Equity Incentive Compensation Plan Considerations for a Limited Liability Company

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A privately held company organized as a limited liability company ("LLC")[1] often wants to offer to key employees and consultants the right to participate in the financial success of the business through an equity incentive compensation plan. The principal owner and key employees typically think in terms of a plan comparable to the equity incentive compensation plans commonly used by publicly traded corporations. But are the typical corporate equity incentive compensation plans right for an LLC?

This article first describes the four broad types of equity incentive compensation plans commonly used by publicly traded corporations and most likely to be familiar to business owners and key employees: restricted stock, phantom stock, stock options, and stock appreciation rights. The article then explains why certain of these corporate plans may not work well for an LLC taxed as a partnership, and describes the more tax efficient alternatives for an LLC.[2]

Key Conclusions:

- For an LLC that wants to award participants an equity interest in the company's existing capital and future profits, a phantom equity plan is generally preferable to a restricted equity plan.
- For an LLC that wants to award participants an interest in future profits only, a "profits interest" plan is generally preferable to awards of equity options or equity appreciation rights, although an equity appreciation rights plan involves much less complexity and is more attractive if the business generates primarily ordinary operating income.
- In the right circumstances, an LLC gain sharing plan (which is a modified form of a profits interest plan) may achieve tax benefits not available in a traditional corporate or LLC equity incentive compensation plan (i.e., deferral of income and capital gains), with minimal tax compliance burdens for participants.

[1] The considerations for an LLC classified as a partnership as discussed in this article are also applicable to a business organized and taxed as a partnership. Special considerations apply to an LLC that elects to be taxed as an S corporation and are beyond the scope of this article.

[2] For a more comprehensive analysis of equity incentive compensation plans for partnerships and LLCs, see Linda Z. Swartz, *A Layman's Guide To LLC Incentive Compensation* (June 25, 2015), available at http://www.cadwalader.com/uploads/books/a2ce6abeb783d13ad1de50b16e12b72a.pdf. *See also* Teresa Y. Huang et. al., *Equity Compensation for Limited Liability Companies* (2ed. April 2013), available at http://www.nceo.org/Equity-Limited-Liability-Companies-LLC-ebook/pub.php/id/463/; and Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions & Buyouts*, ¶ 1505 (Sep. 2015).

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I. Overview

A. Basic Corporate Equity Incentive Compensation Plan Alternatives

Equity incentive compensation plans offered by a corporation to its key employees are most commonly one of the following four types of plans:

Restricted Stock:	The participant is awarded a specified number of shares of the corporation's stock, subject to vesting and forfeiture restrictions.[3]
Phantom Stock:	The participant is awarded the right to receive, upon specified events and conditions, a cash payment from the corporation equal to the value of a specified number of shares of the corporation's stock.
Stock Options:	The participant is awarded the right to purchase a specified number of shares of the corporation's stock at a specified "exercise price" during a specified period. The exercise price is typically equal to the stock's fair market value on the grant date.
Stock Appreciation Rights ("SARs"):	The participant is awarded the right to receive, upon specified events and conditions, a cash payment equal to the value of a specified number of shares of the corporation's stock in excess of a specified "strike price". The strike price is typically equal to the stock's fair market value on the grant date.[4]

As noted, restricted stock and stock options are payable in actual shares of the company's stock (i.e., they are "real" equity interests), whereas phantom stock and stock appreciation rights are settled in cash (i.e., they are "synthetic" equity interests).

In terms of economic rights, restricted stock and phantom stock generally entitle holders to the same economic rights as owners of corporate stock. A holder of restricted stock or phantom stock has economic rights based on both the existing value of the corporation's stock on the date the award is granted (i.e., an interest in the existing shareholders' "capital") plus a right to share in any appreciation in the value of the corporation's stock (i.e., an interest in future "profits," including capital appreciation). Consequently, restricted stock and phantom stock are said to entitle the holder to an interest in both capital and profits. In contrast, a holder of a stock

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[3] In a typical restricted stock plan, the stock awards are forfeited if the employee fails to meet certain service period (vesting) requirements or upon other events (e.g., termination for cause), and may be subject to limitations on sale to third parties. See the discussion of vesting and other restrictions below. For financial reporting purposes, the term "restricted shares" refers to stock that cannot be sold due to contractual or legal restrictions, and the term "nonvested shares" is used for stock for which the agreed upon vesting conditions (such as a minimum service period) have not yet been met. This memorandum uses the term restricted stock to refer to outstanding stock that is subject to vesting or other forfeiture restrictions, and not according to its financial reporting definition.

Restricted stock (as that term is used in this memorandum) is issued and outstanding at the award date, subject to the applicable restrictions. If the stock is not issued and outstanding at the award date (i.e., the award represents a mere promise to issue shares in the future upon satisfaction of the applicable conditions), the plan is more in the nature of a phantom equity plan that is settled in stock rather than in cash.

[4] An SAR is considered a cash settled stock option. SARs are sometimes settled in stock, but this is not common.

option or a stock appreciation right generally has no interest in the existing value of the corporation's stock (due to the exercise price or strike price being set at such value), and therefore is entitled to only a share of future profits and capital appreciation (i.e., a profits interest). This is illustrated in Table 1.

Table 1 – Classification of Common Corporate Equity Compensation Plans

	Real Equity	**Synthetic Equity**
Capital and Profits	Restricted Stock	Phantom Stock
Profits Only	Stock Options[5]	Stock Appreciation Rights

As discussed in more detail below, the principal tax difference between real equity and synthetic equity in the context of corporate stock plans is that (a) real equity interests present the potential for long-term capital gains for the participant on "post-inclusion date" appreciation, but at the cost of no deduction to the company for the capital gain amount, whereas (b) synthetic equity interests are taxed entirely as ordinary income, but allow the company to take a full deduction for the income taxed to the participant. These differences are summarized in the following table.

