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# "CATCH-UP" DISTRIBUTIONS TO HOLDERS OF PROFITS INTEREST

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It is common for a “profits interest” to be granted to a service-provider in a partnership or a limited liability company (“LLC”) taxed as a partnership. If properly structured, such a profits interest will not be taxable to the holder upon the receipt of such profits interest. Instead, the holder will be taxed on its allocable share of the future profits of the partnership/LLC at the time such profits are taxable to the partnership/LLC based on its method of tax accounting.

One of the requirements for a “profits interest” is that the recipient of such interest not be entitled to receive any share of the partnership/LLC’s assets if that entity were to liquidate immediately following the receipt of such interest. In order to satisfy this requirement, it is imperative that the capital accounts of the existing partners/members (excluding the partner/member receiving a profits interest) be “grossed-up” to reflect the net fair market value of the assets of the partnership/LLC (the so-called “Hurdle Amount”) and that any distributions from the partnership/LLC first be made to such existing partners/members in an amount equal to the Hurdle Amount before any distributions are made to the holder of the profits interest.

Thus, for example, if an LLC owned by two members (A and B) grants a 10% profits interest to a service-provider (C) at a time when the LLC’s Hurdle Amount is $1 million, if the LLC later wishes to distribute cash of $1.5 million, the first $1 million (Hurdle Amount) must be distributed to A and B before C is entitled to received its 10% share of the remaining $500,000 (i.e., $50,000). C’s actual share of the distribution is 3.3% ($50,000 divided by $1.5 million). As a result, C will never be entitled to receive 10% of the Hurdle Amount.

What if the parties wish to reward the service-provider for his or her services rendered to the partnership/LLC prior to the granting of the profits interest by allowing the service-provider to share in the Hurdle Amount? Can this be done without creating adverse tax consequences for the service-provider?

Yes, if a properly structured “catch-up” provision is added to the distribution waterfall. For example, the distribution waterfall in the above example could provide that (i) the first $1 million (Hurdle Amount) will be distributed only to A and B (the Existing Members), (ii) the next dollars will be distributed only to C until C has received its 10% share of the total distributions made to the Existing Members and C under (i) and (ii) (i.e., $111,111), and (iii) the remaining amount (i.e., $388,889) will be distributed 90% to the Existing Members (i.e., $350,000) and 10% to C (i.e., 38,889). As a result, C would receive a total distribution of $500,000 ($111,111 plus $38,889) which equates to 10% of the total distribution amount.

For more information, please contact the authors Morrie Brown or Nick Jovanovich on our Business, Finance & Tax Team.

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