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Profits Interests: Private Equity's Trump Card with Management

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Introduction

With the passage at the end of 2017 of the tax reform bill[1] (introduced as the Tax Cuts and Jobs Act, and referred to hereinafter as TCJA) altering the U.S.

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tax landscape, private equity sponsors are reminded to continue to consider the potential benefits of granting profits interests as a source of equity-based compensation for senior executives in connection with acquisition-related transactions. This article provides an overview of profits interests, including their tax advantages, pitfall avoidance measures in deal structuring, and some of the changes and challenges presented to profits interests as a result of the TCJA.

What Are Profits Interests?

Profits interests are interests in an entity taxed as a partnership that give holders the right to participate in the future profits and appreciation in the value of the partnership. In contrast to capital interests, which are entitled to a share of the current value of the company at the time they are issued, profits interests are only entitled to appreciation in the value of the business after the time they are granted. Thus, if the partnership were liquidated immediately after the date of grant, holders of profits interests would not be entitled to receive a share of the partnership's assets.

The key benefit to profits interests is that they are capable of being taxed at the lower long-term capital gains tax rate, in contrast to stock options or restricted stock units, which are generally subject to taxation as ordinary income. Because profits interests represent an ownership interest in future profits, grants of profits interests are, as with stock options, restricted stock and restricted stock units, usually subject to certain time- and performance-based vesting conditions.

Vesting of Profits Interests and Size of Profits Interest Pool

Private equity sponsors have flexibility in designing the vesting conditions of profits interests, resulting in profits interests being able to parallel the economics of other equity-based awards, such as stock options or restricted stock (or restricted stock units), with limited downside to the partnership given that payouts are based on future performance.[2] Like equity- and equity-based awards in C corporations, profits interests are usually granted with a mixture of time- and performance-based vesting conditions. It is common to subject a portion of profits interests to time-based vesting, generally over a four- to five-year service period (*e.g.*, 20–25% of such profits interests vesting annually over a four- or five-year period, so long as the recipient remains employed). The remainder of the profits interests typically would be subject to performance-based vesting. Common

performance hurdles include money-on-money cash return to the initial private equity sponsor (MoM), internal rate of return to the private equity sponsor (IRR), and EBITDA-based vesting.[3]

While profits interests may be granted pursuant to a management incentive program (much like stock options, restricted stock, and restricted stock units granted pursuant to an equity plan), it is more typical to issue the profits interests directly under the operative limited liability company or partnership agreement. The operative documents may state a cap on the number of profits interests to set an upper limit on the amount of grants that may be made (*i.e.*, creating a "pool" for management). Similar to equity incentive plan pools, many profits interest pools range between 5% and 20% of the total future upside economics. As with equity pools, usually a substantial majority of the "pool" of profits interests will be granted at, or shortly after, closing, with the rest reserved for future issuance.

Types of Profits Interests and Comparisons to Other Equity-Based Awards

Comparing Profits Interests to Stock Options

Most commonly, profits interests function like stock options with future performance-based metrics aligned to operate akin to strike and exercise prices in the stock options context. Private equity sponsors can tailor the payouts of profits interests accordingly by setting higher performance metrics for the payout, paralleling premium-priced stock options. For example, a partnership may grant performance-vesting profits interests that share in each dollar of profits after the grant date (after the required return on preferred partnership interests, if applicable, and the capital interest holders' return of capital (*i.e.*, the "distribution threshold")), with a condition that the profits interests only vest upon the partnership hitting a particular performance hurdle (*e.g.*, MoM, IRR, or EBITDA-based, as described above). Such profits interests would operate like performance-vesting stock options that would participate in the upside of a corporation following grant, subject to future vesting upon a performance event. A partnership could also grant profits interests that share only in the profits above a certain threshold return to capital interest holders (rather than in all profits after the distribution threshold). For instance, a profits interest could share in all profits only after a 2x return to the holders of capital interests. Such profits interest would effectively function like premium-priced stock options (*i.e.*, in this case, a stock option with

a strike price that is 2x above fair market value on date of grant) as opposed to performance-vesting stock options (*i.e.*, where the strike price is equal to the fair market value on date of grant, but vesting only occurs upon a 2x MoM).

