Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 34 –
The ABCs of LLC Equity Compensation

By [Darren Goodman](), [Sophia Mokotoff](), [Taryn Cannataro]()

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Taryn Cannataro: Welcome to the latest episode of Just Compensation. I'm Taryn Cannataro, counsel at Lowenstein's Executive Compensation and Employee Benefits Group. I'll turn it over to my colleagues to introduce themselves.

Darren Goodman: I'm Darren Goodman, the vice Chair of the Executive Compensation and Employee Benefits Group.

Sophia Mokotoff: Hi, I'm Sophia Mokotoff, partner in our tax group here at Lowenstein.

Taryn Cannataro: In a previous episode, we've discussed various types of equity award that can be issued by corporation. Today's discussion will focus on equity compensation that can be issued by entities taxed as partnerships with a special focus on profits interests. Equity interests and partnerships can generally be either capital interests where the holder is entitled to a share of the partnership capital or profits interest where the holder is entitled to share in the future appreciation of the partnership. Profits interests are very commonly used equity compensation tools due to their flexibility in structuring and advantageous tax treatment.

This episode will discuss what profits interests are, their tax treatment and things to keep in mind when structuring a profits interest award. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you wish to grant new equity awards. Let's start at the beginning. What is a profits interest?

Darren Goodman: A profits interest is a membership interest at a partnership or limited liability company or LLC that entitles the holder to share in future profits after the date the profits interest is issued. These can only be granted by partnerships and a LLC's taxes partnerships. A corporation cannot issue profits interest. The corporation can issue shares. Sometimes you'll see an LLC that says that it is issuing shares, that also raises a red flag and would be something that you'd want to look into more to understand exactly what's going on.

Profits interests are often used in the private equity context, and we'll talk about some of the benefits of profits interests later on. A key feature of profits interests is ensuring that they do only share in future growths. So profits interests are often granted with an express distribution threshold that's fair market value of the company at the time the profits interest is issued, and for this purpose, fair market value is determined based on the proceeds that the company would receive if the partnership to assets were sold at fair market value and then the proceeds distributed in complete liquidation.

So if the company is sold, the profits interest holder can only share in that appreciation after the time of grant. If the profits interest holder is eligible for distributions by the LLC, it's important to make sure the profits interest holder only shares in distributions of profits that were earned after the profits interest was granted. So the IRS has issued a safe harbor definition of a profits interest. The most important requirement by far is the distribution threshold. That's the one that you normally see as raising factual questions that you have to ensure you get right.

The other requirements are first that the profits interest do not relate to a substantially certain predictable stream of income from partnership assets. The profit's interests are not disposed of within two years of receipt and the profit's interest are non the publicly 3:47 traded partnership. Again, determining fair market value is usually the main issue. Sometimes you can run into an issue with a profit's interest being disposed of within two years of receipt, for example, a company is sold less than two years after the grant occurs.

Just one final point on the profits interest requirements. For unvested profits interests, there are additional conditions. First, both the company and the recipient must treat the recipient as a partner for tax purposes, beginning on the date of grant. So even though the person is unvested, they're still a partner for tax purposes. Second, no compensation deduction can be taken in connection with the grant.

Taryn Cannataro: As we said earlier, the advantageous tax treatment of profits interests make them a valuable incentive tool for employees. How are profit interests treated for tax purposes?

Sophia Mokotoff: As you mentioned earlier, profits interests provide for potentially really favorable tax treatment in terms of equity compensation. There's no tax on grant or vesting and potentially the recipient can get long-term capital gains on an exit. Since the profits interest is a type of partnership interest, it's worth noting some of the differences between being a partner as compared to owning equity in a company that's treated as a corporation for tax purposes.

Employees who receive a profits interest grant will be taxed on the company's income because a partnership is a pass-through entity for tax purposes. High level this means that the company does not pay any entity level tax. The company's profits and losses are allocated or passed through to the partners whether or not the partner receives any actual distributions of cash. So, a partner, including service provider who holds a profits interest must pay taxes on his or her share of the company's profit even if the partnership doesn't distribute any cash.

