Profits Interest

Motivating Employees with an Economic Interest in the Company

By Mark Astling,
Shareholder,
Durham Jones & Pinegar

Giving key employees an ownership interest in a business can be an effective way to hire, motivate and retain them. Traditional methods of giving key employees an ownership interest in a corporation (e.g., stock options, restricted stock awards, etc.) often come with a hefty tax bill or require that an employee make a substantial investment into the company. In contrast, a limited liability company can give an employee a "profits interest" that:

- **allows the employee to have an economic interest in the company,**
- **avoids taxation at grant,**
- **does not require a capital investment,**
- **may contain terms found in traditional equity grants (e.g., vesting, restrictions on transfer, etc.) and provides capital gains tax rates upon liquidation of the interest.**

An Economic Interest in a Company

A profits interest is the right to share in both the future profits earned by an LLC and the appreciation in the value of the assets of the business. To illustrate, assume that when an LLC is worth $1 million, it grants a key employee a 10 percent profits interest. The day after the grant of the interest, the profits interest does not have any value since the LLC has yet to appreciate in the value. If the employee works diligently and the LLC increases in value by $2 million, the profit interest would be worth $200,000 (or 10 percent of the $2 million increase in value).

This increase in value can be realized through operational distributions or upon a sale or other liquidation of the LLC. Since a profits interest has value only if the LLC increases in value, the employee is properly incentivized to work to maximize the value of the LLC.

Avoiding Immediate Taxation

The grant of a profits interest is not taxable to either the employee or the employer if it has been properly structured. To do so, a profits interest must be crafted to represent an interest in future profits and growth and not in a company's historical value or profit. In addition, certain IRS rules must be followed. For example, a profits interest must not relate to a substantially certain and predictable stream of income.

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No Capital Investment

In the corporate context, a stock option requires that an employee pay cash or other consideration to the company on exercise, and the grant of restricted stock requires that the employee pay fair market value for the stock at the time the stock is issued to them (in cash or a full-recourse promissory note). Employees may not have or are reluctant to use the funds required by stock options or restricted stock. Because a profits interest represents future value only, no cash or promissory note is required.

Typical Equity Terms

Profits interests are extremely flexible and may include terms that are typically found in traditional equity grants, including vesting requirements, acceleration and forfeiture provisions, voting restrictions (if desired), drag-along and tag-along rights, and other transfer restrictions.

Capital Gains Tax Rates

Perhaps most important to the employee, if a profits interest has been properly structured, the disposition of a profits interest will allow the holder to recognize capital gains that are taxed at favorable long-term rates. Even with capital gains tax rates set to increase in 2013, the difference between ordinary tax rates and long-term capital gains tax rates can produce a significant economic benefit to an employee.

The advantages over traditional forms of equity compensation make profits interest an effective tool for compensating and retaining key employees. Given the complex legal, accounting and tax issues involved with a profits interest, a company should seek advice before granting a profits interest to an employee. UB