Table 2 – Key Tax Distinctions Between Real and Synthetic Corporate Equity

	Real Equity	**Synthetic Equity**
Participant	Potential for capital gain on post-inclusion appreciation	All ordinary income
Company	No deduction for post-inclusion appreciation	Full deduction

There can be almost infinite variations of the basic arrangements noted above and in Table 1. One common variation is to adjust the number of shares of stock or options awarded, or the cash equivalent payments, based on some performance measure over a specified period (so-called "performance based" awards). For example, the number of shares of stock awarded or referenced in the award agreement could be increased or decreased based on the corporation's earnings or other performance metrics over a specified performance period relative to specified benchmarks for the performance period.

[5] Assumes the exercise price for the stock option is equal to the fair market value of the underlying stock on the grant date.

In a typical plan, the equity or equity-linked award would be subject to vesting and possibly other forfeiture or transfer restrictions. For example, an award might vest ratably over a period of years. Vesting might be accelerated upon certain events, such as a change in control of the company. If the employee quits before the expiration of the vesting period, unvested shares would usually be forfeited. If the employee is terminated for cause or breaches post-employment covenants, both unvested and vested shares might be forfeited.

Special considerations apply if the corporation's stock is not publicly traded. In such cases, it is often difficult to set the exercise price for stock options (or the strike price for SARs) at the grant date at a price equal to the fair market value of the underlying stock on the grant date. In addition, vesting of restricted stock generally triggers a requirement that the participant recognize taxable income equal to the fair market value of the vested stock on the vesting date.[6] The lack of a ready market for the stock makes it difficult to determine the value to be recognized in taxable income, and also generally makes it impractical to sell some of the vested shares in the market as a means of funding the related tax liability. Equity incentive plans for a non-publicly traded corporation must be carefully designed and implemented to deal with these valuation and liquidity issues.

B. Comparable Equity Incentive Compensation Plans for an LLC

It is possible to construct an equity incentive plan for an LLC that has the same pre-tax economic terms as the corporate plans listed above. It is in theory as simple as substituting the term "equity" for "stock" in the description of the plan (to reflect that fact that an LLC's ownership or "equity" interests are represented by membership interests, whereas a corporation's ownership interests are represented by shares of stock). However, due to the unique tax characteristics of an LLC taxed as a partnership[7] as compared to a corporation, the after-tax consequences of the various plans for an LLC will be quite different from the after-tax consequences of the plans for a corporation. Due to these tax considerations,

1. In cases where key employees and other participants are to receive an equity interest in capital and profits, it will *generally* make sense to use a phantom equity plan in lieu of a restricted equity plan.
2. In cases where key employees and other participants are to receive an equity interest in future profits only, a "profits interest" plan may have advantages over equity options or equity appreciation rights. However, this is not always the case, and in some situations an equity appreciation rights plan may be preferable.
3. For certain types of businesses, a gain sharing plan might provide an optimal mix of tax and non-tax benefits.

The considerations influencing these choices are discussed below.

II. Capital and Profits Interests: An LLC Phantom Equity Plan Is Generally Preferable to a Restricted Equity Plan

The discussion below first describes, in very general terms, the most significant tax consequences of a typical corporate restricted stock plan and phantom equity plan. It then

[6] I.R.C. § 83.

[7] References in this article to an LLC assume that the LLC is classified as a partnership for federal income tax purposes under Treas. Reg. § 301.7701-3 and is not a publicly traded partnership as defined in I.R.C. § 7704.

explains why a traditional restricted stock plan has potentially significant disadvantages in the context of a private LLC, and why a phantom equity plan is generally a better alternative for an LLC in cases where the objective is to provide participants with an economic interest in both existing capital and future profits (including capital appreciation).

A. Tax Consequences of Corporate Restricted Stock

In general, the value of restricted stock awarded to an employee or other plan participant as compensation for services is included in the participant's taxable income, as ordinary compensation income, when the stock becomes "substantially vested" (i.e., the stock is either transferable or is not subject to a substantial risk of forfeiture).[8] The amount included in income is adjusted for any amount paid for the stock.[9] Any appreciation in the value of the stock after the date the stock is substantially vested (the "vesting date" or "vesting") is generally taxed as capital gain.[10]

Alternatively, the participant can make a "section 83(b) election" to have the value of the stock on the grant date (less any amount paid for the stock) included in taxable income on the grant date, notwithstanding the fact that the stock is not substantially vested on the grant date.[11] A section 83(b) election must be made within 30 days of the grant date, and there is no relief for a failure to timely file a proper election. If a section 83(b) election is timely and validly made, any appreciation in the value of the stock after the grant date is taxed as capital gain, but the participant generally cannot claim a deduction for any loss in value of the stock after the grant date.[12]

The participant is generally treated as the owner of restricted stock only upon vesting, and if the participant receives a dividend paid with respect to the restricted stock prior to vesting, the dividend is treated as a payment of compensation and is not eligible for the reduced tax rate applicable to qualified dividend income.[13] If, however, the participant makes a section 83(b) election with respect to the restricted stock, the participant is treated as the owner of the restricted stock as of the grant date and dividends received by the participant with respect to the stock can qualify as qualified dividend income.

The corporation may claim a compensation deduction at the time the participant recognizes taxable compensation income in an amount equal to the amount recognized as compensation income by the participant (plus any applicable employer taxes).[14] The corporation has no deduction for any amount taxed to the participant as capital gain.

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[8] Treas. Reg. §§ 1.83-1(a)(1) and 1.83-3(b).

[9] Treas. Reg. § 1.83-1(a)(1).

[10] I.R.C. §§ 1222, 1221.

[11] I.R.C. § 83(b).

[12] Treas. Reg. § 1.83-2(a). A loss can be claimed only if the stock is sold for less than the amount (if any) paid for the stock.

