Advanced Profits Interests Issues for Private Equity Sponsors

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A Practice Note addressing issues that private equity sponsors should consider when granting profits interests. This Note discusses the tax advantages of profits interests, the requirements for tax-free grants of profits interests, structuring the distribution waterfall, common vesting, forfeiture, and repurchase provisions, partner-employee classification issues, restrictive covenants, and granting profits interests in non-US jurisdictions.

Many private equity (PE) deals today use limited partnerships (LPs), limited liability companies (LLCs), or other entities taxed as partnerships to serve as the main holding company for the target business. In most PE deals there are also frequently upper-tier or lower-tier blocker corporations. While detailed information about the overall structure of PE deals is beyond the scope of this Note, for general information about the structure of PE funds, see Practice Note, Private Equity Fund Formation (3-509-1324). For information on structuring private equity co-investments, including using blockers, see Practice Note, Structuring Private Equity Co-Investments (W-000-4825). For ease of reference, except where otherwise indicated, all entities treated as partnerships for U.S. federal income tax purposes are referred to in this Note as partnerships. Structuring PE deals using partnerships to hold the target business provides myriad benefits to PE sponsors, co-investors, and legacy target equity holders, including:

- Avoidance of an entity-level tax on the target holding company.
- Flexibility in crafting bespoke distribution waterfalls.
- Tax-efficient rollover opportunities.
- Tax basis step-up opportunities on acquisition and on future exit with associated premium pricing for tax assets.

Management compensation structures in PE deals, such as leveraged buyouts, typically rely heavily on equity-based incentives to compensate management. Unlike public companies which usually rely on cash and bonus pay packages, in addition to public company equity-based incentives, many privately held portfolio companies of private equity funds offer a more performance-based compensation system for key executives in which equity-based incentives play an outsized role. PE's reliance on partnership structures has an additional benefit in that it allows for the grant of profits interests to management teams. Profits interests can mirror the economics of equity-based awards in corporations but with the possibility of more favorable tax treatment to the holders. Specifically, income allocable to a profits interest may be eligible for the potentially lower long-term capital gains tax rate if held for more than one year. Even after the Tax Cuts and Jobs Act, profits interests granted to the PE sponsor's own employees or management teams can still qualify for the long-term capital gains tax rate, but must generally meet a longer three-year holding period requirement to qualify for long-term capital gains treatment (see Longer Capital Gain Holding Period for Certain Profits Interests).

Additionally, under current guidance, profits interests may be treated as exempt from the complicated nonqualified deferred compensation rules under Section 409A, and therefore offer more flexibility when structuring executive compensation (see IRS Notice 2005-1, 2005-1 C.B. 274). For an overview of Section 409A, see Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview (6-501-2009).

PARTNERSHIP INTERESTS

Partnership interests are interests in an entity taxed as a partnership, including:

- LPs.
- LLCs.
- A variety of foreign equivalents that are or elect to be treated as partnerships for US tax purposes.

Partnership interests can either be capital interests or profits interests, both of which are considered to be equity interests in the partnership.

CAPITAL INTERESTS

Capital interests provide the holder with an interest in the existing value of the partnership, that is, the existing capital or accumulated profits at the time of grant. Capital interests are generally taxable on grant or, if subject to vesting conditions, on vesting, based on the fair market value of the capital interests on the grant date or vesting date, as applicable.

PROFITS INTERESTS

Profits interests are interests that give the holders of the profits interests the right to participate **only** in the future profits and appreciation in the value of the partnership. Profits interest holders are therefore not entitled to receive existing capital or accumulated profits at the time of grant or on a liquidation of the partnership on or immediately after the grant date.

Although profits interests are not explicitly described in the Internal Revenue Code (Code), the Internal Revenue Service (IRS) has confirmed that the grant of a profits interest in connection with the provision of services to or for the benefit of the partnership will not constitute a taxable event if three safe harbors (the Safe Harbors) are met:

- The liquidation value at the time of grant is $0 and the profits interests do not relate to a substantially certain or predictable stream of income from partnership assets.
- The profits interests are not disposed of within two years of receipt.
- The profits interests are not in a publicly-traded partnership.

(Rev. Proc. 93-27.)

PUBLICLY-TRADED PARTNERSHIPS

A publicly-traded partnership, which is classified as a corporation for US federal income tax purposes, is generally a partnership the interests of which are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent of a secondary market), with the participation of the partnership.

PE sponsors may avoid classification of a partnership as a publicly-traded partnership under the private placements safe harbor if:

- All the interests of the partnership are issued in a transaction that is exempt from the registration requirements under the Securities Act of 1933 (Securities Act).
- The partnership does not have more than 100 partners (which may include indirect partners due to the application of look-through rules) at any time during the taxable year of the partnership.

