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Basic Income Tax and Equity Effects of a Profits Interest LLC

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Profits Interest vs. Capital Interest

One of the key properties of an LLC that gives it flexibility is that a member's ownership, or capital percentage, does not have to be equal to their profit percentage.

For example, an LLC has two members, a senior and junior member, with the following percentages:

	Senior Member	Junior Member
Capital	85%	15%
Profit	50%	50%
Loss	50%	50%

In this case, the senior member is said to have an 85% capital interest in the business, and a 50% profits interest in the business. Often when someone's ownership in a business is referred to, the reference is to their capital percentage. So, for this example, the senior member is an 85% owner of the business. A Profits Interest LLC structure uses this principal to allow incoming members to grow their ownership percentage by allocating them a higher percentage of the profits than their ownership percentage, and compensating them for their labor and management with a guaranteed payment rather than a draw.

Tax Basis Capital Accounts

A tax basis capital account is the portion of the LLC's basis each member is deemed to own, and is based on tax profits that have been allocated to them, and any capital contributed or withdrawn. This balance is calculated when the tax return is filed each year.

For example: A new LLC is formed between Partner A, who contributes assets with $100,000 of tax basis, and Partner B, who contributes no assets. The partners agree to split profits evenly, therefore they each have a 50% profits interest. In year 1, the business has a $200,000 tax profit. Both partners draw out $50,000 during the year.

	Partner A	Partner B
Opening Capital Account	$0	$0
Capital Contributed	$100,000	$0
Capital Draws	($50,000)	($50,000)
Allocated Share of Profit	$100,000	$100,000
Ending Capital Account	$150,000	$50,000

Essentially this means that Partner A could draw up to $150,000 out of the business without being taxed on it, while Partner B could draw up to $50,000 out of the business before incurring any tax liability. Also, if a member were to sell their interest in the business, or the business were liquidated and the proceeds distributed, they would only pay tax on the difference between the sale proceeds and their tax basis capital account.

If a tax basis capital account goes negative, the negative amount becomes taxable income, unless they are allocated a sufficient share of the business's recourse debt to offset the negative amount. If in the above example Partner B withdrew an additional $75,000 from the business, he would have $25,000 of taxable income unless they were allocated at least $25,000 of the recourse debt of the business.

Fair Market Value Capital Accounts

A tax basis balance sheet is not equal to a Fair Market Value (FMV) balance sheet or the true economic value of the business. For a Profits Interest LLC to correctly transfer ownership, FMV capital accounts must also be calculated each year, and the capital percentages updated to reflect the new ownership percentages.

In the original example with a senior and junior member, at the beginning of the year the LLC has a total net worth of $1,000,000. During the year, the business had a $100,000 tax profit, but it grew in total net worth by $500,000. Both members took out $50,000 to live on, and neither contributed any capital. The difference between the growth that is accounted for by tax profits and owner draws and contributions is called unrealized appreciation, and must also be allocated between the members.

To find unrealized appreciation the following formula is used: Ending Net Worth - Beginning Net Worth - Tax Profits - Net Owner Contributions and Draws = Unrealized Appreciation

So in this case: $1,500,000 - $1,000,000 - $100,000 – ($100,000) = $500,000.

With the unrealized appreciation known, the new FMV capital accounts can be calculated. The calculation of their FMV capital account is:

	Senior		Junior		Total
Beg FMV Capital Account	$850,000	85%	$150,000	15%	$1,000,000
Allocation of Tax Profit	$50,000	50%	$50,000	50%	$100,000
Allocation of Unrealized Appreciation	$250,000	50%	$250,000	50%	$500,000
Net of Draws and Contributions	($50,000)		($50,000)		($100,000)
Ending FMV Capital Account	$1,100,000	73.33%	$400,000	26.67%	$1,500,000

The junior member's ownership percentage increased, and the senior member's decreased, even though they were each allocated 50% of the profits and growth, and they each took the same amount out of the business. The tax return would show:

	Senior		Junior	
	Beginning	Ending	Beginning	Ending
Capital	85%	73.33%	15%	26.67%
Profit	50%	50%	50%	50%
Loss	50%	50%	50%	50%

Draws vs. Guaranteed Payments

The previous example shows how the amount that a member takes out to live on has a negative effect on the calculation of both their FMV Capital Account and their Tax Basis Capital Account. This can effectively slow the transfer of ownership in a Profits Interest LLC, particularly if the incoming member has higher family living needs or is being compensated for a higher level of labor and management than the senior member. One way to mitigate this issue is by using guaranteed payments instead of draws to compensate the junior generation.