[13] Treas. Reg. § 1.83-1(a); I.R.C. § 1(h)(11).

[14] Treas. Reg. § 1.83-6.

B. Tax Consequences of Corporate Restricted Stock Units ("**RSUs**")

A restricted stock unit ("**RSU**") is an unfunded promise by the corporation to issue a share of the corporation's stock upon satisfaction of specified vesting conditions. Because the participant does not receive the stock unless and until the vesting conditions are satisfied, the participant does not have voting or dividend rights during the vesting period,[15] and the participant cannot file a section 83(b) election with respect to the receipt of an RSU (because the stock is not issued until it is substantially vested).[16] In this manner, the corporation (rather than the participant) controls the timing of the compensation deduction and preserves the possibility of a larger deduction should the value of the stock increase prior to vesting. Additionally, the corporation does not need to keep track of whether participants have made section 83(b) elections.

Other than the participant's inability to file a section 83(b) election for an RSU, the tax consequences of RSUs are the same as the tax consequences of restricted stock.

C. Tax Consequences of Corporate Phantom Stock

A participant in a corporate phantom stock plan is generally taxed only as and when the participant receives payments with respect to the phantom stock, and the entire amount received by the participant is taxed as ordinary compensation income.[17] The corporation generally may claim a compensation deduction at the time the participant recognizes taxable compensation income.[18]

The participant in a phantom stock plan forgoes the ability to obtain capital gain treatment on appreciation in the value of the underlying stock.[19] In this respect, a phantom

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[15] A plan may provide that RSU holders receive dividend equivalent payments during the vesting period.

[16] For this reason, RSUs are generally not used for issuance of "founders' shares" in a startup company. At the formation of a startup company, the initial share awards have little or no value at the grant date and there is therefore little or no tax cost to making a section 83(b) election), and the corporation is less likely to be able to get an immediate cash benefit for the tax deduction upon vesting.

[17] Treas. Reg. § 1.83-3(e) (property does not include an unfunded and unsecured promise to pay money or property in the future).

[18] I.R.C. § 162(a)(1).

[19] A possible exception is for phantom stock transferred in a taxable transaction. The transferee may be able to argue that the phantom stock right is a capital asset and that amounts received pursuant to the phantom stock right constitute capital gains. *Cf. Hurford Investments No. 2, LTD. v Comm'r*, T.C. Unpub. Order (Apr. 17, 2017), 2017 TNT 74-31 (Doc. 2017-50328) (phantom stock transferred by holder's surviving spouse to a limited liability company is a capital asset in the hands of the transferee company following the death of the surviving spouse, and a subsequent "redemption" of the phantom stock gives rise to long-term capital gain under I.R.C. § 1234A, relating to termination of contract rights). A decision in the *Hurford Investments* case is still pending, so it is unclear whether the IRS will appeal the ruling (when the decision is entered) and whether the IRS will challenge the theory of the ruling in other cases involving transferred phantom stock rights.. In that regard, I.R.C. § 1234A confers capital gain treatment on gain from the termination of a right or obligation to buy or sell property (e.g., a stock option), but not to the termination of ownership of the property itself (e.g., the underlying stock). *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311 (5th Cir. 2015). Without much discussion, the Tax Court in *Hurford Investments* characterized phantom stock as a right to buy or sell a capital asset, and not as ownership of property. However, it seems quite clear that phantom stock is a contractual right to receive an amount of cash based on the value of referenced stock, and is not a right to buy or sell the referenced stock or any other underlying asset. The very name of the contractual arrangement – "phantom" stock – communicates that there is no underlying property to buy or sell. Accordingly, it is unclear whether the Tax Court's application of I.R.C. § 1234A in *Hurford Investments* to phantom stock rights will be upheld on appeal (if an appeal is filed) or followed in other cases.

equity plan is generally considered less attractive to participants than a restricted equity plan. In addition, a restricted equity plan gives participants "real" equity in the corporation, typically with real voting rights and other rights associated with ownership, rather than a synthetic or derivative equity interest that does not carry those rights. However, a phantom equity plan solves certain valuation and liquidity issues associated with non-traded restricted stock. In addition, whereas the corporation obtains no tax deduction for restricted stock appreciation taxed to the participant as capital gain, the corporation obtains a deduction for the entire amount of income recognized by the participant with respect to phantom equity, typically making phantom equity a more tax efficient alternative for the corporation and overall.

D. Tax Consequences of LLC Restricted Equity

Awards of restricted equity (membership interests) in an LLC classified as a partnership for federal income tax purposes are generally taxed in the same manner as corporate restricted stock. The restricted equity award is included in the participant's income on either (a) the award date if the award is substantially vested on that date or if the participant makes a timely and valid Section 83(b) election, or (b) in all other cases, such later date on which the equity interest becomes substantially vested.[20] The amount included in the participant's income is the excess of the value of restricted equity on the inclusion date over the amount paid for the equity, and this amount is classified as ordinary compensation income. Because the LLC is not a publicly traded entity,[21] it can be difficult to fund the participant's tax liability on the inclusion date. The company may need to make arrangements to buy back a portion of the equity or to provide loans to the participant to cover the participant's tax liability. The LLC issuing restricted equity is not required to recognize gain on the participant's share of Company assets.[22]

The participant is not regarded as a member of the LLC for tax purposes until the inclusion date described in the preceding paragraph.[23] Until then, any amount paid for the restricted equity represents a conditional credit to the LLC capital. If the restricted equity award vests, the conditional credit is transferred to the participant's capital account on the inclusion date, and the participant's capital account is also credited for any amount recognized in income at that time.[24] If the restricted equity award is forfeited, any conditional credit is apparently transferred to income and closed to members' capital accounts.