For an overview of U.S. federal securities laws and a discussion of private placement exemptions from registration under the Securities Act, see Practice Notes, US Securities Laws: Overview (3-383-6798) and Section 4(a)(2) and Regulation D Private Placements (8-382-6259). For more information on publicly-traded partnerships, see Practice Note, Taxation of Publicly Traded Partnerships (9-501-0947).

For more information on profits interests and capital interests, including taxation of income under different scenarios, see Practice Note, Partnership Equity Compensation (1-525-2704).

VESTING OF PROFITS INTERESTS

PE sponsors typically grant one-third to one-half of the profits interests as time-vesting profits interests, usually in equal annual increments over a four or five-year period (and sometimes with an additional performance hurdle).

The remaining one-half to two-thirds are typically performance-vesting units, based on achievement of a certain minimum multiple on invested capital (MOIC) or money-on-money (MoM) return, and/or a minimum internal rate of return percentage (IRR)., in each case generally in connection with an exit or liquidity event (performance vesting conditions are referred to as the Hurdle) before any distributions are available to the holders of profits interests. Some PE sponsors also have performance-based profits interests that vest based on achievement of operational goals, such as achievement of EBITDA-based targets.

Achievement of the Hurdle is almost always determined after taking into account any payments that will be made with respect to the profits interest holders, that is, if payments to the profits interest holders would cause the Hurdle not to be achieved, the Hurdle is not deemed met for purposes of vesting of the profits interest holders.

PRACTICE POINT

It is important to consider:

- Whether the Hurdle should take into account just initial capital contributions or whether it should also include future capital contributions.
- How this decision may impact the various Hurdle calculations.

The sections that follow address ways in which vested and unvested profits interests may be affected by certain events, such as:

- Termination of employment (see Forfeiture of Profits Interests on Termination of Employment or Service).
- Breach of restrictive covenants (see Termination for Cause or Breach of Restrictive Covenants).
- The occurrence of a change in control or an initial public offering (IPO) (see Special Vesting and Forfeiture in Connection with a Change in Control or Initial Public Offering).

FORFEITURE OF PROFITS INTERESTS ON TERMINATION OF EMPLOYMENT OR SERVICE

Time-Based Awards and Performance-Based Awards Where Performance Condition Not Achieved at Termination

Most profits interest award agreements provide for forfeiture of all unvested profits interests in the event of any termination of employment or services for any reason, including all performance-based vesting profits interests for which the performance condition is not achieved as of the termination date.

Time-Based Awards with Performance Hurdle

In the case of time-based vesting profits interests that also contain a performance Hurdle, it is not uncommon for the profits interest to remain outstanding in the event of a termination without cause or resignation for good reason or retirement, and sometimes in the event of termination for death or disability, to the extent "conditionally-vested" based on length of service (unless otherwise forfeited based on subsequent events).

In this case, achievement of the performance Hurdles of the profits interests is determined either on:

- The next exit or liquidity event.
- The date of termination based on a deemed fair market value as if there was an exit or liquidity event on that date.

Unlike other equity-based awards or phantom awards, since profits interests are exempt from Section 409A, there is no requirement to provide that the next exit or liquidity event must occur within a certain time period or the profits interests will be forfeited. However, most profits interests are structured with time limits as a business matter.

Termination for Cause or Breach of Restrictive Covenants

If the holder's employment terminates for cause at any time, most award agreements provide that all profits interests, whether vested or unvested, will be forfeited. Vested profits interests also typically are forfeited if the holder breaches any applicable restrictive covenants following his or her termination of employment or service.

SPECIAL VESTING AND FORFEITURE IN CONNECTION WITH A CHANGE IN CONTROL OR INITIAL PUBLIC OFFERING

Many profits interests provide for accelerated vesting, to some extent, in the event of:

- A change in control.
- An initial public offering (IPO).

Treatment of Time-Vesting Profits Interests

PE sponsors typically provide for full vesting of time-vesting profits interests in the event of a change in control or IPO but occasionally only vest on a termination without cause or resignation for good reason following a change in control.

Treatment of Performance-Vesting Profits Interests

Performance-vesting units generally accelerate on a change in control or IPO but only to the extent the performance-vesting condition, or Hurdle, is satisfied as a result of the change in control or IPO. The IPO price is typically used to determine if the performance Hurdles are met.

