STRUCTURING EQUITY COMPENSATION IN LIMITED LIABILITY COMPANIES

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What Is a Limited Liability Company?

- A Limited Liability Company (LLC) is a hybrid business entity having certain characteristics of both a corporation and a partnership.
  - Limited liability, like a corporation
  - Pass-through taxation, like a partnership
- Although an LLC can elect to be taxed as a corporation, this presentation assumes that the LLC is taxed as a partnership.
- Advantages of LLCs include:
  - No "double taxation"
  - Flexibility in structuring economic and governance arrangements among members
  - Easily convertible to a corporation

Partnership Taxation Basics

- Not taxed as a separate taxpayer for federal income tax purposes but income and loss is generally classified for tax purposes at the partnership level as if the partnership were a separate taxpayer.
- “Allocations” v. “Distributions:” partnership income and loss is directly attributed to its partners and the partners are taxed on their respective shares of the partnership’s taxable income whether or not such income is actually distributed.
- Subject to certain anti-abuse rules under Section 704 of the IRC, a partnership may generally “allocate” its profits, losses, and other tax items to its equity owners by contract pursuant to its partnership or LLC operating agreement. Allocations very rarely match distributions.

Types of Equity Compensation in LLCs

- Capital interests
- Profits interests
- Options (nonqualified only)
- Phantom equity (not really treated as equity for state law or tax purposes)

What Is a Capital Interest?

- A capital interest is an interest that entitles the holder to share in the proceeds if the LLC's assets are sold at fair market value and the proceeds are then distributed in a complete liquidation of the LLC immediately after the interest is granted (Rev. Proc. 93-27).
- The recipient has a grant date economic right in the underlying capital of the LLC, as well as its profits and losses on a going forward basis.
- Example:
  - Amy is employed by Erin Is Awesome, LLC. Existing members Emilio and Steve each have a capital account of $100, which is equal to the fair market value of the LLC's assets. Amy is admitted as a member and receives a 10% capital interest in the LLC. Amy is effectively entitled to $20 if the LLC were immediately liquidated (10% of the LLC capital of $200).

How Are Capital Interests Taxed?

- The grant of a capital interest is treated as current compensation to the recipient in an amount equal to the fair market value of the capital interest on the date of grant, less any amount paid for the interest. In general, the receipt of a restricted capital interest is taxable when the interest becomes vested (i.e., no longer subject to a substantial risk of forfeiture (IRC § 83 and Treas. Reg. § 1.83-3(e)) absent a special election under Section 83(b) of the Internal Revenue Code.
- If the recipient timely makes an election under Section 83(b), income can be included immediately, based on the fair market value on the date of grant.
  - A later forfeiture does not result in an "ordinary" tax loss to the extent of the amount included in income and later forfeited.
  - An election MUST be made within 30 days following grant – no remedy for late filing!

How Are Capital Interests Taxed?

- The LLC generally deducts the amount of compensation included by the service provider as a trade or business expense under Section 162 of the Code. Deductions are allocated to LLC's members via the LLC's operating agreement. Not generally possible to specially allocate the compensation deduction to the service provider.
- When the recipient sells the interest, the difference between the value at the grant date (or the value at vesting) and the sale price – generally short- or long-term capital gain (subject to ordinary income "hot asset" rules).

What Is a Profits Interest?

- A profits interest is a current equity interest for state law and tax purposes.
- A profits interest is generally an interest that, on liquidation of the LLC immediately after the grant of the profits interest, would NOT allow the recipient to participate in liquidating distributions. The recipient only has a share in the future profits and appreciation in value of the LLC following the date of grant.
- Members other than the profits interest holder must be entitled to receive distributions at or before the liquidation of the partnership at least equal to the net fair market value of the LLC at the time the profits interest is issued.

What Is a Profits Interest?

- Example:
  - Amy is employed by Erin Is Awesome, LLC. Existing members, Emilio and Steve, each have a capital account of $100, which is equal to the fair market value of the LLC's assets. When Amy is granted a profits interest, all future profits and growth in the value above $200 would be shared by Amy as an owner on the same basis as the other owners share. If Amy has a 10% profits interest, she will participate in 10% of all future profits and growth in value.