Comparing Profits Interests to Restricted Stock and Restricted Stock Units

Profits interests can also be tailored to economically function like restricted stock (or restricted stock units). While profits interests do not represent capital in a partnership on the grant date and entitle the recipient to share only in the future profits of the partnership, profits interests can be designed to allow the recipient to share in the value of the partnership as of the grant date *subsequent to* the distribution threshold via a "catch-up" provision in the distribution waterfall. Such provision can allow a profits interest holder to receive all or a substantial amount of the profits of the partnership after the grant date (rather than share pro rata with holders of capital interests) until the profits interest has achieved a stated economic value. Thereafter, the profits interest could be treated pari passu with the capital interests and share pro rata in subsequent distributions.

For example, assume a partnership with ten partners, each having a capital account of $10,000, and a 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 such a design, if the company were liquidated for $200,000, each of the holders of capital interests would first receive $10,000, and each partner would receive 1/11 of the upside above $100,000 (*i.e.*, approximately $9,090.91) (thus, the return to each of the capital interest holders would be approximately $19,090.91). Alternatively, the partnership could design the profits interest so that the profits interest holder receives 1/11 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") go entirely to the profits interest holder, with the remaining profits ($90,000) to be split equally between each of the eleven partners. 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. 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.

Modified Capital Structure Example

Note that in the above example, the distribution waterfall could be tailored to add 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 and profits interests that only share after a 2x return to the holders of capital interests, as well as the ten partners with $10,000 of capital accounts as described above and the partner with the catch-up profits interest with a catch-up amount of $10,000. If the partnership were subsequently sold for $500,000, the distribution waterfall payouts would be as follows:

- $100,000 return of capital to the holders of the preferred partnership interests, plus 8% coupon (*i.e.*, $8,000);
- $100,000 return of capital to the 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 (*i.e.*, $10,000 per person); and
- $172,000 total, split pro rata by the holders of capital interests, the holder of the catch-up profits interest, and the holders of the premium-priced profits interests (*i.e.*, approximately $14,333 per person).

The above waterfall emulates that of a corporation by including preferred partnership interests, in lieu of preferred stock, capital interests that function like capital stock, catch-up profits interests to parallel restricted stock (or restricted stock units), performance-based option components in the catch-up profits interests that share pro rata with the capital interests after the catch-up provision, and premium-priced profits interests that share after the 2x performance condition like premium-priced options.

Note that certain "catch-up" provisions have some risk of being treated as a disguised payment of services (and thereby being treated as ordinary income and not eligible for long-term capital gain treatment) under proposed regulations issued by the Internal Revenue Service (IRS) in situations 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 and the profits interest's entrepreneurial risk in relation to that of the partnership).[4] If the

structure includes preferred partnership interests with a required return of capital, however, the catch-up profits interests would arguably be subject to entrepreneurial risk since the catch-up payment would be contingent on the preferred partnership interests receiving their return before the catch-up profits interest holder receives anything. Private equity sponsors should remain mindful of these proposed regulations, while structuring the waterfall distributions to align with the desired economic outcome.

Potential Tax Benefits

The IRS has confirmed that the grant of profits interests will not constitute a taxable event if:

(i) the liquidation value at time of grant is $0 and the profits interests do not relate to a substantially certain or predictable stream of income from partnership assets;

(ii) the profits interests are not disposed of within two years of receipt; and

(iii) the profits interests are not in a "publicly traded partnership"[5] (collectively, the Safe Harbors).[6]

The IRS has subsequently clarified that the vesting of profits interests that are substantially non-vested (*i.e.*, subject to substantial risk of forfeiture or non-transferability) will not constitute a taxable event, and as such, profits interest holders will not be required to make a section 83(b) election (discussed below) if the profits interests meet the foregoing Safe Harbors and (a) the holder is treated as a partner for tax purposes and 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 interests (*i.e.*, the holder of profits interests is entitled to distributions and receives a Schedule K-1 tax form from the partnership each year), and (b) neither the partnership nor any of its partners takes a compensation deduction for the fair market value of the profits interests.[7] As discussed below, while a section 83(b) election is not technically required for profits interests, practitioners almost universally recommend filing a protective section 83(b) election in connection with the grant of any profits interest subject to vesting.