Vesting on a Sale or Partial Sale

"Change in control" for profits interests is often defined as a sale of a majority of the equity or substantially all of the assets of the company. In the event of a partial sale, that is, a sale of less than all of the equity or assets of the company, most profits interests determine vesting based on actual cash proceeds received as part of the sale (as opposed to an implied valuation as if it was a sale of all of the equity).

An alternative is for the PE sponsor to convert any forfeited profits interests to phantom awards to management through the PE sponsor's entity and not the operating company. This provides management with the opportunity to receive payments as if the profits interests remained outstanding but with the phantom amounts taxable at ordinary income rates on vesting and without the possibility of any capital gain treatment.

In the event of termination without cause or resignation for good reason, and sometimes in the event of termination for death or disability, some PE sponsors provide profits interest holders with the ability to vest in performance-vesting profits interests (and not typically in time-based vesting profits interests) if there is also a closing of an exit or liquidity event that meets any applicable performance Hurdles within a limited time period following termination (a Tail). The duration of the Tail is typically between three and twelve months (most commonly six months) following termination.

The Tail gives the profits interest holder who is no longer employed at the time of the closing of the transaction the ability to participate in a transaction to which their efforts arguably contributed, given the proximity of the closing of the transaction to the holder's termination of employment (and even if the transaction was not contemplated until after the termination of the holder's employment).

Alternative Approaches on an IPO

On an IPO of the operating entity or its parent, profits interests are typically cancelled, and the holders receive substitute awards, such as restricted stock, that are more in line with public company incentive arrangements.

A less common approach is for the profits interests to survive following an IPO with the price of the stock 181 days after the IPO (after the lock-up period expires) used to determine if the performance Hurdles are met. This alternative is less popular because of the substantial disclosure that is required by the new public company about the profits interests. However, it does not accurately track the amount the PE sponsor actually receives as return on investment.

A third approach is to wait for the PE sponsor to receive cash after the IPO equal to the required performance Hurdles.

Forfeiture or Conversion of Unvested Profits Interests

In the event of a sale or partial sale, it is common for any profits interests that do not vest based on the change in control, even if a partial sale, to be forfeited. Although management might take issue with the fact that the PE sponsor continues to have the opportunity to hit the Hurdles on a sale of the remainder of their equity interests, most buyers of a controlling interest in the partnership will want the opportunity to provide incentive equity of their choosing rather than be tied to seller's incentive equity.

REPURCHASE ON TERMINATION OF EMPLOYMENT OR SERVICE

The partnership, the operating company, or the PE sponsor typically has broad rights to repurchase vested profits interests that are not otherwise forfeited, in the event of termination of employment or service. The partnership typically has the right, but not the obligation, to repurchase the units between six and twelve months after the termination date, with the purchase price being the fair market value as of the date of termination. If the profits interests provide for a Tail and a transaction closes within the Tail period, the Tail also typically provides for a top-up of the purchase price on the repurchase so that the repurchase would instead be the fair market value based on the closing date purchase price (assuming it is higher than the fair market value on the date of termination).

If the repurchase right is not exercised within this time period, some profits interests will freeze the fair market value of the units as of the date of the termination based on an implied valuation as if there was an exit at the date of termination. In this case, on a subsequent, actual change in control, these units will receive the lesser of the fair market value as of:

- The termination date.
- The date of the actual change in control.

Some profits interests permit repurchase over a longer period after termination of employment, for example, two years or even up to immediately before a change of control. However, the purchase price is typically fair market value as of the date of the notice of repurchase (at least after some initial period of lesser duration).

PROTECTIVE SECTION 83(B) ELECTION

Under Revenue Procedure 2001-43, the vesting of profits interests that are substantially non-vested when granted does not constitute a taxable event (regardless of whether a Section 83(b) election has been made) if the following requirements are met:

- The profits interests meet the Safe Harbors.
- The holder is treated as a partner for tax purposes from the grant date.
- The holder takes into account the distributive share of partnership income, gain, loss, and deduction associated with the profits interests for the entire period for which the holder holds the profits interests.
- Neither the partnership nor any of its partners takes a compensation deduction for the fair market value of the profits interests.

(Rev. Proc. 2001-43.)

Despite this guidance, a holder of profits interests who is working in the US or who is a US citizen (and therefore subject to tax on worldwide income) can and should make a protective Section 83(b) election to ensure that the fair market value of the profits interests ($0) is included in the holder's gross income at the time of grant.

The fair market value of the profits interests on the grant date is $0 because the holder is not eligible to receive anything in respect of the profits interests if the partnership were to be liquidated immediately following the grant date (assuming it is properly structured). This election must be made within 30 days following the grant of the profits interests. For a sample Section 83(b) election for profits interests, see Standard Document, Code Section 83(b) Election: Profits Interests (4-563-5607).

