Alert | Tax

March 2024

Quick Guide to Partnership Profits Interests

The issuance of a partnership profits interest is a tax-efficient tool for a partnership (including an LLC or other entity treated as a partnership for tax purposes) to incentivize its employees or other service providers. If structured properly, the grant of a profits interest should not constitute a taxable event for the recipient. In addition, the recipient of a partnership profits interest may be eligible to benefit from the reduced tax rate for long-term capital gains upon a sale or change of control of the partnership.

GT's Quick Guide to Partnership Profits Interests summarizes the key requirements to qualify as a partnership profits interest, the benefits of qualifying, and certain other tax consequences to the issuing partnership and the recipient.

QUICK GUIDE TO PARTNERSHIP PROFITS INTERESTS			
What Is a Profits Interest?	**Key Benefits**	**Tax Status of Profits Interest Holder**	**Key Considerations for the LLC Operating Agreement/Partnership Agreement**
A partnership interest issued to a person providing services to (or for the benefit of) the partnership with zero "liquidation value" at time of issuance.	No taxable event for recipient upon grant of profits interest or vesting of profits interest provided certain requirements are satisfied.	A profits interest holder is treated as a partner and allocated its distributive share of all items of partnership income, gain, loss, or deduction on a Schedule K-1 to IRS Form 1065.	Establishing "hurdle amounts" or "distribution thresholds" for profits interests to satisfy zero liquidation value requirement.
Zero liquidation value: recipient of profits interest would not share in any liquidation proceeds if, at the time of receipt of profits interest, partnership were to sell all of its assets at fair market value and distribute proceeds in complete liquidation of the partnership.	Recipient may be eligible for reduced long-term capital gains rate with respect to proceeds received upon a sale or other change of control of the company. By contrast, a holder of compensatory options or phantom equity will generally be taxed at ordinary income rates with respect to proceeds received upon a sale or change of control.	Salary paid to individual holder of a profits interest treated as a "guaranteed payment" reported on a Schedule K-1 (without withholding) and not employee wages reported on IRS Form W-2 (subject to withholding).	Allocations of income and loss made to profits interest holders (including in respect of unvested profits interests).
			Tax distributions to profits interest holders in respect of income allocations.
Issuing company must be treated as a partnership for U.S. federal income tax purposes.		Consider employee holding company or other structure for profits interest holders to retain their employee status.	Forfeiture and repurchase provisions in event that profits interest holder's employment is terminated.
Additional Considerations			
"Disposition" of profits interest within two years of receipt is inconsistent with IRS profits interest safe harbor.	Recipients of unvested profits interests are generally advised to make protective 83(b) elections within 30 days of grant date.	Profits interests may be issued with special distribution "catch-up" rights after the applicable distribution hurdles are satisfied.	Carried interest received by investment fund sponsors may be subject to a special three-year holding period requirement to qualify for long-term capital gains rates.

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