Section 83(b) Election

Generally, under the Internal Revenue Code (IRC), property (including a partnership interest) that is subject to substantial risk of forfeiture is only included in income when the property ceases to be subject to a substantial risk of forfeiture. Thus, profits interests or restricted stock that is subject to vesting would not be included in income until vested. Note that stock options and restricted stock units are not considered property under the IRC and thus no section 83(b) election can be made on such awards.[8] However, a section 83(b) election allows a recipient of restricted property to elect to have the fair market value of property included in gross income at the time of grant (rather than at vesting). Such an election must be made within thirty days of the date of grant of the restricted property. The benefit from a section 83(b) election is that any gain in value from the date of grant until disposition of the property will be treated as a long-term capital gain rather than ordinary income. While the IRS has stated that a section 83(b) election need not be filed for profits interest grants if the Safe Harbors are met, it is considered best practice for recipients to nevertheless file a section 83(b) election as a protective measure. This is done so that even if the Safe Harbors are not met (*e.g.*, if profits interests are disposed within two years following grant), the section 83(b) election would still make clear that the recipient is eligible to receive capital gains tax treatment.

A section 83(b) election on profits interests normally would not result in any tax liability upon grant as the value of the profits interests on the date of grant would be $0 (based on there being no value if the partnership were liquidated immediately after the grant) and the amount paid for the profits interests would also be $0.

Transaction Structures

Private equity sponsors intending to provide equity-based compensation in the form of profits interests in connection with an acquisition must pay particular attention to the post-closing transaction structure. The IRS has taken the position that individuals may not be partners and employees of the same entity.[9] Repercussions to the taxation of employees being treated as partners by the IRS include employees' potential disqualification of participation in the company's cafeteria health and welfare plans (in which partners are prohibited from participating).

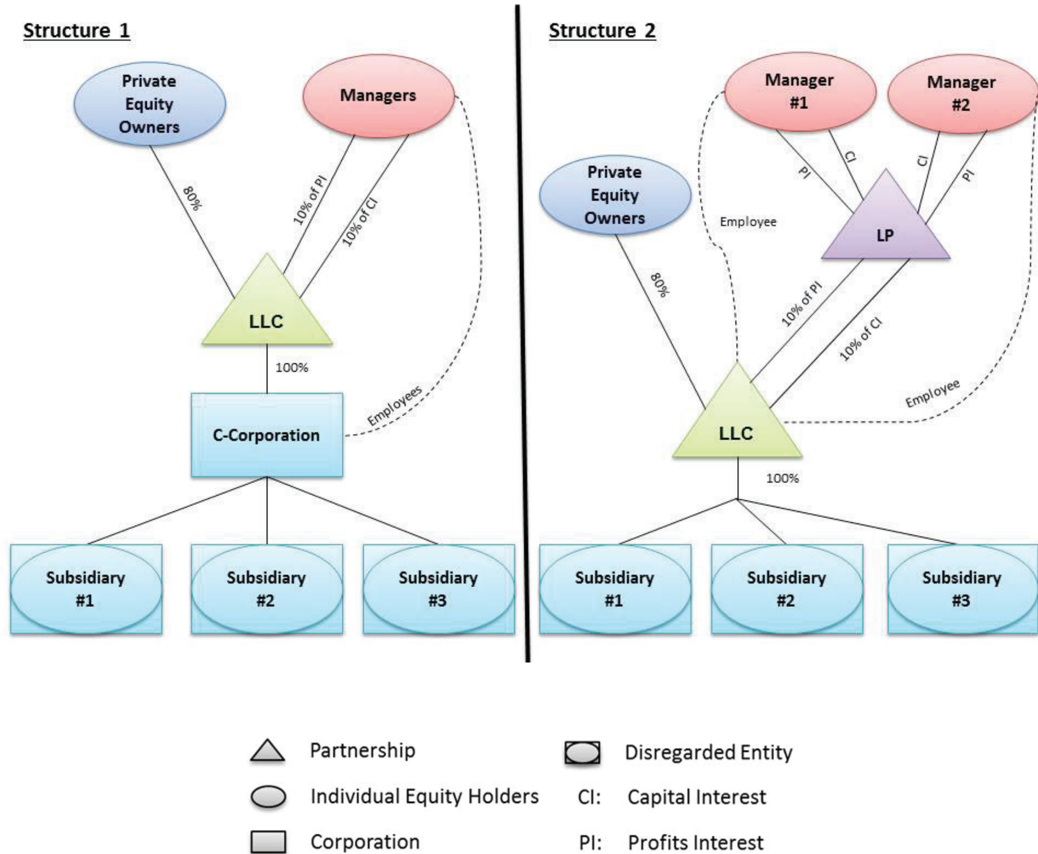
Note also, that because the IRS has clarified that partners in a partnership that owns a disregarded entity may not also be employees of such disregarded entity, profits interests should not be issued at the parent level to employees of a disregarded subsidiary of such parent.[10] In order for recipients of profits interests to receive the benefits of being treated as a W-2 employee while also being treated as a "bona fide" K-1 partner in respect of their profits interests, many private equity sponsors set up one of the two following structures:

Structure 1: LLC/C-Corp Structure

A C corporation is a wholly owned subsidiary of a limited liability company in the acquisition, with such limited liability company being taxed as a partnership. The limited liability company interests are held by the private equity funds (often holding 80% or more of the limited liability company interests) with management and senior employees of the C corporation holding the remaining equity (split between capital interests and profits interests). The C corporation employs all employees (including management and senior employees). See the simplified illustration of this structure below.

Structure 2: Management LP "Tiered Partnership" Structure

A limited liability company that is taxed as a partnership is acquired and its subsidiaries are deemed disregarded entities for tax purposes. The limited liability company interests are held by the private equity funds, with the remaining equity (similar to the above illustration, often split between capital interests and profits interests) being held by a separate management limited partnership. This structure is called a "tiered partnership," with both the limited liability company and management limited partnership being treated as separate and distinct partnerships for tax purposes. The management limited partnership is controlled by the private equity sponsor, and its sole asset is an ownership stake in the limited liability company. The management limited partnership grants capital interests and profits interests in itself to management and senior employees of the limited liability company. Usually these grants are parallel to or "piggyback" the management limited partnership's underlying economic ownership in the limited liability company. However, the management limited partnership is the owner of the underlying limited liability company and the executives do not have any direct ownership stake in the limited liability company. The limited liability company employs all employees (including management and senior management). See the simplified illustration of this structure below.



Using one of the two above transaction structures helps mitigate the possibility that employees would be deemed partners of the employing entity.

TCJA's Effects on Profits Interests

The TCJA, which amends the IRC, adds a new "carried interest" provision that requires certain owners of profits interests to hold such interests for at least three years to qualify for long-term capital gains treatment. This new provision applies to "applicable partnership interests" (*i.e.*, any partnership interests that are directly or indirectly transferred to (or held by) the taxpayer in connection with

performance of substantial services by such taxpayer, or any related person, in any "applicable trade or business"). An "applicable trade or business" is defined as any activity consisting in whole or in part of raising capital and either investing in or disposing of "specified assets" (or identifying specified assets for investing or disposition), or developing specified assets. "Specified assets" include, among other things, securities, commodities, real estate held for rental or investment, cash or cash equivalents, options, and derivative contracts. As such, this provision has implications to hedge funds, private equity firms, and real estate investment–based businesses.

