

The “Self-Employed Problem” with LLC Profits Interests

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You have likely heard of the tax benefits of an LLC or other tax partnership issuing “profits interests” to executives and other service providers. Whereas with C and S corporations there is a tension between issuing stock (for long-term capital gains upon a liquidity event) and options (to avoid immediate taxable income), profits interests combine the best of both

provides services to a partnership is “self-employed,” and not an “employee.” Put another way, an individual cannot be both an employee and a partner in a tax partnership. Being self-employed has some advantages, such as the full deduction of an individual’s business expenses and access to IRAs and other retirement

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worlds. Be cautious, however, about issuing profits interests to rank-and-file employees. Being a partner in a tax partnership involves certain complexities that can be burdensome and confusing to workers who are not accustomed to being “self-employed.”

Partners are Self-Employed

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savings plans for the self-employed. When it comes to tax withholding and benefits, however, self-employment may hold unpleasant surprises.

No More Payroll Tax Withholding

In addition to equity in the company, a profits interest holder may also receive a salary or other compensation for services. Unlike with an

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employee, a partnership does not withhold income taxes from payments to a partner. Instead, a profits interest holder must pay “estimated taxes” quarterly throughout the year. Obviously, estimated taxes require additional returns and the habit of putting aside a portion of one’s paycheck to pay them.

Similarly, the company does not withhold the so-called “FICA” taxes for Social Security and Medicare. Worse (from the worker’s perspective), the company doesn’t pay the “employer-half” of such taxes. Instead, a profits interest holder is subject to “self-employment tax,” which tries to replicate the FICA taxes that would have been due, combining the employer’s and employee’s shares, and including the Social Security cap (\$117,000 for 2014) and deductibility of the employer-half. As with estimated income taxes, there is the burden of filing and reserving for self-employment taxes, and bearing the employer-half may cost a worker up to 7.65% of his or her compensation in extra taxes.

Exclusion from Certain Employee Benefits

A profits interest holder’s self-employed status extends to the company’s health and welfare benefit plans. First and foremost, you will want to consult with an employee benefits expert to determine if the company’s plans can and do apply at all to the company’s equity owners. Even if they do, self-employed individuals are not eligible for certain tax-advantaged benefits, such as parking and transit subsidies and health care flexible spending accounts, but they remain eligible for others, such as educational and dependent care assistance.

Most consequential for the majority of workers is the question of employer-subsidized health insurance. Normally, an employer’s contributions to an employee’s health insurance premiums are not taxable income to the employee. This doesn’t apply to the self-employed, and the profits interest holder would be taxed on the company’s health insurance subsidy. The profits interest holder may, however, be able to deduct all of his or her health insurance premiums under certain conditions, the most important of which is the individual is not otherwise eligible for employer-

subsidized health insurance through another job or family member. This health insurance deduction for the self-employed may be just as good or even better than an employer subsidy, but the individual-specific eligibility standards make this difficult to plan for among large groups of workers.

Work-Arounds

As you can see, the prospect of adapting to estimated and self-employment taxes, and changes to health insurance and other benefit plans, may be daunting to a rank-and-file employee receiving a small percentage interest in an LLC or other tax partnership. The practical “work-arounds” seek to prevent an individual from being both a partner and an employee of the same entity. These include inserting an S corporation holding company to hold the profits interest, allowing the individual to remain an employee while the S corporation (and not the individual) is the partner. Generally, the more employees are involved, the more difficult it is to implement these types of work-arounds.

The alternative is to avoid the workers becoming partners at all

by issuing them options or phantom equity instead of “real” equity. The employees will realize ordinary income upon exercise or payment, but the company’s owners will receive an equivalent deduction for compensation-paid. If the owners are in a higher tax bracket than the employees (and can utilize the deduction), options or phantom equity can

be very tax-efficient, and the company could consider making the employees whole by issuing additional options, phantom equity, or simply cash bonuses.

Takeaway

Profits interests are great; they represent one of the biggest tax advantages of partnerships. Absent a customized work-around,

however, profits interests will render the holder “self-employed,” and that comes with significant tax complexity. As a rule of thumb, think twice about issuing profits interests to employees who have not previously been self-employed or who don’t have their own sophisticated tax advisors. Sometimes the game isn’t worth the candle.