Oftentimes we see this dealt with by providing that the company has to make tax distributions to his partners, including recipients of profits interest if applicable. As we'll discuss a little later on, the IRS has generally taken the position that service providers cannot be both a W2 employee or a 1099 independent contractor and a partner for tax purposes. So, upon receiving a profit's interest, the recipient is no longer treated as an employee of the company and instead the recipient becomes a partner for tax purposes and will receive forms K1 reporting his, her, their share of the LLCs profits and losses in accordance with the operating agreement of the company. The K1 also will include payments for services or what' was previously reported on the W2 as salary.

Because a partnership is a pass-through entity for tax purposes, gain or loss recognized at the company level retains its character when allocated to the partners. So, if a recipient of a profits interest is entitled to share in operating profits, some of this income may qualify for long-term capital gains treatment. Qualifies long-term capital gains, the assets of the company must be capital assets which were held for more than one year. In certain contexts, because of recent tax law changes, a longer three-year holding requirement applies to qualify for certain preferential long-term capital gains treatment on gains realized from certain profits interests. This special three-year holding period requirement was specifically designed to target profits interests and investment funds.

The way this was implemented was it applies to profits interest received for performing substantial services in a business that consists of both raising or returning capital and investing in, disposing of, or developing securities, commodities, real estate held for rent or investment, cash equivalents, options, or derivatives on any of these assets, on an exit gain from the sale of profits interests, or generally capital gain. However, unlike with stock, there are rules that require some of the gain to be treated as ordinary income depending on the types of assets held by the partnership.

One point about unvested profits interests. Profits interest holders are often encouraged or even required to file section 83B elections, which need to be filed within 30 days of the date of grant. These are often thought of as protective, but there really is very little downside to filing them because the fair market value of the profits interest for tax purposes is treated as $0 at the date of grant. So, there's no tax due or triggered because of the 83B election. Filing the 83B election also protects the holder in the event that the profits interests unexpectedly did not qualify as profits interests at the time of grant because of failure to meet one of the requirements that Darren described earlier.

Darren Goodman: Taryn, aside from the favorable tax treatment, what are some other benefits and downsides to profits interests?

Taryn Cannataro: A few benefits of profits interest is that there's no exercise price or purchase price required by the profits interest holder. There's also considerate flexibility in structuring terms and economic terms, and profits interest promote immediate ownership, so employees have the opportunity to share in ownership of the company once the profits interests are granted.

A few downsides are that as discussed earlier, for tax reasons, profits interests can only share an increase in value after the date of grant, although profits interest can be issued with a catch up to make up for this. A catch up provides that profits interest holders receive 100% or some other disproportionately large share of the income after the distribution threshold has been satisfied to catch them up to the amount they would have received if they were entitled to receive their proportionate share of the income before the distribution threshold.

Darren Goodman: Taryn, if a profits interest is granted with a threshold that allows people to share in preexisting value, the interest would be a capital interest, so the capital interests are taxed less favorably than profits interests. In general, assuming there was no purchase price paid, the fair market value of the interests would be taxed at ordinary income rates at the time the capital interests vest or at the time of grant of an 83B election is made. It's a big difference from profits interests where you file the 83B election and normally the ordinary income tax will be zero, but the capital interest you're facing ordinary income tax, which is why there's such emphasis on getting the threshold right and granting profits interest. Just another downside of profits interests or capital interests, if they were granted, and Sophia talked about this a bit, is that they convert W2 employees into partners for tax purposes if they're issued by the employing entity. This one's particularly important to note because many people are unaware of this.

Being a partner rather than an employee means among other things, the employee gets a K1 to do their taxes rather than a W2, will be subject to self-employment tax, meaning they're paying the employee and the employer portion of Social Security and Medicare taxes, will have to make quarterly estimated tax withholdings rather than having the employer withhold, and they will be eligible to participate in the cafeteria plan, which is a plan that allows pre-tax contributions towards health insurance premium and some other benefit plans. There is ways to structure around this, but if you are an executive and you are receiving an offer where you're getting profits interests, it's important to think about am I going to be turned into a partner for tax purposes? Has the company structured around it because it's something that has an impact on people?