Although one of the main benefits of a profits interest is that vesting should not constitute a taxable event, the filing of a protective Section 83(b) election is standard and clearly the best practice. This is because at the time of grant it is unknown whether the profits interests will be disposed of within two years and, as a result, fail to meet the Safe Harbor requirements.

If a protective Section 83(b) election is filed, even if it turns out that the profits interests do not meet the Safe Harbor requirements:

- The holder would have already elected to be taxed on the fair market value of the profits interests in the year of the grant.
- To the extent that the profits interests are deemed to have had some value on the grant date, the value will presumably be less at the time of grant than at the time of vesting.

If a Section 83(b) election is **not** filed and two years or more pass between the grant date and the date of exit or liquidity event, then the units should be treated as partnership profits interests (assuming no built-in value on the grant date and other Safe Harbor requirements are satisfied) under the IRS guidance in Revenue Procedure 2001-43.

LONGER CAPITAL GAIN HOLDING PERIOD FOR CERTAIN PROFITS INTERESTS

Under Code Section 1061, after December 31, 2017, certain profits interests must be held for **at least three years** to qualify for long-term capital gains treatment (instead of the typical greater than one-year requirement) (26 U.S.C. § 1061). These profits interests must be provided for substantial services or activities relating to raising capital and investing in, disposing of, or developing a "specified asset," including:

- Securities.
- Commodities.
- Real estate held for rental or investment.
- Cash or cash equivalents.
- Options.
- Derivative contracts.

Equity holders in, among others, hedge funds, PE funds, and real estate investment-based businesses are subject to the three-year requirement. Employees, including executive and management teams, of PE sponsors' portfolio companies that operate outside of investment management-type businesses are typically not subject to the three-year holding requirement. The Secretary of the Treasury has discretion to limit the requirement to income or gain attributable to any assets **only** held for portfolio investments on behalf of third-party investors.

STRUCTURING DISTRIBUTIONS TO PROFITS INTERESTS UNDER THE DISTRIBUTION WATERFALL

Waterfall provisions (also known as distribution provisions) are included in partnership agreements to specify how the partnership distributes assets to its partners. They create different priorities of payments among different classes of partners. State partnership statutes typically defer partnership distribution obligations to the specific terms of the applicable partnership or LLC agreement. Partners therefore can structure a wide variety of economic arrangements. For a detailed discussion of waterfall provisions, see Practice Note, Structuring Waterfall Provisions (8-506-2772).

In theory, a basic or 'naked' profits interest (meaning the holder participates on a pro rata basis in future profits) may receive distributions from the partnership once distributions from that partnership to other partnership capital interest holders equal the fair market value of the partnership on the grant date of the profits interest (the Distribution Threshold).

Example: Assume a partnership with ten partners, each having a capital account of $10,000 and one additional partner holding a profits interest, with each of the ten partners with capital accounts and the profits interest holder being entitled to share equally in the future profits of the partnership. In this design, if the partnership is worth $100,000 on the grant date of the profits interest and is later liquidated for $200,000, each of the holders of capital interests would first receive $10,000 (as the return of their capital), and each partner (both capital interests and profits interests) would receive one-eleventh of the upside above $100,000 (approximately $9,090.91). Each of the capital interest holders' return would therefore be approximately $19,090.91.

The Distribution Threshold in the above example would be the $100,000 in capital accounts as of the grant date. To the extent that additional contributions are made during the lifetime of the profits interest, the Distribution Threshold would increase as necessary. The Distribution Threshold only needs to be taken into account on exit or a liquidity event, and therefore does not prevent a profits interest holder, whether vested or unvested, from receiving interim distributions of profits following the grant date.

THE CATCH UP OR SUPER-PRIORITY PROFITS INTEREST

The partnership could alternatively design the profits interest so that the profits interest holder receives one-eleventh of the **total** return by requiring that after the Distribution Threshold (here $10,000 on each capital account, or $100,000), the next $10,000 of profits (the Catch-Up Amount) goes entirely to the profits interest holder, with the remaining profits ($90,000) to be split equally among each of the 11 partners. A profits interest with this design is relatively common and is sometimes called a catch-up or super-priority profits interest.

In this scenario, the profits interest holder and each of the holders of capital interests would receive approximately $18,181.82 in the $200,000 liquidation. Here, the profits interest would be on equal footing with the capital interests, assuming there are sufficient profits (after achieving the Distribution Threshold) to meet the profits interest holders' Catch-Up Amount.

