Tax Consequences of Contributing "Sweat Equity" for LLC and Partnership Interests

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When counseling clients with regard to forming new business entities, I'm always interested in understanding what "capital" the owner or owners of a business are planning on contributing to get the new business started. It isn't uncommon to find one owner contributing cash or property and another owner contributing "sweat equity." I also frequently meet with business owners who are interested in rewarding their key employees with an ownership interest in their partnership or limited liability company for the employees' past and future services to that business. The concept of contributing services to a business or rewarding employees for past or future services with the grant of ownership interests isn't uncommon. What is uncommon is the business owner that understands the tax consequences that come with the grant of partnership interests in exchange for services and how to plan around potential tax pitfalls.

In very general terms, owners of a partnership or limited liability company (LLC) may contribute as capital to the business cash or property without incurring a tax liability. However, very often the contribution of services in exchange for a partnership or LLC interest gives rise to taxable income. In effect, the grant of the partnership of LLC interest is payment in exchange for services performed. This result is particularly onerous since the service provider has not been compensated with cash with which to pay any associated tax liability. *(Since multi-member limited liability companies are generally taxed as partnerships, from this point on this article will simply refer to partnerships though readers should be aware the following concepts apply equally for most limited liability companies).*

The tax consequences to a service provider are often dependent upon the nature of the partnership interest granted in exchange for services. This should be the first issue examined when evaluating the grant of a partnership interest to a service provider. The IRS has identified two possible types of partnership interests that may be granted to person and each are defined as follows:

- a "capital" or "equity" interest in a partnership can be defined as an interest that grants the holder a share of the proceeds if the partnership were to liquidate after selling off all of its assets at fair market value, and
- a "profits" interest as any partnership interest that is not a capital or equity interest.

The law generally treats the grant of a capital interest in a partnership in exchange for services as a taxable transaction. In the case of a new partnership, where some partners are contributing cash or property and others are contributing services to the partnership, careful attention to the way in which the partnership agreement (or operating agreement in the case of a limited liability company) defines the rights of each partner is of paramount importance. If the partnership agreement gives the sweat-equity partner an immediate right to proceeds upon dissolution of the partnership (a "capital" interest), the sweat-equity partners must recognize income upon receipt of their partnership interest.

> *Example:* In Year 1 individuals A, B and C decide to form partnership P. A and B each contribute $25,000 cash to the partnership and C agrees to

> manage the investment of that cash in marketable securities. A, B and C decide to share all profits equally (their "percentage interests" are 33.3% each, roughly). Upon formation A and B each contribute capital to the partnership, and a corresponding capital account for each is credited for the $25,000 contribution. If the partnership agreement states that upon liquidation proceeds are distributed to the partners in accordance with their percentage interests, C will recognize income upon his receipt of his interest in the partnership. This is because if the partnership were immediately liquidated, C is entitled to 33.3% of the $50,000 of contributed capital, and C's interest was given in exchange for services it was anticipated that he would provide.

Similarly, if an employee is granted a partnership interest that entitles the employee to an immediate right to liquidation proceeds, the employee will have to recognize taxable income at the time of grant. However, if A,B and C's partnership agreement provides that liquidation proceeds are distributed in accordance with the partners' positive capital account balances C could be granted a capital interest and face no tax liability. This is because at the time of the grant, C, as having contributed no cash or property to the partnership, has a zero balance in his capital account and is not entitled to a distribution if the partnership were immediately liquidated.

Instead of granting a capital interest, a partnership might be inclined to instead grant a "profits" interest, which would entitle the recipient to only share in the partnership's future profits. The tax treatment afforded such a grant has been the subject of debate for many years. In 1993 the IRS declared that the recipient of a profits interest in a partnership does not have to recognize income at the time that interest is granted because the recipient is not entitled to immediately receive a distribution if the partnership were liquidated. Referring back to the above example, if the partnership agreement makes it clear that there are two forms of partnership interests, capital and profits, C will not recognize income when he is granted a profits interest. With a profits interest, the recipient is then taxed only on his or her share of partnership income or gain from the time of grant onward.

The IRS has provided for the following three instances in which the grant of a profits interest will be taxable:

- Where the profits interest relates to a substantially certain and predictable stream of income from partnership assets, a situation many business owners will admit is uncommon and unlikely. Some examples might be where the income of the partnership comes from a very high quality lease or high quality debt instruments;
- if the profits interest is disposed of by the partner within two years of its receipt, the partner will be required to report taxable income from the original grant, or
- where the profits interest concerns a limited partner interest in a publicly traded partnership the grant of that interest would also be taxable.

The proposition that the grant of a profits interest is not taxable inevitably creates the potential for tax abuse. Internal Revenue Code § 707 permits the IRS to recharacterize a service partner's share of the partnership's income as a payment to a third party for services. Stated differently, the IRS will not allow a taxpayer to forgo taxation on services performed by merely accepting partnership interests as payment for those

services. For example, if I were to accept profits-only interests in my clients' partnerships as my sole source of payment for legal services I would most likely have to treat the receipt of such interests as taxable income. The proper analysis of these "disguised compensation" rules, which is complex and beyond the scope of this article, often focuses on whether or not the services were performed in the context of the service provider being a participant in the partnership endeavor, or as an independent contractor. The resolution of this determination is dependent upon the analysis of several factors.

When considering whether to grant a partnership of limited liability company interest to someone on the basis of past performance or in anticipation of future performance, the business needs to consider how the partnership or LLC is currently structured. Failure to take the above issues into account can have devastating tax consequences.

Readers should note that the above analysis does not concern the grant of stock in exchange for performance of services. If you have any questions about forming a new business, modifying the structure of your existing business, or any transactions you believe may have tax implications, feel free to contact Steven Weiser at sweiser@fostergraham.com.