Employee Memorandum: 
Explanation of Profits Interest Award

A Lexis Practice Advisor® Practice Note by Henrik Patel, White & Case LLP

Form Summary
This Employee Memorandum: Explanation of Profits Interest Award explains how a grant of profits interests intended to be a safe harbor profits interest grant (in accordance with Rev. Proc. 93-27 and Rev. Proc. 2001-43) will impact the recipient. This form includes practical guidance, drafting notes, and alternate clauses.

This form is drafted assuming that the entity granting the profits interest is a partnership. If the entity is instead a limited liability company taxed as partnerships, change the references to “partnership” to “LLC.” This memorandum is intended to supplement a separate profits interest award agreement that governs the issuance of the interest.

For more information on incentive profits interests, see Profits Interests as Incentive Compensation and Partnership and LLC Equity Compensation. For additional related form documents, see Profits Interest Plan, Profits Interest Award Agreement, Section 83(b) Election Form (Profits Interest) and Profits Interest Clauses (Limited Liability Company Operating Agreement).
Introduction
This memorandum briefly explains the consequences of holding profits interests in [partnership name] (the “Partnership”). This memorandum does not comprise a complete and exhaustive legal analysis on this subject and you are advised to consult your legal and/or tax advisor(s) about the implications of your grant of profits interests. For additional details, please refer to your profits interest award agreement. The Partnership does not guarantee the tax treatment of any profits interest grant.

Overview of Profits Interests
Your profits interest grant is a form of partnership interests that gives you the right to participate in the future profits and appreciation in value of the Partnership. Profits interests are distinguishable from capital interests, which give the holder the right to a share of the existing value of the partnership. Compare individuals A and B in the below example:

If A were recently granted profits interests and the partnership liquidates, A would not receive any share of value because no future profit or appreciation has occurred. In contrast, if B were recently granted capital interests, upon liquidation, B would be entitled to a share of the existing and current value of the partnership.

Your profits interest award has been granted to you in exchange for your services to or for the benefit of the Partnership.

Grant
The Partnership grants to you [number] profits interest units in the Partnership from [date of grant]. Such profits interests do not entitle you to receive existing capital or accumulated profits and remain subject to the distribution threshold and the vesting conditions (if applicable) described below, as well as any other terms and conditions set forth by the Partnership.

Vesting
The Partnership’s grant of profits interests may be unvested on the date of grant and may be subject to certain vesting conditions. Such vesting conditions may be imposed in the form of either time-vesting profits interests or performance-vesting profits interests, or a combination of both. The vesting terms under your profits interest grant are as follows:

• [percentage]% of your profits interest units are time-vesting profits interests, subject to the following [cliff OR graded] vesting period: [time-vesting schedule]. [In addition, these time-vesting profits interests are subject to an additional performance hurdle: [description].]
• [percentage]% of your profits interest units will be deemed performance-vesting profits interests, subject to the achievement of the following performance goals: [performance-vesting terms].

Drafting Note to Vesting Section
Profits interest awards are commonly subject to time-based vesting, performance-based vesting, or both. This language assumes two tranches, one time based (with or without an additional performance hurdle) and one performance based. (If the grant is fully vested upon grant, this section can be omitted.) For single-tranche grants, see First Alternate “Vesting” Section (time based, with or without performance hurdle) or Second Alternate “Vesting” Section (performance based).
**First Alternate “Vesting” Section:**

**Vesting**
The Partnership’s grant of profits interests may be unvested on the date of grant and may be subject to certain vesting conditions. Such vesting conditions may be imposed in the form of either time-vesting profits interests or performance-vesting profits interests, or a combination of both. The vesting terms under your profits interest grant are as follows:

- 100% of your profits interest units are time-vesting profits interests, subject to the following [cliff OR graded] vesting period: [time-vesting schedule]. [In addition, these time-vesting profits interests are subject to an additional performance hurdle: [description].]

**Second Alternate “Vesting” Section:**

**Vesting**
The Partnership’s grant of profits interests may be unvested on the date of grant and may be subject to certain vesting conditions. Such vesting conditions may be imposed in the form of either time-vesting profits interests or performance-vesting profits interests, or a combination of both. The vesting terms under your profits interest grant are as follows:

- 100% of your profits interest units will be deemed performance-vesting profits interests, subject to the achievement of the following performance goals: [performance-vesting terms].

**Distribution Threshold**
You will be entitled to distributions of profits in accordance with the terms of the Partnership’s [name of limited partnership agreement] (the “Partnership Agreement”). Typically, you will receive distributions from the Partnership once distributions from the Partnership to other capital interest holders equal the fair market value of the Partnership on your date of profits interest grant, which is $[amount] (the “Distribution Threshold”). The below example illustrates the Distribution Threshold:

Assume a partnership with 10 partners, each with a capital account of $10,000 and one additional partner holding a profits interest, with each of the 10 partners with capital accounts and the profits interest holder being entitled to share equally in the future profits of the partnership. 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 all eleven partners (holders of both capital interests and profits interests) would next receive one-eleventh of the upside above $100,000. The Distribution Threshold would then be the $100,000 in capital accounts as of the grant date.