Once the LLC restricted equity is included in the participant's income (either by vesting or by making a section 83(b) election), the participant is considered a member of the company

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[20] *See Crescent Holdings, LLC v. Comm'r*, 141 T.C. No. 15 (2013) (service provider partner is not taxed on receipt of substantially non-vested interest in partnership capital and profits in the absence of a section 83(b) election, and is not allocated any partnership tax items with respect to such interest if it is forfeited prior to vesting).

[21] See footnote 7 (for purposes of this memorandum, an LLC is assumed to be classified as a partnership for federal tax purposes and is assumed to not be a publicly traded partnership).

[22] Some commentators have suggested that the Company should be required to recognize gain on the participant's share of the Company's assets as if the Company had transferred an undivided interest in the assets to the participant as compensation, and the participant had then contributed those assets back to the Company. The IRS has rejected this analysis. REG–105346–03, 70 Fed. Reg. 29675, 29679 (2005) ("partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest").

[23] Treas. Reg. §§ 1.83-1(a), 1.83-2(a); *Crescent Holdings, LLC v. Comm'r*, 141 T.C. No. 15 (2013).

[24] REG–105346–03, 70 Fed. Reg. 29675, 29677 (2005).

for tax purposes.[25] and must be issued a Schedule K-1 for the participant's share of company tax items each year, whether or not any cash distributions are made to the participant.[26] The participant's share of company tax items will generally be taxed as ordinary income or as capital gain depending on the character of the income to the company. Special tax distributions to participants may be required to fund their tax liability on company tax items allocated to them for tax purposes. LLC income taxed to the participant is effectively deductible by the other LLC members in that the income is "deflected" to the participant. In contrast, a holder of corporate restricted stock is generally not taxed on company profits until distributed as a dividend, such dividends are taxed entirely at favorable long-term capital gain tax rates,[27] and the corporation does not obtain any deduction for dividends paid to the participant.

If the participant receives reasonable compensation (guaranteed payments) for services rendered to the LLC in the participant's capacity as an employee of the LLC or in any other service provider capacity, the participant may be able to take the positon that the participant's distributive share of the LLC's income and gains accruing with respect to the participant's restricted equity interest is exempt from self-employment tax by virtue of I.R.C. § 1402(a)(13) (distributive share income of a limited partner), and is also exempt from net investment income tax under I.R.C. § 1411(c)(2), assuming the income is derived from a business that is not trading in financial instruments or commodities and is not a passive activity as to the participant (taking into account the participant's participation in the business as an employee). This position will depend on the structure and activities of the LLC and the participant's rights and activities as a restricted equity interest holder.

Upon disposition of LLC restricted equity, the participant's gain is capital gain except to the extent attributable to the participant's share of company "hot assets" (generally defined as assets that would produce ordinary income if sold).[28] An LLC can increase the basis of its assets to account for any gain recognized by the participant on the disposition of the participant's restricted equity.[29] This effectively creates a deferred deduction for the LLC equal to the gain recognized by the participant. In contrast, in the case of a sale of corporate restricted stock, there are no hot asset rules (all gain is capital gain), and there is no basis adjustment (deferred deduction) available for gain recognized by the participant on the sale of the restricted stock.

Once LLC restricted equity is taxed to the participant and the participant is classified as a member of the LLC (i.e., following the inclusion date), the participant may also be subject to state tax filing requirements in all states in which the LLC does business, and may be subject to state income tax on the participant's share of company income and on the participant's gain from the disposition of the LLC restricted equity. In contrast, a holder of corporate restricted stock is generally not subject to tax on income from the stock in any state other than the state in which the participant's maintains his or her domicile.

[25] Treas. Reg. §§ 1.83-1(a), 1.83-2(a).

[26] I.R.C. § 702.

[27] I.R.C. § 1(h).

[28] I.R.C. § 751.

[29] I.R.C. §§ 734, 743, 754.

The IRS view is that a person who owns an equity interest in an LLC classified as a partnership for federal income tax purposes cannot also be an employee of the LLC.[30] Accordingly, under the IRS view, following the inclusion date, the participant must have regular compensation and bonuses reported as guaranteed payments on Schedule K-1 rather than as compensation income on Form W-2. This can have potentially significant collateral effects,[31] and can be confusing to participants. Similarly, it is possible that a compensation paid to a participant that is an independent contractor might have to be reported on Schedule K-1 rather than on Form 1099, leading to similar confusion. It may be possible to avoid having participant compensation reclassified as guaranteed payments using a variety of legal structures,[32] but these structures add cost and complexity.

In summary, the tax reporting for the holding and sale of corporate restricted stock is much simpler than the tax reporting for the holding and sale of LLC restricted equity, and the issuance of corporate restricted stock does not interfere with the participant's existing employment relationship with the company. For these reasons, a restricted equity plan is generally not be the best choice for an LLC equity incentive compensation plan.

E. Tax Consequences of LLC Restricted Equity Units ("<u>REUs</u>")

An LLC restricted equity unit is an unfunded promise by the LLC to issue a unit of LLC equity upon satisfaction of specified vesting conditions. The tax consequences are the same as for LLC restricted equity that is subject to vesting conditions and for which no section 83(b) election is filed. As with corporate restricted stock units, LLC restricted equity units are generally issued when the LLC wants to prevent the filing of a section 83(b) election with respect to restricted equity awards and thereby control the timing of the inclusion date, avoid having to track section 83(b) elections, and obtain a deduction for any appreciation in the value of the underlying units between the award date and the vesting date.

F. Tax Consequences of LLC Phantom Equity

Under a phantom equity plan, participants are awarded nominal equity units ("<u>Phantom Units</u>") that represent a contractual right to receive a cash payment equal to the value of a unit of LLC membership interest upon defined payment events. An LLC phantom equity plan has essentially the same tax consequences as a corporate phantom equity plan (i.e., taxation deferred until payment, and all payments taxed as compensation income).

