



Profits Interests: A Great Way to Give Key Employees a "Piece of the Pie"

A common method of rewarding employee for past services or incentivizing an employee to remain is granting the employee an ownership interest in the business. However, many businesses are closely-held and owned by the founders or by family members. Those owners usually are not excited to admit new owners. For businesses taxed as partnerships (typically, LLCs), a grant of a profits-only interest (or, more simply put, a "profits interest") strikes the proper balance. An interest in an LLC taxed as a partnership gives the holder two separate interests- a profits interest and a capital interest. A profits interest gives the holder his or her proportionate share of the business's profits and losses from normal business operations. A capital interest gives the holder a share of the gain or loss realized from the sale of capital assets (such as equipment or buildings) and a share of assets if the company liquidates.

A profits interest may be fully vested upon grant or may vest in the future. Even if the profits interest is fully vested at grant, it is usually not taxable to the employee upon receipt. One reason the grant is not taxable is because valuing a profits interest can be very difficult. The benefit of a profits interest is a share in future profits, which are generally unknown. The Federal tax regulations therefore make the grant and receipt of a vested profits interest, a non-taxable event to both the employee and the company, if the following safe-harbors are met:

- the recipient must receive the profits interest in his or her capacity as a partner, or in anticipation of becoming a partner, in exchange for the provision of services to or for the benefit of the partnership granting the interest;

- the interest must not relate to a substantially certain and predictable stream of income from partnership assets (e.g., income from high-quality debt securities or a high-quality net lease);
- the recipient must not dispose of the profits interest within two years after receipt; and
- the profits interest must not be a limited partnership interest in a publicly traded partnership.
- A profits interest that is not vested upon its grant will also be non-taxable, both at grant and upon vesting, if:



- Both the company and the recipient treat the recipient as a "real" partner for tax purposes with respect to the entire profits interest granted beginning on the date of grant (meaning, among other things, that the partnership must provide the recipient with a Form K-1, and the recipient must pay his or her share of the taxes on the partnership's taxable income, to the extent there is any);
- neither the partnership nor the recipient may take any compensation deduction in

connection with the profits interest; and

- all of the above requirements for interests vested upon grant must be satisfied.

The company granting the profits interest can also make the interest a non-voting one, which keeps all of the control over the company in the hands of the current owners. The interest can also be subject to forfeiture if the employee's employment is terminated, ensuring that a former employee does not continue to hold an interest in the company.

Which entity types benefit?

It is important to note that the rules and safe-harbors discussed above only apply to entities taxed as partnerships. An S corporation cannot grant a profits interest without terminating its S election because a profits interest is a "second class of stock". Receipt of a class of stock that is profits-only from a C corporation is taxable immediately upon receipt as ordinary income. Furthermore, the holder of a profits interest in a partnership is treated as a partner for Federal income tax purposes which means the holder cannot be an "employee" of the partnership. Thus, a W-2 employee who receives a profits interest in a partnership will no longer receive a W-2 or be subject to withholding, will receive a K-1 each year, must pay self-employment taxes, must make quarterly estimated income tax payments, and will be subject to phantom income (i.e., have to pay tax on income allocated to him or her even if he or she does not receive a corresponding distribution).

The grant of profits interest is not the best option for every employer, and not every employee wishes to be treated as a partner for tax purposes. But, in the right circumstances, a profits interest is a great way to give a key employee a "piece of the pie". Please contact your Carlile Patchen & Murphy LLP business attorney if you have any questions or wish to further explore granting profits interests (or any equity award) to an employee.