TOPIC TWO – PROFITS INTERESTS ARE COOL… OPTIONS NOT

Options are not easy. They must be priced at market value on grant, stock purchased under options must be paid for, options cashed out on exits are taxed at compensation rates, and options are capital rights that complicate the cap table. Is there a better way to issue equity rights in tech?

Look no further. For US limited liability companies (LLCs) consider “Profits Interests” (PIs) which, suddenly, are all the thing. Why? Because, as a right to profits which is not a capital right (like stock and options) Profits Interests (i) require no buy-in; (ii) PIs are not taxable at grant or upon vesting and (iii) profit distributions prior to a Company exit are taxed as dividends or upon an exit are taxed as capital gains, not as ordinary income. This favorable tax treatment applies not only in the US but in most other countries as well. And there’s more: (i) PIs don’t need to be priced on grant, (ii) PIs don’t need to be exercised with payment to acquire an underlying security, and (iii) in the event of the holder’s termination of employment PIs simply expire without need of the Company to repurchase the interest.

But here’s the rub. PIs can only be issued by pass-through entities taxed as partnerships, like LLCs, Partnerships or Limited Partnerships. And for US tax residents, units issued in LLCs are not eligible for QSBS (Qualified Small Business Stock) treatment under US-IRC Sec 1202 (which if held for 5 years entitles the holder to an exclusion from federal tax equal to the higher of $10M or 10X the purchase price of the QSBS). This is a major reason why institutional investors in startups prefer investing in C corporations, as this is the only corporate form in the US allowing for QSBS. Given this, how can a holder get the dual tax benefits of both PIs tied to units or partnership interests and QSBS tied to stock issued in US C-corporations?

One approach is to create two separate companies consisting of an LLC holdco parent and INC subsidiary. The INC subsidiary conducts business operations including employing staff, selling and supporting customers, invoicing and collecting customer revenues and retaining earnings for future working capital taxed at lower corporate rates. Prior to an enterprise sale any excess cash in the INC not retained for working capital can be distributed as a dividend to the LLC parent and passed through to the LLC owners – allowing for liquidity prior to an exit. Upon an enterprise sale both the LLC and INC are then sold to the Buyer with the purchase price mostly allocated to the purchase of the INC with proceeds paid to the INC stockholders applied against their QSBS federal tax exclusions. As the business scales and adds new employees, incentive compensation in the form of PIs can be issued through a PI Reserve Pool in the LLC. In this way interests to new employees are not priced and securities are not acquired and paid for, and profits distributions enjoy favorable tax treatment.

<u>Topic References</u>:

1. This National Law Review article specifically addresses the tax advantages of profits interests compared to stock options for US limited liability companies (https://parsonsbehle.com/images/pdfs/should_my_partner_be_my_ceo.pdf)
2. JPMorgan Chase's Investopedia offers a clear comparison of profits interests and stock options, highlighting the ownership rights and tax implications for each (https://www.investopedia.com/terms/p/profits-interest.asp)
3. LegalZoom provides a breakdown of how profits interests work in LLCs and how they differ from ownership interests typically associated with stock options (https://www.legalzoom.com/business/business-formation/llc-overview.html)
4. Cooley LLP dives into the legal and tax complexities of profits interests for LLC members, including comparisons to equity compensation (https://www.wtwco.com/en-us/insights/2023/09/profits-interests-are-they-the-right-lti-design-for-your-llc-firm)
5. This Law.com article discusses how profits interests in LLCs are taxed for US residents, providing a clear contrast to stock options with their capital gains tax treatment (https://www.hutchlaw.com/blog/what-is-a-profits-interest)