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[30] Rev. Rul. 69-184, 1969-1 C.B. 256. *See also* Treas. Reg. § 54.4980H-1(a)(15) (a partner is not an employee for purposes of the "shared responsibility payment" imposed under the 2010 Affordable Care Act). *But see Armstrong v. Phinney,* 394 F.2d 661 (5th Cir. 1968) (partner treated as an employee for purposes of the exclusion for meals provided to employees for the convenience of the employer).

[31] *See* Noel P. Brock, *Treating partners as employees: Risks to consider*, J. Accountancy (Aug. 1, 2014).

[32] One solution involves forming a holding company to own the equity interests of participants, with non-participant owners continuing to own equity interests in the operating company. *See* Swartz, *supra* n. 2, pp. 22-24, and Illustration 1 below. Previously, many advisors recommended that the operating company form a wholly-owned subsidiary to act as the employer of the participants. However, the IRS has indicated that it will challenge such an arrangement, and has requested comments on the application of the employee/partner prohibition of Rev. Rul. 69-184 to tiered partnership arrangements. See Treas. Reg. § 301.7701-2T(c)(2)(iv)(C)(2) and -2T(e)(8) (a partner in a partnership may not be treated as an employee of a disregarded entity owned by the partnership) and T.D. 9766, 81 Fed. Reg. 26693 (May 4, 2016).

For an LLC, a phantom equity plan has several advantages over a restricted equity plan, including:

1. Whereas owners of LLC restricted equity are taxed on their allocable shares of the LLC's income after vesting or an 83(b) election, whether or not the income is distributed, Phantom Units are taxed more like restricted stock in that the holder of Phantom Units is only taxed as and when cash is distributed to the holder.

2. Because owners of Phantom Units are not considered equity owners, their status as employees of the company is not affected by the issuance of Phantom Units. Accordingly, they can continue to be issued a Form W-2 for their wages, bonuses, and other compensation and benefits (including payments in respect of the Phantom Units).

3. Equity owners of an LLC are generally deemed to be doing business wherever the LLC is doing business, and are therefore required to file state (and local) income tax returns everywhere the LLC does business, and pay tax on their share of LLC income attributable to other states and cities imposing an income tax. The company can usually arrange to file composite tax returns on behalf of its equity owners, but the equity owners are typically still responsible for payment of the taxes. In contrast, assuming a participant works exclusively in his or her state of domicile, amounts received with respect to Phantom Units would not be subject to any state or local income tax outside the participant's state of domicile, and neither the participant nor the company would be required to file any additional state or local income tax returns for the participant.

4. Awards of restricted equity are generally taxed to the participant no later than the date the restricted equity becomes vested, whereas Phantom Units are not taxed to the participant until the specified payment date. A phantom equity plan therefore eliminates the need for special provisions to either defer vesting or to provide liquidity for payment of taxes on vested restricted equity.[33]

5. If a restricted equity plan includes arrangements to allow participants to sell a portion of the restricted equity at vesting in order to pay the tax due, the participant has a smaller percentage interest in any future appreciation in the value of the business. There is no similar need to reduce the invested balance of a holder of Phantom Units.

6. The issuance of restricted equity can trigger taxable income to other LLC members (including participants that have previously vested restricted equity) to the extent the LLC has debt and holds hot assets.[34] These deemed income rules don't apply to the issuance of Phantom Units.

7. Although not of direct concern to participants, all payments by the company with respect to Phantom Units are immediately deductible by the company. In contrast, any payment made to retire restricted equity is generally not immediately deductible by the company but must

[33] If a phantom equity award vests (i.e., is no longer subject to a substantial risk of forfeiture) prior to payout (e.g., upon death, or permanent disability), the company might be required to pay and withhold social security and other employment taxes on the value of the award as and to the extent it becomes vested. See I.R.C. §§ 3121(v)(2) and 3306(r)(2). Withholding can be taken from other wage payments to the affected participant, or IRS Notice 2005-1, IV Q&A 15(f) allows for acceleration of payments to pay employment taxes, and to pay income tax withholding on the accelerated payments, without violating I.R.C. § 409A.

[34] I.R.C. §§ 751, 752.

instead be added to the basis of undistributed company assets and recovered through depreciation or other basis recovery provisions.

8. A phantom equity plan avoids significant accounting complexities for the LLC associated with recalculating all equity owners' capital accounts, sharing ratios, and tax basis allocations every time additional equity interests vest or are retired. These administrative costs can drain significant value and resources from the business without producing any value for the participants or the other investors.

An LLC phantom equity plan is subject to several potential disadvantages as compared to a restricted equity plan:

1. The entire amount received by a participant with respect to Phantom Units is taxed as compensation income; none qualifies as tax favored capital gain. In contrast, a significant portion of the appreciation in the value of restricted equity might be taxed as capital gain. This tax detriment associated with Phantom Units is mitigated by (a) the fact that the participant hasn't had to pay tax on the vesting of the Phantom Units, and therefore may have larger percentage interest in any such appreciation under a phantom equity plan, and (b) the fact that the LLC obtains an ordinary compensation deduction for the compensation income recognized by the participant (see paragraph 7 above).[35]

2. Income and gain from restricted equity might qualify as exempt from both self-employment tax and net investment income tax, whereas income from a phantom equity plan is always subject to FICA tax (at the same rate as self-employment tax).

3. A phantom equity plan will normally be subject to the deferred compensation rules of I.R.C. § 409A, whereas a restricted equity plan is generally not subject to those rules.[36] I.R.C. § 409A specifies permissible payment events, restrictions on funding, requirements for deferral elections, and other applicable requirements. Failure to comply with the requirements can subject participants to acceleration of income and penalties. Nevertheless, with careful drafting, an LLC phantom equity plan can comply with I.R.C. § 409A without undue interference with the company's compensation objectives.

