Business owners and investors alike often use a profits interest grant (an equity-based incentive award) as a means to incentivize employees and protect the owners/investors’ interests in a company. Many politicians view the use of profits interest as a tax loophole that should be closed. Despite calls to end their use because of perceived improper conversion of certain compensation from ordinary income to capital gains treatment, some form of profits interests should remain available. In any event, business owners and investors alike should understand the basics of a profit interest grant.

What is a profits interest?

As an initial matter, profits interests are only available for companies that are taxed as a partnership (e.g., a limited liability company, limited partnership, general partnership, etc.). A company can award an equity ownership to an employee through the grant of either (1) a capital interest or (2) a profits interest. A capital interest is an interest that gives the employee an actual share in the value of the company at the time of grant.

By contrast, a profits interest is an interest that gives the employee the right to receive a percentage of future profits, but not any current capital. In many respects, a profits interest is akin to a stock option in a corporation because both interests represent a share in the appreciation of a company, but not any previously created value.

Example: A group of owners owns Company, a partnership, with a value of $100. Company grants Employee a 10 percent capital interest in Company. The grant of the capital interest will entitle Employee to $10 if Company were immediately sold.

Employee will pay ordinary income tax on the $10 of value received.

Example: A group of owners owns Company, a partnership, with a value of $100. Company grants Employee a 10 percent profits interest in Company. The grant of the profits interest in Company will entitle Employee to 10 percent of the appreciation above the $100 value. If Company were immediately sold, Employee would not be entitled to anything in respect of the profits interest grant. If Company were subsequently sold for $500, Employee would be entitled to $40 (10 percent of $400 appreciation).

Importantly, under current guidance, Employee will pay no tax upon grant of the profits interest. Employee will pay tax on the $40 realized.
The basics of profits interests

upon sale of the profits interest, likely at capital gains rates.

How to grant profits interests?

Step 1: In order to actually make a profits interest grant, a company should first review its partnership or operating agreement. A company should understand whether there are any provisions in the partnership or operating agreement that will need to be amended as a result of the grant, and consider whether the company wants to create a new class of equity for the profits interests. While the creation of a new class of equity is not necessarily required, many companies create a new class of equity for profits interest grants in order to limit the rights of employee-equity holders and for administrative ease.

Example: A group of Owners own Company, a partnership. Owners have an Operating Agreement that, among other things, governs their management rights, voting, distributions of profits, access to Company information, and pre-emptive rights (the right to maintain a set ownership percentage in Company). Company wants to grant Employee a 10 percent profits interest in Company, but does not want Employee to have the same equityholder rights as Owners. Before granting the profits interest to Employee, Company could amend its Operating Agreement to create a new class of units (e.g., Class 2 Units) that entitles the holder to participate in the economics of Company, but does not have other equityholder rights. Thus, if Employee is granted Class 2 Units, Employee would be entitled to 10 percent of the appreciation of Company, but may not be able to vote or exercise pre-emptive rights (or other equityholder rights).

Step 2: Second, companies should provide the employee with a written agreement describing the terms and conditions of the grant, including a statement that the grant only represents a share of the company above the value on the date of grant. The written grant agreement is particularly important as it typically recites the value above which the employee will be able to participate. In other words, the grant agreement will state the agreed upon value of the company on the date of grant so that there is no dispute as to the value of the company when calculating the employee’s share of appreciation. Further, the grant agreement can serve other purposes, such as setting forth the vesting schedule, imposing restrictive covenants, and creating other contractual rights in favor of the company.

Example: A group of Owners owns Company, a partnership, with a value of $100. Company grants Employee a 10 percent profits interest in Company. However, the bookkeeper for Company records the grant as a flat 10 percent stake in Company, rather than 10 percent of the appreciation in Company over $100. As a result, Owners will be deemed to have given up 10 percent of their interest (leaving them with $90 of value), and Employee will be subject to $10 of ordinary income tax upon grant. If the bookkeeper had properly recorded the grant as a profits interest, Owners would retain $100 of value and be entitled to 90 percent of any appreciation of Company over $100, and Employee would not be subject to immediate taxation upon grant.

While the foregoing example seems extraordinary, it is actually quite common for profits interests to be misconstrued from a bookkeeping perspective, particularly if a company does not create a second class of equity that highlights the disparate treatment of the capital and profits interests, respectively.

Considerations when granting profits interests?

As illustrated, profits interests offer significant potential advantages to both companies and employees. There are, however, numerous considerations that must be properly vetted prior to moving forward with a profits interest program. First, an individual who receives a profits interest grant cannot simultaneously be treated as an employee of the company. In other words, when an employee receives a profits interest grant, the employee’s salary is converted into self-employment income. As a result, the employee (now a partner) is obligated to remit quarterly estimated income tax payments. In addition, the employee (partner) will become disqualified from participating in certain employee benefits programs.

Second, because employees who receive a profits interest grant become partners in the company they will not only have rights as an equityholder, such as access to the company’s books and records, but may also have the obligations as an equityholder, such as requirements to make capital contributions and even personal liability. While some of the issues associated with providing an employee an equity stake in the company can be mitigated through the partnership or operating agreement or a second class of equity, certain entity forms (e.g., a general partnership) may create personal liability for the employee, despite the terms of the partnership or operating agreement.

Third, employees who receive a profits interest grant will be taxed on company income because a partnership is a “pass-through” entity for tax purposes. In short, this means that the company does not pay an entity level tax. Rather, the company’s profits and losses are allocated among the partners, whether or not the partner receives an actual distribution of cash. In other words, a partner (including an employee holding a profits interest) must pay taxes on his or her share of the company’s profit even if the partnership does not distribute cash. In such a case, an employee will have to use his or her own cash from other sources to pay a tax bill currently in order to retain an interest in a company that may result in a cash payment at some unknown point down the road. To solve this issue, many partnership and operating agreements provide for mandatory tax distributions to address a situation where a partner has to pay taxes but does not have an associated cash distribution to cover the cash outlay. Nonetheless, there are numerous ways to craft a partnership tax distribution provision, and the existence of such a provision does not necessarily mean that the problem is solved from the employee’s perspective.

Conclusion

Using profits interest to incentivize employees can be beneficial. A company considering profits interests, however, must take the necessary preparatory steps to review its structure and organizational documents, as well as weigh the benefits and burdens of the grant, to ensure the profits interest program is successful. Companies should weigh whether the burdens and costs of a profits interest grant exceed the benefits of the grant, particularly if the size of the grant is relatively
small in comparison to the employee’s aggregate compensation. Understanding the mechanics of a profits interest program is critical to the program’s success. If a company determines that a profits interest program is not the right fit, there are numerous alternative equity-based incentive compensation programs to consider (see "ARM" yourself to Attract, Retain and Motivate).

Benjamin D. Panter
Team member bio