Under proposed IRS regulations, certain catch-up provisions have some risk of being treated as a disguised payment for services (and thereby being treated as ordinary income and not eligible for long-term capital gain treatment) where a payout arrangement of a profits interest does not expose the profits interest to significant entrepreneurial risk (based on the business success of the venture) (Prop. Reg. § 1.707-2(b), 80 Fed. Reg. 43,652 (July 23, 2015)).

This IRS guidance caused many practitioners concern that catch-up (or so-called super priority) profits interests do not have significant entrepreneurial risk as they effectively are entitled to 100% of the first dollar of profits after the return of capital (up to the Catch-Up Amount). However, since the question of significant entrepreneurial risk is a facts and circumstances-based analysis, the overall capital structure of the company should matter.

If the structure includes debt or preferred partnership interests with a required return of capital plus a percentage priority return or "coupon," the catch-up (or super-priority) profits interests would appear to be subject to entrepreneurial risk since the catch-up payment would be contingent on the debt holders and preferred partnership interests receiving their returns before the catch-up profits interest holder receives anything. If the structure does not include debt or preferred partnership interests, the catch-up (or super priority) profits interests might not be seen to bear sufficient entrepreneurial risk to qualify for treatment as profits interests. PE sponsors should bear in mind the risk that certain catch-up profit allocations might be treated as disguised payments for services when structuring the waterfall distributions.

OVERACHIEVEMENT (OR PREMIUM-PRICED) PROFITS INTERESTS

The percentage of the equity pool available for profits interests is typically within the range of 5% to 20% of the fully-diluted units, with most profits interest pools matching what would be given in a typical equity award pool in a C-corporation (for example, a stock option, restricted stock unit, or restricted stock pool).

One relatively common way to provide additional incentive to management is to provide so-called "overachievement profits interests," which only participate in profits and appreciation in value above a certain performance Hurdle. Overachievement profits interests operate similarly to premium-priced stock options (that is, options that are granted with an exercise price above fair market value on the grant date), in this respect.

Example: Assume a partnership with ten partners, each having a capital account of $10,000, and one additional partner holding an overachievement (or premium-priced) profits interest that permits the holder only to share in profits after a 2x return to the holders of capital interests with respect to their capital contributions. In this design, if the Company were liquidated for $300,000, each of the capital interest holders would first receive $10,000 (as the return of their capital) and then another $10,000 (to bring their return up to 2x their capital contributions). Then each partner (both capital interests and profits interests) would receive one-eleventh of the upside above $200,000 (approximately $9,090.91). So, in this example each of the capital interest holders' return would be approximately $29,090.91 and the profits interest holder would receive $9,090.91.

MODIFIED CAPITAL STRUCTURE EXAMPLE

One of the greatest advantages of profits interests is that they allow flexibility, so the distribution waterfall can be tailored to add, among other things, preferred partnership interests and premium-priced profits interests. For example, assume a partnership capitalized with:

- $100,000 in preferred partnership interests that have an 8% priority return or coupon.
- $100,000 from the 10 partners with $10,000 each of capital accounts as described above.
- The partner with the catch-up profits interest with a Catch-Up Amount of $10,000 as described above.
- Additional profits interests that only share after a 2x return to the holders of capital interests with respect to their capital contributions.

If the partnership were subsequently sold for $500,000 at the end of year one, the distribution waterfall payouts would be as follows:

- $100,000 return of capital to the holders of the preferred partnership interests, plus an 8% coupon ($8,000) (at which point the preferred partnership interests typically cease to share in any future returns).
- $100,000 return of capital to the ten holders of capital interests.
- $10,000 to the holder of the catch-up profits interest in respect of the Catch-Up Amount.
- $110,000 total to the holders of capital interests and the holder of the catch-up profits interest ($10,000 per person) (at which point the ten capital partners will have received a 2x return).
- $172,000 total, split pro rata (based on their percentage of equity interests on a fully-diluted basis) by the holders of capital interests, the holder of the catch-up profits interest, and the holders of the premium-priced profits interests (approximately $14,333 per person).

PARTICIPATION IN INTERIM PROFITS DISTRIBUTIONS

Profits interest holders must be treated as partners from the date of the award, regardless of whether the profits interests are subject to vesting or forfeiture conditions. This means holders of profits interests should receive annual Schedule K-1s from the partnership detailing the profits interest holders' allocation of profits for the prior year and corresponding allocations of taxable income, if any.

In many structures, this allocation will be zero either because:

- The partnership does not have allocable profits.
- The profit interest holders do not receive annual distributions but rather receive distributions only on a liquidity or exit event.

Even where the profit allocation is zero for the profits interest holder, best practice would still be to issue the profit interest holders Schedule K-1s to show that they are being treated as partners of the partnership.