G. Summary

Considering all of the factors discussed above, an LLC phantom equity plan is generally preferable to an LLC restricted equity plan for both the participants and the LLC.[37]

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[35] The LLC members might not have sufficient ordinary income in the year in which the Phantom Units are paid to fully absorb the LLC's deduction for Phantom Unit payments, and a portion of the LLC's deduction might offset long-term capital gains. If this occurs, the holders might pay tax at ordinary income rates whereas the LLC members might get a tax benefit at lower long-term capital gain rates.

[36] Treas. Reg. § 1.409A-1(b)(6), (7).

[37] See the discussion in Sections IV(F) and V below regarding profits interests and gain sharing interests with a "catch up" allocation. It may be possible to structure a profits interest that has no capital account value upon issuance, but which is allocated a preferential share of future profits (either from all sources, or solely from capital transactions) equal to the capital interest that is forgone at the issue date (sometimes referred to as a "catch up" allocation). In this manner, a profits interest or gain sharing interest can mimic the effects of a phantom equity plan while conferring on the participant the opportunity for capital gains treatment.

III. Profits Interests: An LLC Profits Interest Is Generally Preferable to Equity Options or Equity Appreciation Rights

This section describes, again in very general terms, the most significant tax consequences of corporate stock options and corporate stock appreciation rights ("SARs"), and compares those tax consequences to the tax consequences of the LLC equivalent plans. The discussion also describes a "profits interest," which is a special form of equity appreciation right available to LLCs classified as partnerships. As discussed below, an LLC profits interest is generally preferable to equity options or equity appreciation rights. But for businesses that don't expect to generate significant capital gain income (e.g., a professional service business), or where the complexities of a profits interest plan are untenable, an equity appreciation right may be a preferred alternative.

A. Tax Consequences of Corporate Stock Options

In general, no taxable income is recognized on the grant or vesting of a corporate stock option.[38] Rather, when such an option is exercised (and assuming the stock is substantially vested when purchased or a Section 83(b) election is filed in connection with the exercise[39]), the participant recognizes ordinary compensation income equal to the excess of the value of the stock on the exercise date and the amount paid to acquire the stock (i.e., the exercise price).[40] Any appreciation in the value of the stock after the exercise date is generally taxed as capital gain.

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[38] The discussion in text assumes that the option does not have a readily ascertainable fair market value, covers a fixed number of shares, and has an exercise price not less than the fair market value of the underlying stock on the grant date. *See* Treas. Reg. § 1.83-7 and Treas. Reg. § 1.409A-1(b)(5)(i)(A). Treas. Reg. § 1.409A-1(b)(5)(iv) provides safe harbors for establishing the fair market value of stock. A stock option that has an exercise price below the fair market value of the underlying stock on the grant date is subject to tax under I.R.C. § 409A on the vesting date, plus a 20% penalty, unless the option is mandatorily exercised either (a) within the short-term deferral period after the vesting date, or (b) only on a permitted payment date under I.R.C. § 409A (i.e., a predetermined date, separation from service, death, disability, unforeseeable financial emergency, or a change of control). *See* Treas. Reg. § 1.409A-1(b)(4)(iii) (Example 8). *See also Sutardja v. United States*, 109 Fed. Cl. 358 (2013).

[39] If the stock purchased upon exercise of the option is substantially nonvested (i.e., is subject to a substantial risk of forfeiture and is non-transferrable as determined under Treas. Reg. § 1.83-3) and no Section 83(b) election is filed, there is no taxable income upon exercise. Instead, the participant recognizes ordinary compensation income when the stock becomes substantially vested in an amount equal to the excess (if any) of the value of the stock at that time over the purchase price paid for the stock pursuant to the option exercise. The service recipient obtains a corresponding deduction. Any subsequent appreciation in value is eligible for capital gain treatment. To avoid the risk of failing to properly account for the tax consequences of the exercise of a compensatory stock option in the case of purchased stock that is substantially nonvested, some plans require the participant to file a Section 83(b) election in connection with all stock option exercises.

[40] Treas. Reg. § 1.83-7. The discussion in text deals with "non-qualified" stock options, meaning options that are not "incentive stock options" covered by I.R.C. § 422. The advantage of an incentive stock option is that there is potentially no tax on exercise of the option (rather, tax is due only when the underlying stock acquired upon exercise of the option is ultimately sold) and the entire gain on the sale of the stock acquired upon exercise of the option may qualify for long-term capital gain treatment. The disadvantage (which generally outweighs the potential advantages) is that the company is not allowed any tax deduction for the grant or exercise of the option or for the sale of the underlying stock. *See* I.R.C. § 421(a).

There is generally no ability to accelerate gain recognition (i.e., no section 83(b) election) with respect to the receipt of a compensatory corporate stock option.[41]

The corporation may claim a compensation deduction at the time the participant recognizes taxable compensation income, and the amount of the corporation's deduction is equal to the amount recognized as compensation income by the participant.[42] The corporation has no deduction for any amount taxed to the participant as capital gain.

Stock options were at one time the favored form of equity incentive compensation for emerging growth companies because the corporation was not required to recognize any expense for financial reporting purposes with respect to the issuance or exercise of the options. That favorable financial reporting treatment was changed in 2005,[43] and the financial reporting treatment for restricted stock is now generally considered more favorable than for stock options (because the value, and associated financial reporting expense, of stock options tends to be overstated by applicable valuation models). As a result, beginning in 2006 many publicly traded corporations began preferring restricted stock to stock options as a means of providing equity incentive compensation to key employees.

B. Tax Consequences of Corporate SARs

A corporate SAR is taxed in the same manner as a corporate phantom equity plan (described above). Payments are taxed as ordinary income only when paid to the participant, and the corporation can deduct the payments as compensation expense at that time.