A guaranteed payment is a method of compensating owners. Generally when used in a Profits Interest LLC structure, it is for labor and management, although it can also be a form of compensation for use of capital. One of the keys to a guaranteed payment is that by definition it is guaranteed. It is not tied to the profitability of the business, and must be set and agreed upon before payments are made. From a tax standpoint, a guaranteed payment is treated more similarly to a wage than a draw, as it is taxed directly to the recipient and is a deduction to the business. Guaranteed payments, if they are for labor and management, and not use of capital, are subject to self-employment tax.

If in the previous example instead of the junior member taking a $50,000 draw from his capital account, he was compensated with a $50,000 guaranteed payment for labor and management:

	Junior Partner Compensated with Capital Draw	Junior Partner Compensated with Guaranteed Payment
Tax Profit	$100,000	$50,000
Partner Draws	$100,000	$50,000

Unrealized appreciation stays the same: $1,500,000 - $1,000,000 - $50,000 - ($50,000) = $500,000. So calculation of FMV capital accounts now looks like:

	Senior		Junior		Total
Beg FMV Capital Account	$850,000	85%	$150,000	15%	$1,000,000
Allocation of Tax Profit	$25,000	50%	$25,000	50%	$50,000
Allocation of Unrealized Appreciation	$250,000	50%	$250,000	50%	$500,000
Net of Draws and Contributions	($50,000)		$0		($50,000)
Ending FMV Capital Account	$1,075,000	71.67%	$425,000	28.33%	$1,500,000

By giving the junior member a guaranteed payment rather than drawing his family living from his capital account, his growth in ownership percentage is accelerated.

Draws vs. Guaranteed Payment - Income Tax Effect

While use of guaranteed payments redistributes the growth in equity, it also redistributes the taxable income to each member. Draws are neither deducted by the business nor taxed to the individual receiving them (assuming they do not exceed their tax basis capital account). Guaranteed payments on the other hand are both a deduction to the business and income to the individual.

Using the above example:

	Junior Partner Compensated with Capital Draw	Junior Partner Compensated with Guaranteed Payment
Tax Profit	$100,000	$50,000
Partner Draws	$100,000	$50,000

Since each member has a 50% profits interest, their taxable income is:

	Junior Partner Compensated with Capital Draw		Junior Partner Compensated with Guaranteed Payment	
	Senior	Junior	Senior	Junior
Flow through Business Profit	$50,000	$50,000	$25,000	$25,000
Guaranteed Payment	$0	$0	$0	$50,000
Total Self-Employment Income	$50,000	$50,000	$25,000	$75,000

Prior Equity vs. Future Equity Growth

Also important to note is that a Profits Interest LLC model effectively transfers future equity growth, not prior accumulated equity. Look again at the earlier FMV Capital Account calculation:

	Senior		Junior		Total
Beg FMV Capital Account	$850,000	85%	$150,000	15%	$1,000,000
Allocation of Tax Profit	$25,000	50%	$25,000	50%	$50,000
Allocation of Unrealized Appreciation	$250,000	50%	$250,000	50%	$500,000
Net of Draws and Contributions	($50,000)		$0		($50,000)
Ending FMV Capital Account	$1,075,000	71.67%	$425,000	28.33%	$1,500,000

While the senior generation's ownership *percentage* decreased, note that the dollar value of their ownership still increased. None of their original $850,000 of equity was transferred to the junior member.

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