    Assume a sale of the LLC at a time when the value is $300. At that time, Amy would be entitled to $10 ($300-$200 = $100 x 10% = $10).

How Are Profits Interests Taxed?

- Revenue Procedure 93-27 provides “safe harbor” guidance on what constitutes a profits interest and the tax consequences associated with profits interests.
- No income tax is recognized by a service provider receiving a profits interest if the following conditions under the Revenue Procedure 93-27 Safe Harbor are satisfied:
  - Profits interest holder must be respected as a partner for tax purposes
  - The profits interest is not related to a substantially certain and predictable stream of income.
  - The profits interest is not disposed of within two years following the date of receipt.
  - The profits interest is not a limited partnership interest in a publicly traded partnership.
- If the Safe Harbor is not satisfied, then common law profits interest classification may be possible based on the facts and circumstances

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How Are Profits Interests Taxed?

- Revenue Procedure 2001-43 provides guidance on the tax treatment of profits interests subject to vesting requirements.
- Under Revenue Procedure 2001-43, the determination of whether an interest granted to a service provider is a profits interest is made at the time the interest is granted, even if it is not yet vested.
  - Recipient must be treated as a member for tax purposes.
  - Although Revenue Procedure 2001-43 does not require it, best practices (and proposed regulations) require that a $0 value Section 83(b) election be made on the grant date
- The LLC is not entitled to a compensation deduction for the grant.
- Redemption or sale of profits interest generally results in short- or long-term capital gains (subject to ordinary income "hot asset" rules).

Profits Interest Customization and Drafting

- Simple uniform % vs. “fill-up” allocations
  - Do the parties want to replicate a capital interest?
  - Will “fill-up” allocations be made out of operating profits?
- Share in all profits (operating and capital) vs. share in capital transactions
  - What economics are the parties trying to capture?
- Capital account based implementation vs. unitized series of profits interests with unique “threshold” distribution floor designations
  - What type of operating agreement is the LLC using?
- Distribution issues (including tax distributions)
  - Will full distributions be made if the profits interest is still subject to vesting?
- Forfeiture issues
  - Should prior income allocations be reversed?

What Are Options?

- An option entitles a recipient to purchase LLC interests at a later date for a purchase price that is at least equal to the fair market value of the LLC interests on the date the option is granted
- Option holder generally not an equity holder for tax and state law purposes with respect to the underlying option equity until date of exercise
- Under Section 409A of the Code, options cannot be granted with an exercise price below fair market value
- Profits interests and options on LLC interests are economically similar, but there are tax advantages for holders of profits interests

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How Are Options Taxed?

- No income tax upon grant
- Ordinary income on exercise equal to the excess of the fair market value of the interests on the date of exercise and the exercise price (i.e., fair market value on the date of grant)
- When the recipient sells the interest, short- or long-term capital gain on the difference between the amount realized on the sale and the tax basis in the interests (exercise price, plus the amount of income recognized at the time of exercise) subject to ordinary income “hot asset” rules
- Assumes option granted with an exercise price equal to or greater than the fair market value of the underlying interests on the date of grant
- A valuation (internal or external) must be performed

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What Are the Tax Consequences of Profits Interests vs. Options?

- Profits interests are usually issued without payment by the recipient.
- No income is recognized on grant of a “good” profits interest, but the recipient’s holding period begins at grant.
- The LLC is entitled to a deduction equal to the income recognized by the option holder upon exercise of the option.
- The option holder is not a member until the option is exercised.
- Most option holders exercise and sell on the same date (in a liquidation event), so there are no capital gains.
- Complexity of flow through tax accounting for profits interest holders v. option holders (e.g. payroll classification issues, need to file tax returns in multiple states and local jurisdictions, estimated tax payments etc.)

What Are the Consequences of Membership?