The Distribution Threshold only needs to be taken into account on exit or a liquidity event, and therefore does not prevent you as a profits interest holder, whether vested or unvested, from receiving interim distributions of profits following your date of grant, in accordance with the Partnership Agreement.

**Interim Distributions**
As a profits interest holder, you will be treated as a partner from your date of grant, regardless of whether the profits interests are subject to vesting or forfeiture conditions. You may receive annual Schedule K-1s from the Partnership detailing your allocation of profits for the prior year with respect to your profits interests and corresponding allocations of taxable income, if any. Whether taxable income allocated to you with respect to your profits interests will be characterized as ordinary income or capital gains depends on how the income is characterized for the Partnership.

**Filing a Section 83(b) Election**
To the extent your profits interest grant is subject to vesting, the award agreement and Partnership Agreement require that you file a Section 83(b) election in connection with the profits interest grant you accept. The Section 83(b) election must be filed with the Internal Revenue Service (IRS) by no later than 30 days after the grant date, with a copy sent to the Partnership.

Once you file a Section 83(b) election, it is intended that should the grant of your profits interest become taxable, it will be taxed on its value as determined on the grant date, which is expected to be $0.
Drafting Note to “Filing a Section 83(b) Election” Section

Under current IRS guidance, neither the grant of an unvested “safe harbor” profits interest (under Rev. Proc. 93-27) nor the vesting of the interest will generally be considered a taxable transaction (if the holding requirements are satisfied), even if the recipient does not file a Section 83(b) election. Rev. Proc. 2001-43. Nevertheless, many practitioners recommend a protective Section 83(b) election, showing a $0 value as of the grant date, to protect the recipient from adverse tax effects should it be determined that the interest falls outside the safe harbor. For a sample election form, see Section 83(b) Election Form (Profits Interest).

Long-Term Capital Gains

As long as you timely file your Section 83(b) election and remain an employee or service provider to or for the benefit of the Partnership, your profits interest grant is not expected to be treated by the IRS as a taxable event when your award vests. You must hold your profits interest award for (i) at least [one year OR three years] after the interests vest, and (ii) for at least two years from the date of grant, to be eligible to receive long-term capital gains tax treatment on any gain in the value of your profits interest grant from the date of grant until the time you sell your profits interests.

Drafting Note to “Long-Term Capital Gains” Section

The applicable holding period under clause (i) of the first sentence (one year or three years) depends on whether the profits interests constitute so-called applicable partnership interests under I.R.C. § 1061, introduced by 2017 tax reform. The general rule for long-term capital gain treatment (one year) applies unless the interests are applicable partnership interests. The three-year period generally applies for certain carried interests granted by entities that conduct investment activities on a regular, continuous, and substantial basis, such as private equity, real estate, or hedge funds. For more information, see Partnership and LLC Equity Compensation.

The two-year period under clause (ii) reflects one of the safe harbor profits interest requirements under Rev. Proc. 93-27.

The Partnership is pleased to be able to offer you an opportunity to share in its value appreciation. Should you have any questions about your profits interest grant, please contact [partnership representative contact information].

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Henrik Patel is the Global Head of the Employment, Compensation & Benefits Practice at the global law firm, White & Case LLP. Henrik advises numerous US and non-US clients (including public and private companies, boards of directors and executives) on executive compensation and employee benefits aspects of various corporate transactions, including mergers, acquisitions, divestitures, spin-offs, succession planning, debt and equity financings, initial public offerings, private equity and leveraged buyout transactions and banking transactions. He has extensive experience with financial services institutions, private equity and hedge fund clients.

Henrik also provides ongoing counsel to public and private companies, compensation committees and executives with respect to day-to-day executive compensation and employee benefits matters, including corporate governance matters and best practices, executive compensation plan design, employment contracts and equity incentive compensation arrangements, as well as advising on related regulatory, securities, tax, public disclosure and ERISA issues. He negotiates and drafts employment, retention, separation, change of control, non-competition, non-solicitation and other compensation-related agreements, plans and provisions, as well as relevant sections of proxy statements, periodic and current reports (e.g., Forms 8-K, 10-K and 10-Q) and registration statements.

Henrik is a frequent contributor and speaker at Global Equity Organization (GEO) and National Association of Stock Plan Professional (NASPP) conferences. He was named to the “40 Under 40” list of outstanding M&A lawyers by The M&A Advisor and has been named a recognized individual by Legal 500 in Employee Benefits & Executive Compensation.

He received his JD from New York University School of Law and BA in Political Science from Tufts University.

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