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Profits Interests: How Do They Work?

Profit interests are an effective way to provide employees with true equity stake in your firm. But is this award method right for you? Here are a few key points to consider.

Profits interests are considered a long-term incentive vehicle typically issued by private companies (partnerships or LLCs) to motivate performance and retain talent. However, profits interests may also be issued by limited liability corporations (LLC) or real estate investment trusts (REITs) that are taxed like partnerships. In particular, profits interests may be issued to members of a partnership in an umbrella partnership corporation (UP-C). A common type of profits interest grants participants an interest in a fixed percentage of the equity value of the company above the threshold value. The value conveyed to a profits interests award holder mirrors that of a stock option.

This article outlines key considerations for the management team to take into account before adopting profits interests as an award vehicle.

Grant & settlement practices

- Profits interests can vest in a variety of ways: time-based, performance-based or upon the completion of an event, such as an initial public offering (IPO).

- Companies granting profits interests may need to consider the share class they are tied to, as this will impact the value delivered and expense taken.

- Profits interests can also be settled in stock upon IPO.

Tax considerations

- If structured appropriately and not otherwise disqualified, the IRS does not treat the vesting of a profits interest as a taxable event for the recipient or the company. Therefore, no ordinary income is attributable to the individual interest holders. Any realized value will be taxed as capital gains.

- If no ordinary income tax is claimed by an individual, then there will be no tax deduction for the issuing company and no Deferred Tax Asset (DTA) to be recognized.

Accounting considerations

- Profits interests can be structured as equity-classified under ASC 718 (stock-based compensation accounting rules), but analysis by an equity compensation accounting expert will be required to ensure validity.
- Equity-classified profits interests will need to be valued at grant for expense purposes. This is typically done using an option-pricing model that considers all classes of company equity.
- Cash settlement provisions can trigger liability accounting, which means the fair value must be remeasured at the end of every reporting period until the award settles (quarterly for public companies, yearly for private companies).

A brief example

A company grants 100 profits interests to key employees that vest upon the earlier of a change in control or three years and have a threshold value of $500 million. The profits interests have the same rights as Class A shares, of which there are 900 units outstanding. At the end of year two, the company is acquired by a competitor for $600 million.

- At the end of year two, the profits interests are entitled to their portion of the amount above the threshold value ($600 - $500 million = $100 million).
- The $100 million is split evenly amongst the 900 Class A shares and the 100 profits interests since they have the same rights.
- Each award holder receives $100,000 per profits interest unit they were awarded.
- 100% of the $100,000 gain is taxed as capital gains for the award holders. No ordinary income tax is recognized.

Next steps

Are profits interests right for you? Consider them as a form of employee or executive compensation by any company (public or private) that is a partnership or is taxed like a partnership (including an UP-C). Profits interests provide the ability for companies to give their employees a true equity stake in the organization with a favorable tax treatment for the award holders.

Aon Equity Services is a group of consultants, technical accounting and valuation experts specializing in equity plan design and all aspects of Accounting Standards Codification 718 (ASC 718) as it pertains to profits interests and other equity vehicles. We offer fully outsourced financial reporting, valuation services and plan design to help companies determine appropriate, reliable and auditable compensation expense associated with profits interests and other equity awards. To learn more, please contact grant.peterson@aon.com.

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