BioCT

https://mcusercontent.com/20a92af1c5b4813680921d74a/files/1fd4f04f-3878-6814-7ae3-4da4aa7b72ab/MarcumLLP_Article_ProfitsInterest_VilleccoBrooder_APR112022.pdf?mc_cid=f3ab1ea37d&mc_eid=e81776d6d8

Profits Interest: An Attractive Option for Retention

DANIEL VILLECCO, CPA, MBA, PARTNER, MARCUM LLP
MICHAEL BROODER, CPA, PARTNER, MARCUM LLP

BACKGROUND

The employment marketplace has undeniably changed from pre-COVID times. Life science and technology industries specifically have experienced many ups and downs, but attracting and retaining quality talent remains a core challenge.
Marcum works with many clients in the tech and life sciences industries. Based on their feedback, it’s clear that granting employees’ equity is key to attracting and retaining top talent. When employees have equity in a company, they see themselves as owners and are more motivated and accountable.
Partnerships and other pass-through entities, like LLCs, often use profits interest as a mutually beneficial equity grant. An offer of profits interest can vary in terms, but it entitles a recipient to receive distributions of future profits of the LLC and participate in the increase in the value of the business.

Bottom line: This form of compensation gives key employees a share in the future growth in value of the partnership or LLC in return for their efforts in making that happen.

TYPICAL STRUCTURES

There are multiple options that can be written into profits interest agreements to make them as beneficial for companies as possible. Typical structures can include:

• Vesting:

– Time-based: The grant can vest only upon a sale (whether the individual vests over time or can participate in profits only if a qualified sale occurs).

– Performance-based: upon reaching revenue of $100MM.

• Voting rights.

• Distribution thresholds (the holder will only participate in income and losses over a defined valuation).

• Transferability (whether or not holders can transfer without penalty).

• Repurchase options by the company (whether the company can repurchase shares upon certain events).

TAX CONSIDERATIONS

Profits interest has several tax advantages, including capital gains versus ordinary income. The receipt or grant of profits interest is not a taxable event, and any resulting distributions received upon the liquidating event of the company will be taxed at a long-term capital gains rate if it was held for more than one year. This long-term capital gains treatment is a key distinction from so-called phantom equity awards, which are subject to ordinary income taxation.

GAAP CONSIDERATIONS ACCOUNTING FOR UNDER ASC 718 OR ASC 710

Companies need to understand the terms and conditions associated with the profits interest awarded and whether the award has predominately equity characteristics. If it does, ASC 718 should be applied. If it does not, ASC 710 should be applied (it's more akin to profit-sharing or deferred bonus arrangements). See below for summary of terms:

- Value of the award: Based on equity, or based on a fixed value or one derived from a formula.
- Settlement features via change of control ("COC"): The award can survive a COC, or the employee can be required to settle or terminate.
- Distribution rights: These can occur at any time prior to an exit, or they can be limited to an exit event or not pro-rata.
- Separate cash bonus plans: Employees can also be allowed to participate in these plans, or profits interest can be offered in lieu of plans.
- Retention of interests upon termination of employment and repurchase features: Employees can retain vested awards following termination or separation, or companies can dictate that they forfeit or repurchase the award upon termination or separation.
- Legal form of instrument.
- Voting rights: Holders have voting rights or no voting rights.
- Transferability: Grants are transferable or non-transferable.
- Pre-emptive, tag-along or drag-along rights: There are, or are not, anti-dilution provisions.
- Initial investment.
- Management's intent: Equity intent or incentive bonuses upon exit.

Management will assess each provision above to determine whether the terms and conditions of the award are more akin to a share-based compensation arrangement (718) or to a profit-sharing arrangement (710).

If management concludes that the arrangement is more akin to profit sharing, the company will record its compensation expense at the date the payment is both probable and reasonably estimable.

– If management concludes the arrangement is more akin to a share-based compensation, the company should determine classification (equity or liability) utilizing ASC 718-10-25-6 through 25-19.

– For awards classified as equity, the company should record costs over the requisite service period based on the grant date fair value, with an offsetting entry to additional paid-in capital. If there is performance vesting, the company should only recognize expense when probable.

For awards classified as liability, the company should record compensation cost over the requisite service period based on the fair value of the award at the end of each reporting period, with an offsetting entry to a liability. If there is performance vesting, the company should only recognize expense when probable.

OTHER CONSIDERATIONS

Additionally, many companies will offer profits interest at a parent or holding company level, for services provided by employees of the operating company. In such cases, in accordance with ASC 718-10-15-4, share-based compensation issued by a parent or holding company to employees of a subsidiary or operating company should be reflected on the books and records of the operating company as a capital contribution (through APIC). Thus, compensation expense will be reflected at the operating company level for the related services of that employee.

CONCLUSION

Although accounting for GAAP purposes can get slightly complex (as described above), profits interest can be a useful instrument that provides a useful benefit to both the company and the holder. Additionally, with the current marketplace, granting employees contingent equity instruments can be the difference between retaining that employee or losing them to another role.

###