

Keeping Employees Interested

Profits Interests – Their Potential Business Benefits and Caveats

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One of the first and most important tax-driven decisions a founder must make is the type of entity in which to house his or her venture. Though much ink has been spilled over the pros and cons of choosing a corporation versus a limited liability company, or LLC, one thing is certain: most folks understand corporations better than LLCs. And who could blame them? LLCs can be complicated entities – so flexible that they often seem downright weird. As a result, even when a founder decides that an LLC is the right fit, it is often structured to look as much like a corporation as possible. We denote membership interest as stock-like units, we view boards of managers simply as directors by another name, and yes, we sometimes even issue options to employees. Equity compensation strategies in the world of the LLC, however, can be much thornier propositions than they are for the humble corporation.

Tax lawyers generally prefer to structure LLC equity compensation awards as issuances of profits interests rather than grants of options. It remains unclear how the IRS views options in an LLC in certain respects. In particular, it is likely from a tax perspective that the exercise of an option granted by an LLC would be equivalent to an issuance of a capital interest, the consequence of which remains unclear in some respects, but which would be taxable to the service provider. Additionally, LLCs cannot issue incentive stock options, or ISOs. ISOs have the benefit over other stock options of allowing the recipient to defer the tax bill. Therefore, with an ISO, the employee would recognize no income (except under the alternative minimum tax, or AMT) when he or she exercises, even if there is a spread between the strike price and the fair market value of the stock when the option is exercised. Instead, he or she can pay the tax on that spread later, usually upon an exit (although the tax on the spread is ordinary income if he or she has not held the stock for at least a year after exercise and two years after grant).

Nevertheless, there is a viable alternative – the profits interest. In the most basic sense, a profits interest is interest in the LLC that is deemed to have zero value on the date it is issued. This means that if the company were to be sold at the moment after a profits interest is issued, the holder of the profits interest would receive nothing in the waterfall. The recipient of the profits interest award realizes no income at issuance. As the LLC grows, however, the holder of the profits interest begins to accrue his or her share of that growth. In other words, the profits interest grows in value as the LLC does.

A profits interest is very different from an option in that the service provider owns equity from the outset, and it is likely that difference that makes potential users uncomfortable using them as their equity compensation vehicle of choice. To be fair, the arrangement described above is very different from an option, where an employee is granted an option to purchase stock at a particular strike price and with vesting before he or she can exercise the option. But their differences from options can make them a great incentive device for certain classes of employees, worthy of consideration, not only for their relative tax benefits, but also for their business virtues.

Because the employee does not need to worry about realizing gain at issuance, neither the employee nor the company need worry about the tax need for consideration. Say good-bye to the dreaded option strike price, which requires the employee to have the liquidity to pay up before realizing the benefit of an option. Because the employee owns the equity as soon as the profits interest is issued, the employee recipient knows that he or she will share in any appreciation of the LLC, without the impediment of any exercise requirement or the uncertainty over whether he or she will even have the liquidity to exercise in the first place. This may give some employees a greater sense of partnership and a greater incentive to grow the business than even traditional options would.

It should be noted, however, that profits interests are not free from traps for the unwary. Because a recipient of a profits interest is effectively granted equity in the LLC on day one, they immediately become an LLC partner for tax purposes. As a result, the LLC no longer withholds income tax from the employee's paycheck, pays half of the employee's employment tax burden or issues the employee a W-2. Instead, the employee will receive his or her entire gross pay and will then have to ensure that he or she has the liquidity to pay the taxman when he comes calling. As a result, it may be best to reserve profits interests for more sophisticated, executive level employees, and, given the uncertainty around options in LLCs, rely on bonuses to incentivize rank-and-file employees. Nevertheless, for those willing to navigate the sometimes choppy tax waters of equity compensation in the LLC world, the flexibility of the LLC can provide a myriad of choices to help give employees a piece of the action.

For more information about profits interests and other equity compensation strategies, please contact **Ryan J. Perry**.