Excluded from this three-year requirement are profits interests held by corporations and employees of an entity *outside* an applicable trade or business, so long as such person provides services only to such entity. As a result, it is anticipated that (i) employees, including members of the executive and senior management team, of private equity firms' portfolio companies that operate outside of investment management–type businesses will not (in most circumstances) be subject to this new three-year holding requirement, and (ii) equity holders in the private equity funds will be subject to this three-year holding requirement. We also note that the TCJA gives the Secretary of the Treasury the discretion to limit the new three-year requirement to income or gain attributable to any assets only held for portfolio investments on behalf of third-party investors. Further guidance from the Secretary of the Treasury and the IRS (through regulations, revenue rulings, revenue procedures, notices, and/or announcements) is expected and will be necessary to determine the potential scope, breadth, and application of the TCJA on existing profits interests and the grants of new profits interests. Areas for potential guidance may include

(a) whether individuals who own equity in or direct the management of a private equity fund, but are solely employed at the portfolio company at such private equity fund, will be exempt from this three-year holding requirement;

(b) the extent to which the Secretary of the Treasury will distinguish between the private equity funds and their portfolio companies for purposes of determining an applicable trade or business; and

(c) tax treatment of applicable partnership interests sold after three years from the grant date, but where particular underlying assets (*e.g.*, real estate) have been held for less than such time.

The new three-year holding requirement under the TCJA applies to taxable years beginning after December 31, 2017, and any profits interests issued prior to such date are *not* subject to grandfathering (*i.e.*, any applicable existing profits interest awards are expected to be captured by this new holding requirement). Therefore, private equity funds are urged to evaluate existing profits interests in light of the new "carried interest" provision, and factor in, among other things, the grant date of such awards, the trade or business in connection with these awards, and potential uncertainty presented to the disposition of awards held for less than three years given the current lack of guidance from the Secretary of the Treasury and the IRS.

Conclusion

With 2017 representing another successful year for private equity and 2018 having started off very strong, private equity sponsors will have to continue to consider awards that best attract, retain, and incentivize senior executives and management. Profits interests can serve to award management teams and provide private equity sponsors the flexibility to determine performance and payout metrics to mimic stock options and restricted stock on a tax-favorable basis. With those benefits in mind, sponsors must remain cognizant of the Safe Harbors, so that awards can be eligible for long-term capital gains treatment, and of proper transaction structuring, to avoid any classification issues for management being treated as partners rather than as employees. Furthermore, sponsors should stay attuned to subsequent guidance of the Secretary of the Treasury and the IRS to further decipher the impact of the TCJA.

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NOTES

1. Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).
2. Potential downsides of profits interests to a partnership include that they are not tax-deductible, are complex depending on the intended waterfall distributions, and must be structured properly when issued to employees (further discussed below).
3. EBITDA-based vesting can also contain a “catch-up” provision for prior year performance misses. For example, if the minimum performance hurdles for each of the first and second year requires an EBITDA of $1 million, respectively, the operating agreement may contemplate a catch-up provision after the second year if the EBITDA hurdle was not met in the first year, provided, that the EBITDA generated in the second year is at least $2 million.
4. *See* Prop. Treas. Reg. § 1.707-2(b), 80 Fed. Reg. 43,652 (July 23, 2015).
5. A “publicly traded partnership,” which is classified as a corporation for U.S. federal income tax purposes, is generally a partnership where its interests are traded on an established securities market or readily tradable on a secondary market (or the substantial equivalent of a secondary market), with the participation of the partnership. Note that private equity 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 and 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.
6. *See* Rev. Proc. 93,-27, 1993-2 C.B.343.
7. *See* Rev. Proc. 2001-43, 2001-2 C.B. 191.
8. Note that this is why early exercise of stock options is allowed under certain equity plans, as such early exercise may allow executives to pay the option strike price upon grant and receive restricted stock with respect to which they may make a section 83(b) election.
9. *See* Riether v. United States, 919 F. Supp. 2d 1140, 1159 (D.N.M. 2012) (citing Rev. Rul. 69-184, 1969-1 C.B. 256).
10. *See* T.D. 9766, 81 Fed. Reg. 26,693–26,695 (May 4, 2016).