Many practitioners do not believe that the requirement to be treated as a partner from day one means that holders of unvested profits interests must receive interim distributions at the same time as capital interest holders. To be conservative, however, some practitioners prefer to structure the arrangement so that the profits interest holders are eligible to receive interim distributions. Even in instances where profits interests are entitled to interim distributions, however, it is common to provide that interim distributions with respect to unvested profits interests will be held back (typically without a formal escrow arrangement) and payable to the profits interest holders only if and when the profits interests vest.

Some practitioners go further and provide that the profits interest holders are not eligible to participate in any interim distributions but will instead receive a catch-up to the extent that they receive payments through the waterfall in, for example, an exit or liquidity event. Given the complexities surrounding interim distributions, it is common to have profits interests that only have a right to receive liquidation proceeds but not share in other interim distributions.

There is significant additional complexity with respect to allocations of book and taxable income to unvested profits interest holders, which is an area that PE sponsors often overlook when deciding to issue profits interests. Despite the substantial tax benefits available from profits interests, the following administrative requirements can be challenging:

- Keeping track of issuances of profits interests at different times and at different strike prices.
- Booking up capital accounts to reflect non-de minimis adjustments to the economic arrangements of the partners.

Moreover, trying to preserve qualification of profits interests under the Safe Harbor's requirement to treat holders as partners can result in unexpected consequences. For example, a profits interest that is issued with a MOIC or IRR Hurdle and that is only payable on a sale event can attract allocations of book income and corresponding allocations of taxable income before the sale event if the MOIC or IRR Hurdle would be triggered on a hypothetical liquidation based on booked-up carrying values for the partnership's assets. These allocations may require profits interest holders to file tax returns in states in which the partnership operates and to receive tax distributions, in each case, during the term of the partnership.

Further complications would arise if these profits interest holders were terminated without vesting of the profits interests that received these allocations and distributions. In this case, offsetting allocations to remaining holders would be necessary to zero out the capital accounts corresponding to the profits interests.

A complete analysis of these issues is beyond the scope of this Note, but PE sponsors are well-advised to discuss with their tax advisors the administrative and economic impact of the Safe Harbor requirement to treat holders of profits interests as partners in the partnership not just on exit but throughout the life of the partnership.

Clawback from Unvested Profits Interest Holders

If interim distributions are provided to holders of unvested profits interests, the partnership often requires the holders to return these amounts if the profits interests are later forfeited before vesting, for example, if the holder:

- Resigns from employment.
- Is terminated for cause or breach restrictive covenant agreements.

The profits interest holder may then seek to recover from the IRS any taxes paid by the holder in respect of such clawed back distributions. It is less common to require the holders of unvested profits interests to refund any mandatory tax distributions previously provided, even if the holders might be able to get refunds of the taxes paid by them with respect to the refunded distributions.

PHANTOM INCOME AND TAX DISTRIBUTIONS

Because profits interest holders are treated as partners from the date of the award regardless of whether the interests are subject to vesting or forfeiture conditions, they must receive a Schedule K-1 tax form each year (even if the K-1 shows zeroes for allocations and distributions). If the partnership has profits in a taxable year, a profits interest holder may receive an actual allocation on the K-1 of the holder's share of the profits irrespective of whether the profits are distributed to the holder during the year. This may result in phantom income (income allocated to, but not received by, the holder), for which taxes will be due. As a result, most LLC agreements require the payment of mandatory tax distributions to all holders, whether capital or profits interest and whether vested or unvested, to the extent the holders have phantom income.

PRACTICE POINT

An issue to consider is whether tax distributions should be taken into account when determining achievement of the Hurdle. Many PE sponsors expressly exclude tax distributions from this calculation. Others view any distributions of cash as qualifying with respect to achievement of the various Hurdles.

In many cases, tax distributions are excluded for purposes of calculating whether the PE sponsor has achieved its preferred return or Hurdle, but serve as an advance against distributions payable in the residual tranche of the distribution waterfall.

PARTNER/EMPLOYEE CLASSIFICATION ISSUES

Profits interest holders cannot be employees and partners of the same entity (Rev. Rul. 69-184, 1969-1 C.B. 256). In addition, partners in a partnership that owns a disregarded entity, such as a wholly-owned, direct or indirect subsidiary of the partnership, also may not be employees of the disregarded entity and partners of the partnership parent of the disregarded entity. (See 81 Fed. Reg. 26,693 (May 4, 2016).) Therefore, employees of a disregarded entity who receive profits interests at the parent partnership level will be considered partners of the parent partnership and not employees of the disregarded entity. This may create unwelcome tax consequences for these individuals. For more information on Revenue Ruling 69-184 and the implications of treating partners as employees, see Practice Note, Dual Status: Treating Partners as Employees (9-583-9305).

