for Key Employees

The Limited Liability Company (“LLC”) taxed as a partnership for federal income tax purposes is unique in its flexibility. One area where this structure provides flexibility unmatched by corporations, including S corporations, is the ability to grant equity to key employees in the form of “Profits Interests,” allowing these employees to share in future profits and appreciation of the LLC without triggering immediate income taxation.

Overview

- Generally, awarding equity to an employee in any entity, regardless of whether the entity is taxed as a C corporation, S corporation or tax partnership, requires the employee to recognize income equal to the value of the equity interest received (known as “phantom income”).
- However, if a profits interests meets certain requirements (See [Rev. Proc. 2001-43](#) and Rev. Proc. 93-27), it is not taxable to the recipient upon grant.
- Following the grant of a profits interest, the profits interest member shares in LLC income and appreciation to the extent the LLC appreciates in value from the time of the grant.
- The profits interest member will receive long-term capital gains treatment upon the sale of his or her profits interest, which is most likely to occur when the LLC sells.
- Although the profits interest doesn’t give the member voting rights, he or she becomes a member for other purposes and must report salary paid from the LLC as self-employment income subject to employment taxes, and becomes entitled to information, including the right to review LLC books and records.
- However, because the profit interest does not require recognition of income upon receipt and does not have an acquisition cost (unlike a stock option), it is an attractive employee incentive to consider.
- Using an LLC also provides special asset protection (see LLCs and Charging Order Protection – Why Single Member LLCs Are Not Always Enough <https://ivanlawgroup.com/blog/f/llcs-and-charging-order-protection>).

Example:

- Key employee runs the day to day operations of LLC and is vital to its success. The LLC owners wish to incentivize key employee to remain with the LLC and share in its future success without causing immediate tax consequences and without requiring the family members who started the LLC to give up control of the company.
- The family members who own the LLC decide to grant the key employee a 10% profits interest in the LLC effective January 1, 2020.
- Assuming the requirements are met, no income is recognized on the employee’s year 2020 federal income tax return with respect to the profits interest grant. Instead, the key employee shares in 10% of the LLC profits for year 2020 and in all future years.
- In addition, if the value of the LLC was \$2,000,000 on January 1, 2020, and sells for \$4,000,000 in 2030, the key employee would be entitled to 10% of the appreciation (i.e., \$200,000) upon sale taxed at long-term capital gains rates, with the remaining \$3,800,000 being split among the other members.