

## USING PROFITS INTEREST TO COMPENSATE KEY EMPLOYEES

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We are often asked by clients operating as partnerships or limited liability companies how to provide incentive compensation to key employees. They want to set up plans that (1) give them a stake in the business, (2) do not require them to make a capital investment, (3) result in no taxation to employee on receipt of such interest, and (4) when profits related to that stake are paid, are taxed at lower capital gains rates.

Just to set the stage, it is not unusual for business owners to want to incentivize key employees by granting them an ownership stake in the business without forcing such employees to make an investment, and most certainly without triggering immediate taxable income for the employee. For example, in a typical real estate LLC or partnership (joint venture) arrangement, the investors provide the needed investment capital, while the business is managed by a real estate professional. To incentivize the manager, an ownership stake in the business may be granted, entitling the manager to a share of the venture profits after the investors have received back their investment and an agreed upon return. Most often, this share of profits is not related to an actual cash investment, and is commonly referred to as a “promote” or “carried interest.” In tax parlance, it is called a “profits interest” since it is not related to a capital investment, and only entitles the owner to a share of the profits after capital has been returned.

If the agreement is properly structured, the receipt of the profits interest is not taxed when received, and the profits upon sale of the joint venture business or property is taxed at lower capital gains rates. This can be true even if the profits interest is not vested when issued.



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Likewise, if the business manager is itself a business entity (partnership or limited liability company) which provides management services, the profits interest it receives in the underlying business can be shared among its own team members. This structure can be utilized by awarding employees profits interests in the management entity. This will entitle such employees to a share of the profits (at favorable capital gain rates) that the management entity receives from the underlying business entity.

Generally speaking, to obtain this tax treatment, there are three rules or requirements to have in mind: (1) the profits interest can share in current operating profits of the business, as well as in the profits from sale of the business to the extent they exceed the value of the enterprise when the profits interest was granted; but it must not share in profits attributable to the existing enterprise value; (2) the profits interest must not relate to a substantially certain and predictable stream of income (e.g., intent on high quality bonds); and (3) that the holder of the profits interest must not dispose of the interest for 2 years. Careful crafting of the joint venture agreement is important to assure compliance with these requirements.

The favorable tax treatment accorded to profits interests has received a lot of attention recently as Congress looks for ways to raise revenue. For the time being, however, the granting of properly structured profits interests is a tax effective way to grant ownership stakes in a business to key employees, to align the interests of the employees with the employer, and promote greater management focus on company performance. And, even if the current law changes, prior draft legislative proposals suggest that profits interests held in non-real estate or securities businesses would not be impacted by the proposed new laws.

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