- Salary and fixed payments made to a service provider who is a member, whether the member holds a capital interest or a profits interest (and has made an 83(b) election), will be classified as guaranteed payments.
  - No withholding of income taxes or employment taxes
  - Reported on Schedule K-1, not Form W-2
  - Recipient must pay estimated income taxes on all income from the LLC
  - Potential self-employment taxes of up to 16.2% (for 2013) on all self-employment income (including distributive share allocations of residual profits; compare v. S corps)
  - Limitations on ability to participate in tax-advantaged benefit plans
  - Payroll/self-employment tax mitigation structures

What Is Phantom Equity?

- Bonus awards that mimic equity (not equity for tax or state law purposes)
- Employee can participate in financial rewards of ownership without voting and other rights associated with equity ownership
- Generally subject to vesting, whether time-based or performance-based
- Taxed like a nonqualified deferred compensation plan
  - Must comply with or be exempt from Section 409A of the Code
  - If the arrangement is subject to and not compliant with Section 409A of the Code, the amounts are taxed at ordinary income rates at vesting, plus 20% penalty tax, plus interest for the deferral period
  - If properly structured under Section 409A of the Code, employee is subject to tax when income is received under the arrangement
  - The LLC receives a deduction at the time of payment

What Are the Accounting Considerations?

- Under FASB ASC Topic 718, options granted to employees and nonemployee board members must be valued at fair value as of the grant date under an appropriate valuation methodology (e.g., Black-Scholes).
- The value established must be charged as a compensation expense against a company's reported earnings over the vesting period of the award. The compensation cost is amortized over the vesting period.
- For securities issued on the vesting of restricted interests, a company is generally required to amortize over the vesting period a compensation cost equal to the fair market value of the underlying securities on the date of the award.
- The accounting treatment will be applicable whether vesting is tied to service periods or performance goals. For grants that vest based upon the achievement of performance goals, the charge to earnings is to be taken over the period over which the goals are expected to be attained.

What Are the Securities Law Considerations?

- Under Rule 701 of the Securities Act, companies can offer their own securities as part of a compensatory benefit plan or through written compensation agreements to employees, directors, general partners, trustees, officers, or certain advisors and consultants without having to comply with federal securities registration requirements.
- Offers and sales to consultants and advisors must be made for compensatory purposes and not for other purposes (such as to raise capital). Consultants and advisors must be natural persons providing bona fide services at the time of the offer.

What Are the Requirements of Rule 701?

- Limitations on Amount – Rule 701 contains limitations on the amount of securities that may be offered and sold in reliance on the rule.
  - The maximum amount of securities that may be sold in reliance on Rule 701 during the 12-month period preceding any sale is the greatest of the following:

    (i) $1,000,000,

    (ii) an amount that does not exceed 15% of the total assets of the issuer (measured at the issuer's most recent balance sheet date), or

    (iii) a number of securities that does not exceed 15% of the outstanding securities of that class (measured at the issuer's most recent balance sheet date).
  - **Note:** For purposes of Rule 701, outstanding securities of a class include securities issuable pursuant to the exercise of outstanding options, warrants, or rights, or pursuant to the conversion of convertible securities.
- If Rule 701 exemption is not available, consider other exemptions such as the "accredited investor" exemption.

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What Are the State Securities Laws Considerations?

- Rule 701 is a federal exemption, and does <u>not</u> exempt companies from state securities laws, and it is important to confirm that offers and sales will not violate such laws.
- General patterns:
  - Many states have exemptions similar to Rule 701, or require the offering to meet the requirements of Rule 701.
  - Those states with exemptions similar to Rule 701 (such as California) often have some additional requirements.
  - Many states have limited-offering exemptions for sales to up to 35 nonaccredited investors and an unlimited number of accredited investors.
  - Many states require filings with their Department of Securities or Corporations in order to perfect the exemption. There is often an associated filing fee.

What Happens in Corporate Conversions?

- Treatment of corporate conversions to holders of:
  - Capital interests
  - Profits interests
  - Options
  - Phantom equity

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