Another downside, again, because you need an LLC or a partnership to grant the profits interests. If you don't have one in the structure already, you might need to create one and there can be work and complexity involved in doing that. You have to determine fair market value, which sometimes it's straightforward, sometimes it's not. Then finally, there can be some communication challenges in explaining these to employees. People generally know what stock options are. Profits interests not so much. So, for those people who understand and familiar with them, generally they're comfortable with it. They understand that they're getting some potential for some really favorable tax treatment as a result of the profits interests. Not everyone's in that position and some people need more explanation.

Taryn Cannataro: We've mentioned a few times that profits interests have flexibility in structuring. What are some of the different features that can be incorporated into a profits interest award?

Darren Goodman: So, a common question is how does the profits interest vest? It can be time vesting. It can be performance vesting. It's pretty common for people to get a mixture of both time vesting profits interest and some profits interest that'll only invest based on performance. The performance of vesting can be based on achievement of multiple uninvested capital targets or minimum internal rate of return targets. So, there's a lot of flexibility there.

Another question will be what happens at the time of a change in control? Are we going to accelerate vesting? Are we not going to accelerate vesting? Again, there's flexibility to structure this how a company wants. Another question is, what happens on termination of employment? Unvested profit interests are normally forfeited, but sometimes, especially for senior executives, there are special provisions negotiated. For example, if they're terminated without cause, they'll get some or all acceleration of vesting.

Taryn Cannataro: Another feature that we see often is the company retaining the ability to repurchase vested profits interest upon a termination of employment of the profits interest holder. The repurchase price for good leavers is often fair market value. The repurchase price for bad leavers, for example, someone who's terminated for cause, can be less than fair market value. For example, we often see the lesser of fair market value and the purchase price, which for a profit's interest is typically zero. The company can set the repurchase window, which is often within one year of determination of employment.

Darren Goodman: Just to add to that, Taryn, the definitions of what's a good leaver or what's a bad leaver, what is the definition of cause, those are all types of things that are negotiated sometimes very heavily before the profits interests are granted.

Taryn Cannataro: Another feature is that you can condition profit interest issuances with compliance with existing or new confidentiality, non-competition, non-solicitation, non-disparagement, and other restrictive covenants. One thing to be mindful of here is that enforceability of restrictive covenant will depend on applicable state law.

Darren Goodman: That's another important point, Taryn, because there's been a lot of activity, especially in the non-compete space. So, understanding where your employees are located, what's permissible, what isn't, it's an important point.

Taryn Cannataro: If a company wants to issue profits interest, what should they do?

Darren Goodman: It'll be very important to work with tax and benefits counsel and other corporate counsel to make sure that the profits interest are structured properly. Because there's a lot of flavors of profits interest, a lot of variability, it's important to make sure you get the details right. So, there is upfront work involved, but because of the potential tax benefits, companies often find that it's worth it. The LLC agreement or operating agreement will need to be reviewed to make sure that it can accommodate profits interests, or make sure whatever changes that are needed are in fact made.

There'll need to be a profits interest grant agreement. Sometimes these are structured to have both the profits interest plan and a profits interest grant agreement analogous to a corporation with an equity incentive plan and forms of grant agreement. Again, it could require putting an LLC or an LP in the structure if not there already. So again, there'll be some upfront work involved, but once you do that work, it becomes much more routine to grab the profits interests thereafter.

Taryn Cannataro: Profits interest can be a very valuable tool to incentivize employee and they provide an opportunity to share in the ownership of the company in a tax favorable way. However, as we've learned today, there are a number of considerations to keep in mind when structuring profits interest. Proper planning and structuring can help make profits interest issuances go smoothly and allow employees to receive a tax favorable treatment in the event of a sale or other changing control.

This episode is intended to be a high-level overview but is by no means the exhaustive discussion. If you're considering granting profits interest, or are receiving a profits interest grant, we recommend that you reach out to benefits and tax advisors to discuss. Thanks for joining us today. We look forward to having you back for our next episode of Just Compensation.

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