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Insights

Profits Interests 101: The Basics and Uses of Profits Interests

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With today's ongoing workforce development challenges, businesses constantly seek innovative and effective ways to attract, incentivize, or otherwise retain top talent. In certain cases, a business may wish to reward an executive or employee or recruit new leadership for their prospective contributions to the organization's success; in other cases, a business may be in the process of restructuring but wishes to retain certain key individuals. Awarding profits interests can help accomplish these goals.

Businesses have many tools at hand to accomplish these objectives, such as stock option programs, deferred compensation, and value appreciation plans. Some provide only compensatory benefits that treat the benefits as ordinary income to the employee. Others will provide equity interests that will allow the value appreciation to be taxed at capital gains rates, thus providing a more tax efficient benefit to the employees. Generally, most alternatives can be implemented by corporations or LLCs. Some, however, can be implemented only by corporations or by partnerships – including LLCs taxed as partnerships for federal income tax purposes. (Any reference to LLCs in the remainder of this article will refer to any entity taxed as a partnership for federal income tax purposes.)

Profits interests can be adopted by LLCs and provide a tax-efficient way to grant equity to targeted individuals or groups who provide services to the entity, ensuring their interests are aligned with future growth of the business. This article describes the components of a profits interest, the related tax implications of a profits interest, both to the issuer and the recipient, as well as the key considerations for issuing profits interests, should a business elect to do so.

What are profits interests and when are they used?

A profits interest provides one form of a non-taxable incentive available to LLCs which allows the holder of the profits interest to participate in the future appreciation in the value of a business without requiring the recipient to contribute capital. Businesses typically grant profits interests to key employees or service partners in exchange for services, incentivizing them to continue contributing to the business's growth. Profits interests can also be used as a reward for past services. If structured properly, the receipt of the profits interest will not trigger current income.

A profits interest differs from a capital interest. A capital interest typically requires a contribution of capital to the entity and gives the recipient an immediate right to share in the proceeds of the business if all the assets are sold at fair market value in an event of complete liquidation. By contrast, as typically structured, a profits interest provides no present value but allows the recipient to receive a percentage of future appreciation in the value of the business. The threshold value for the profits interests will be set so that the recipient receives no positive value on the grant date to ensure that the recipient will not share in any net proceeds if the LLC liquidated on that day. However, the recipient shares in the value of the business to the extent it appreciates following the grant date, subject to any vesting requirements.

If an employee receives a profits interest, they will likely no longer be treated as an "employee" for federal income tax purposes but are treated as a "partner." The profits interest can be structured so that the holder may defer income until gain is recognized by the partnership, and potentially receive long term capital gain treatment on proceeds that might typically be taxed at ordinary income rates. However, as a partner, the recipient must pay tax on any income passed through from the partnership on a Schedule K-1, including self-employment taxes, rather than reported as wages from employment and reflected on a standard Form W-2.

How does the IRS characterize profits interests?

Pursuant to Internal Revenue Service (IRS) Revenue Procedure 93-27, 1993-2 C.B. 343 (Rev. Proc. 93-27) and Revenue Procedure 2001-43, 2001-2 C.B. 191 (Rev. Proc. 2001-43), the IRS grants a safe harbor to both vested and unvested profits interests, so long as certain requirements are met:

1. Profits interests are received by the recipient as a partner or in anticipation of becoming a partner, in exchange for services to or for the benefit of the partnership granting the interest.

2. The profits interests may not relate to a substantially certain and predictable stream of income from partnership assets.

3. The profits interests must be held by the recipient for a period of two years.

4. The profits interest must not be a limited partnership interest in a "publicly traded partnership."

5. The partnership must treat the recipient of the profits interest as a true partner beginning on the date of grant, regardless of whether the interests are fully vested (including for purposes of allocating distributive shares of income, gain, loss, deduction, and credit associated with the interests).

6. Neither the partnership nor the recipient of the profits interest may take a compensation deduction in connection with the profits interest.

If the profits interests as issued meet the safe harbor's requirements, the granting of profits interests will be a non-taxable event for both the recipient and the LLC. In this case, neither compensation is recognized for the recipient, nor a compensation deduction is available for the LLC.

Given the risk of the safe harbor failing, profits interest plans or grants will typically recommend (if not require) that the recipient file an election under Section 83(b) in connection with the receipt of the profits interest as a "protective filing" in case one or more of the safe harbor requirements are not met. The 83(b) election must be filed within 30 days of the grant date for the election to be effective.

Key considerations with issuance of profits interests

While the issuer of a profits interest should be mindful to treat recipients of profits interests as partners, other key considerations should be taken into account to determine the full extent of the rights granted to holders of profits interests.

Vesting. Profits interests may be granted either all at once (vested) or over a period of time (unvested). The documentation signed by the parties in connection with the issuance of the profits interest may contain a vesting schedule incentivizing the recipient to make a long-term commitment to the company. Vesting may be performance-based and/or purely time-based.

Forfeiture and Repurchase Rights. Typically, companies tie eligibility for granting or retaining profits interests to the recipient's employment with the company. Therefore, depending on whether the profits interests are vested or unvested, the termination of the recipient's employment with the company may trigger either a repurchase right of the company at a predetermined value or a forfeiture obligation of the recipient.

Voting Rights and Access. To satisfy the safe harbor rules, the company should draft its governing documents to ensure that profits interest holders are treated as partners. This could include voting and other governance rights, such as access to books and records and the right to attend meetings. However, the entity's governing documents will commonly include certain limitations on the rights of profits interest holders, including limited voting rights or management rights, preemptive rights, transfer restrictions and drag along/tag along rights.

Distributions. The issuer can also tailor its governing documents to manage the receipt and timing of any distributions, including different rights among classes of partners.

Take Aways

Profits interests can be an effective tool for retaining key employees and incentivizing performance to increase the value of a company. If structured properly, profits interests offer benefits both to the recipient and the issuer and may contribute to the overall success of the business.

If you have any questions concerning profits interests, please contact Maria Vladimirova Geltz, Robert A. Greising or any member of the Krieg DeVault Business Practice.