C. Tax Consequences of LLC Equity Options

The IRS has not issued definitive guidance on the tax consequences of LLC equity options. Until definitive guidance is issued, the tax rules for LLC equity options are generally assumed to be the same as for corporate stock options. That is, there are no tax consequences associated with the grant or vesting of equity options[44], but if and when the option is exercised, assuming the equity received on exercise is substantially vested, the participant recognizes ordinary compensation income equal to the spread between the value of the underlying equity on the exercise date and the exercise price, and the LLC has a deduction for the amount included in the participant's income. Following exercise, the participant becomes an equity owner with a capital account equal to the value of the underlying equity taken into account in determining the participant's compensation income. Going forward, the participant is allocated a distributive share of LLC tax items and receives a Schedule K-1.[45] The participant's holding period for the

[41] Treas. Reg. § 1.83-7(a). If the stock acquired upon exercise of the option is restricted (i.e., not substantially vested), a section 83(b) election can be made upon exercise of the option. Also, if the stock option is transferrable and immediately exercisable, it might be possible to take the position that the option has a readily ascertainable fair market value on the grant date, in which case the value of the option on the grant date would be recognized as compensation income on the grant date. See Treas. Reg. § 1.83-7(b)(2), (3).

[42] Treas. Reg. § 1.83-6.

[43] *See* Financial Accounting Standards Board, *Statement No. 123(R) Share Based Payment* (Dec. 2004).

[44] The discussion in text assumes that the option does not have a readily ascertainable fair market value, covers a fixed number of shares, and has an exercise price not less than the fair market value of the underlying equity on the grant date). See footnote 38.

[45] *Cf.* Prop. Treas. Reg. § 1.721-1(b), 70 Fed. Reg. 29675, 29683 (May 24, 2005) (treating receipt of a compensatory equity interest, including an equity interest acquired upon exercise of an option granted in connection with the performance of services for the LLC, as taxable to the participant (service provider) under I.R.C. § 83,

equity interest begins on the day following exercise,[46] and therefore an exercise of an equity option in anticipation of a sale of LLC equity interest will generally produce ordinary income (upon exercise) and short-term capital gain or loss (upon a sale of the equity interest within one year following exercise).

The exercise of an LLC equity option leads to an equity interest that is more complicated than the stock ownership interest acquired upon the exercise of a corporate stock option. Whereas a holder of corporate stock recognizes income only to the extent of actual dividends and gains received, the holder of LLC equity is subject to the complexities and associated with equity ownership as described above in section III(C) with respect to restricted equity. On the other hand, unlike in the case of a corporate stock option (where the corporation gets no deduction for gain realized by the participant after the exercise date), all post-exercise income or capital gain allocated to the participant reduces income or gain that would otherwise be allocated to the remaining LLC members, with the effect that the LLC effectively obtains a deduction (deflection of income) for the post-exercise income or gain realized by the participant with respect to the LLC equity option.

LLC equity options are not common. A profits interests (discussed below) will generally be a preferred alternative because profits interests do not require an exercise of option rights, payment of an exercise price, or valuation of the underlying equity in connection with any such exercise, and generally provide more favorable tax consequences (although at the cost of some additional complexity).

D. Tax Consequences of LLC Equity Appreciation Rights

Because equity appreciation rights are merely a contractual obligation to make a future cash payment by reference to the change in value of the underlying LLC equity, the tax consequences of an LLC equity appreciation rights plan are the same as the tax consequences of a phantom equity plan; i.e., the payments are taxed as ordinary compensation income to the participant as received, and are deducted by the LLC as they are included in the participant's income. An equity appreciation rights plan also has some of the same advantages over an LLC equity option plan that an LLC phantom equity plan has over an LLC restricted equity plan. For example, an equity appreciation right never leads to an equity ownership interest, so the complexities of having the participant as a member of the LLC are avoided. Potential drawbacks of a equity appreciation rights plan are (a) the entire amount paid to the participant is ordinary compensation income, and (b) the plan may be subject to the requirements of I.R.C. § 409A.

E. Tax Consequences of LLC Profits Interests

A "profits interest" is a special class of LLC equity that entitles the holder to a share in the LLC's future profits, but no share in the LLC's asset values as of the date the award is granted (i.e., no "capital interest"). Under current IRS rules, a profits interest is not taxable either at the grant date or at the vesting date. In effect, the participant is deemed to make a section 83(b) election and include zero value in income at the grant date.[47]

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without giving rise to gain or loss to the LLC). *See also* Karen C. Burke, *Taxing Compensatory Partnership Options*, 100 Tax Notes 1569 (Sep. 22, 2003).

[46] Rev. Rul. 78-182, 1978-1 C.B. 265.

[47] *See* Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. Note that the safe harbor tax treatment prescribed in Rev. Proc. 93-27 and Rev. Proc. 2001-43 does not apply if (a) the interest relates to a

A profits interest is economically equivalent to an equity appreciation right, but it has some unique features. In contrast to an equity appreciation right (where any value paid to the participant is taxed as compensation income), a profits interest causes the participant to be a partner as of the grant date, and the participant's income (if any) with respect to the profits interest depends on the character of the LLC's income or gains (or the character of its assets upon a sale or redemption of the profits interest). A profits interest therefore generally creates an opportunity for the participant to recognize capital gains, whereas an equity appreciation right results in payments classified entirely as ordinary compensation income.

A profits interest is also economically equivalent to an equity option, except that there is no exercise price to be paid for the profits interest. And whereas the appreciation in value of an equity option prior to exercise (i.e., the "spread" at exercise) is taxed as compensation income, a profits interest creates a greater opportunity for capital gains with respect to such appreciation.