If an individual who works for the partnership is granted a profits interest and therefore treated as a partner for tax purposes, there are a host of collateral consequences, including:

- Her fixed periodic compensation (referred to as guaranteed payments or the partner's draw) is self-employment income rather than employee wages and therefore:
  - is subject to self-employment tax, which is paid through estimated tax payments instead of employer withholding; and
  - should be reported on a Schedule K-1 instead of a Form W-2.
- She cannot participate in the partnership's cafeteria health and welfare plans.

The transition from employee to partner can be confusing and make individuals anxious. It is, therefore, important that anyone becoming a partner for the first time due to the receipt of a profits interest understands these implications upfront. For a sample memo to individuals who are becoming partners due to their receipt of a profits interest, see Standard Document, Memo to Recipients of Profits Interests Explaining Implications of Award (W-001-6378).

Most executives prefer to be treated as employees to avoid higher self-employment taxes and to continue to be eligible for certain health and welfare benefits plans, including the benefit of pre-tax contributions.

STRUCTURES TO ENABLE DUAL PARTNER/EMPLOYEE STATUS

To permit executives to receive the benefits of being an employee while also being treated as a partner (or service partner), PE sponsors use a variety of structures to allow portfolio company management to be employees in one entity while partners of another entity. Two of the most common structures are:

- An LLC/C-Corp Structure.
- A Management LP tiered partnership structure.

LLC/C-Corp Structure

In an LLC/C-Corp structure, a C-corporation becomes a wholly owned subsidiary of the LLC/partnership. The LLC interests are held by the PE funds (typically, 80% of the interests) with management and senior employees holding the remaining equity (typically, 20% of the LLC interests split equally between capital interests, (usually a rollover from the prior company) and profits interests). The C-corporation or its subsidiaries employ all of the employees. Therefore, the profits interest holders are partners of the LLC/partnership and employees of the C-corporation. The disadvantage of this structure is that it adds an additional layer of tax at the C-corporation level that is not present in a tiered partnership structure.

Tiered Partnership Structure

In the tiered partnership structure, an LLC is acquired and elects to be taxed as a partnership. The LLC interests are held by the PE funds (typically split between capital and profits interests), with the remaining equity held by a separate management LP. The management LP is controlled by the PE sponsor or target company management. The management LP grants capital and profits interests in the management LP to management and senior employees of the LLC (typically, in parallel to its equity ownership in the LLC in so-called "back-to-back" issuances) with a residual interest in the management LP held by the LLC to allow for return of unvested amounts or amounts representing the Distribution Threshold on the grant date.

These tiered partnership structures often reduce the reporting and compliance burden as the LLC issues the full amount of the authorized profits interests to the management LP on the closing of the acquisition transaction or shortly thereafter. When profits interests are subsequently issued by the management LP post-closing, the book up of capital accounts by the management LP reflects adjustments in value with respect to the interests in the LLC as opposed to the underlying assets of the business. This distinction can result in material reductions in tax reporting and preparation expenses.

The management LP is the owner of part of the LLC, and the executives have no direct ownership of the underlying LLC/partnership. The LLC or its subsidiaries employ all of the employees.

Although most practitioners take the position that these tiered partnerships work to permit the individuals to be employees of one entity but partners in a related entity, the IRS regulations on this issue expressly decline to address the viability of tiered partnerships in this context (see 81 Fed. Reg. 26,693 (May 4, 2016)). However, recognizing the issues and perhaps unfairness with equity holders being regarded as partners in all cases, the Treasury Department and the IRS have requested comments on:

- The application of Revenue Ruling 69-184 to tiered partnership situations.
- The circumstances under which it may be appropriate to permit partners to also be employees of the partnership.
- The impact on employee benefit plans and employment taxes if Revenue Ruling 69-184 were to be modified to permit partners to also be employees in certain circumstances.

DILUTION, PREEMPTIVE RIGHTS, AND NEW ISSUANCES

Profits interests rarely have anti-dilution protection or preemptive rights. For that reason and others, profits interests also typically have no obligation to contribute capital in the future. Partnership interests receive some protection based on the terms of the amendment provisions set out in the LLC agreement, which typically provide that the LLC agreement, and in particular the distribution waterfall, cannot be amended in a manner that would materially, adversely, and disproportionately affect any class of partnership interests.

NEW ISSUANCES WHEN VALUE GOES UP

If the value of the partnership increases, additional profits interests can still be granted to employees and service providers but with a Distribution Threshold that reflects the fair market value of the partnership on the grant date. If the desire is to provide new management with the same level of incentives as existing management, this is typically accomplished by issuing new management with additional units to make up the difference or by issuing catch-up or super-priority profits interests.

NEW ISSUANCES WHEN VALUE GOES DOWN

If the value of the partnership decreases, additional profits interests can still be granted to employees and service providers but with a Distribution Threshold that reflects the fair market value of the partnership on the grant date.

PRACTICE POINT

An issue that arises when the value of the partnership decreases is that the Hurdle for the profits interests does not take into account that the interests are being awarded after the decrease. If the goal is to entice new management to come in and turn around the operations of the partnership, the partnership can either:

- Issue new management with additional units, primarily time-based vesting units, to make up the difference.
- Reduce or remove the Hurdle to the extent consistent with the particular amendment language in the LLC agreement.

TAG AND DRAG

Holders of profits interests are typically subject to being dragged along on certain sales by the PE sponsor and will have certain rights to tag along on certain sales by the PE sponsor. These rights are set out in the LLC Agreement that the profits interest holder must execute when he or she receives the profits interest.

VOTING RIGHTS

Profits interests almost never have voting rights. However, it is more common for rollover equity to have voting rights.

RESTRICTIVE COVENANTS

Profits interests, like other equity interests, might include restrictive covenants in addition to those to which the holder may already be subject in his or her capacity as an employee. These may include non-compete and non-solicitation provisions that restrict the holder from competing with the partnership or soliciting employees or clients from the partnership for a designated period of time. Since the restrictive covenants imposed in the context of profits interests are in the nature of ongoing equity ownership, they should theoretically be subject to the same lesser standard of enforceability applicable to equity holders as opposed to employees.

Although laws vary by jurisdiction, restrictive covenants must generally be reasonable in time and scope to be enforceable (see Non-Compete Laws: State Q&A Tool). One issue that is of particular concern with respect to profits interests and other management equity is the duration of the restrictive covenants. Previously it was not uncommon to have restrictive covenants run for the entire period in which the holder held the equity and then for a period ranging from 12 to 36 months thereafter. There was always the concern, however, that a court could potentially see this as a perpetual restrictive covenant and therefore unreasonable to the extent the holder was required to remain in the equity until an exit or liquidity event.

The Delaware Chancery Court highlighted this risk *in EBP Lifestyle Brands Holdings, Inc. v. Boulbain*, in concluding in a footnote that the non-compete in that case was unreasonable because, among other things, it applied "for a period of two years after the disposition of his shares, which is contingent upon the entirely discretionary approval of EBP's majority stockholder." (2017 WL 3328363 (Del. Ch. Aug. 4, 2017).)

As a result, even though the restrictive covenants are being provided in the context of the holder's ownership of equity, it is more typical to have the restrictive covenants run only during the holder's employment with the company and then for some period (generally, 12 to 36 months) thereafter.

As a practical matter, if the equity interest is significant enough, a buyer of the company may require the holder to sign a 'sale of business' restrictive covenant in connection with the exit or liquidity event, which runs for a certain period of time (generally one to five years) following the date of the closing of the exit or liquidity event.

For more information on employment-related restrictive covenants and their enforceability, see Restrictive Covenants Toolkit (4-523-8981).

PROFITS INTERESTS IN NON-US JURISDICTIONS

In many countries, profits interests are subject to income tax on the value received by the employee on vesting or sale. In others, they are taxed on grant, but the method of valuing them for tax purposes varies depending on the practice of the local tax authority. In the United Kingdom (UK), profits interests are generally treated as restricted employment-related securities and participants may have the choice of paying income tax on either:

- The grant of the interests.
- Vesting and/or sale.

Many choose to enter into a joint election with the employer under section 431 of the Income Tax (Earnings and Pensions) Act 2003 within fourteen days of grant, with the effect that they will be subject to income tax on the value of the profits interests on the grant date, which should be low, but will not be zero.

Individuals who enter into these elections should then be subject to capital gains tax at significantly lower rates than income tax when they dispose of the interests based on the increase in value since the grant date. Care may need to be taken to address the possibility of double taxation in the US and the UK on income arising from the profits interests, depending on the structure of the arrangement.

PRACTICE POINT

If a foreign person granted a profits interest intends or is likely to move to the U.S. and work in the U.S. during the vesting period, the holder must take into account that the profits interest may become subject to U.S. taxes. In this case:

- The partnership can consider vesting the holder immediately before his or her move to the U.S. so that the profits interest becomes taxed by the foreign jurisdiction before the holder moves to the U.S.
- The holder should consider whether he can and should file a protective Section 83(b) election at the time of grant.

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