In addition to the opportunity for capital gains treatment on income accruing to a profits interest, a potential additional tax benefit of a profits interest is the opportunity to avoid both self-employment tax and net investment income tax on such income (whether capital gain or ordinary income). If the participant receives reasonable compensation (guaranteed payments) for services rendered to the LLC in the participant's capacity as an employee of the LLC (or other service provider capacity), the participant may be able to take the positon that the participant's distributive share of the LLC's income accruing with respect to the profits interest is exempt from self-employment tax by virtue of I.R.C. § 1402(a)(13) (income of a limited partner), and is also exempt from net investment income tax under I.R.C. § 1411(c)(2), assuming the income is derived from a business that is not trading in financial instruments or commodities and is not a passive activity as to the participant (taking into account the participant's participation in the business as an employee). This position will depend on the structure and activities of the LLC and the participant's rights and activities as a profits interest holder.

There are a number of potential drawbacks associated with a profits interest. One potential drawback is that the participant receives an actual equity interest in the LLC and is considered a member on and after the grant date regardless of any vesting restrictions. Consequently, the participant faces the complexities associated with equity ownership discussed above in paragraphs III(C) (relating to restricted equity interests), including taxation of LLC income without regard to cash distributions, impact on employee status, state income tax implications, and liability allocation and tax basis implications for other members. In contrast, an equity option defers issuance of an actual equity interest until the option is exercised, and a equity appreciation right never involves issuance of an actual equity interest.

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substantially certain and predictable stream of income from partnership assets, (b) the service provider "disposes" of the interest within two years of receipt; (c) the partnership is a publicly traded partnership, or (d) the partnership or any partner fails to report the transaction consistent with the treatment of the service provider as having made a constructive section 83(b) election. In cases where a profits interest may not comply with the requirements of the IRS safe harbors, it is generally advisable to file a protective section 83(b) election with respect to the receipt of a profits interest. See Rev. Proc. 2012-29, 2012-28 I.R.B. 49, regarding sample language for section 83(b) elections.

The IRS has proposed an additional limitation on the profits interests safe harbors to curb situations where a profits interest is issued pursuant to a "fee waiver." The IRS has proposed to issue a supplemental Revenue Procedure providing that the safe harbors will not apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services. REG-115452-14, 80 Fed. Reg. 43652 (Jul. 23, 2015), corrected 80 Fed. Reg. 50240 (Aug. 19, 2015).

Another potential drawback of a profits interest is the valuation and accounting complexities associated with issuing such interests. Because a profits interest, by definition, cannot be entitled to share in any portion of the value of the business on the date the profits interest is issued, the company must determine the value of the business on the issuance date and must keep an accounting of that value for the benefit of the existing members. This is generally not a significant problem for a newly formed business having no significant non-cash assets and wishing to award profits interests to a predetermined class of participants only upon formation or shortly thereafter. But in the case of business that wishes to award profits interests on an ongoing basis, the valuation and accounting issues can be more problematic. Even if the value of the company's assets can be ascertained with reasonable accuracy on any grant date, the company generally must adjust the capital accounts of the existing members to reflect that value prior to the issuance of the profits interest.[48] This is commonly referred to as "booking up" the capital accounts and creating "Section 704(b)" capital accounts. This process can create significant accounting complexity.[49] Accordingly, where the company contemplates issuing equity interests on an ongoing basis, the valuation and accounting complexities associated with profits interests might militate against using profits interests as equity incentive awards.

A third potential drawback of a profits interest is the handling of forfeitures (if the interest is subject to vesting conditions or other forfeiture provisions). Complex special allocations of tax items may be required for the year of the forfeiture to account for prior allocations of profits or losses with respect to the forfeited interest.[50] There is also an unsettled question whether the participant is entitled to a deduction for the tax basis of the forfeited interest. In a worst case, the IRS might argue that the participant is not allowed any deduction for the tax basis of the forfeited interest,[51] and the existing members have an immediate income recognition event (i.e., a "capital shift") upon the forfeiture of the interest.[52]

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[48] See Treas. Reg. § 1.704-1(b)(2)(iv)(f).

[49] As an alternative to the "booking up" (or down) all assets and liabilities and reflecting the net change in the capital accounts, many LLC and partnership operating agreements provide that a "distribution threshold" amount (or similar amount) must be specified for each profits interest issued, with the specified amount representing an amount equal to or greater than the value of the capital interests in the company immediately prior to the issuance of the profits interests. The profits interests are not entitled to distributions until the distribution threshold has been distributed to existing members or otherwise reserved for distribution to them. This may avoid the need for adjusting the assets and liabilities and capital accounts to fair market value each time profits interests are issued. Nevertheless, there is still significant complexity associated with tracking multiple distribution thresholds for multiple series of profits interests.

[50] *Cf.* Prop. Treas. Reg. § 1.704-1(b)(4)(xii)(c), 70 Fed. Reg. 29670, 29681 (May 24, 2005) (describing special allocations for year in which a compensatory partnership interest is forfeited).

[51] *Cf.* REG–105346–03, 70 Fed. Reg. 29670, 29677 (May 24, 2005) ("Comments are also requested as to whether section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. In particular, comments are requested as to whether section 83 or another section of the Code provides authority for such a rule.").

[52] *See* Swartz, *supra* n. 2, p. 46 (noting that forfeiture of a profits interest could raise capital shift issues) and pp. 8-9 (discussing tax consequences of capital shifts). *See also* Treas. Reg. § 1.704-1(b)(2)(iv)(s)(3) and -1(b)(4)(x) (allocations with respect to noncompensatory options and related capital shifts; rejecting income allocations in excess of partnership gross income and deduction items).

Because of these drawbacks, an equity appreciation rights plan is sometimes preferable to a profits interest plan. Note that the company might be able to offer a more generous equity appreciation rights plan to account for the fact that participants are not allocated underlying LLC capital gains under an equity appreciation rights plan.[53]

F. Summary

In the case of a business that generates most of its income in the form goodwill and other sources of capital gain, a profits interest preserves the participant's opportunity for sharing in capital gains generated upon a disposition of the company's capital assets or upon a sale of the equity interests. A profits interest may also present an opportunity to avoid surtaxes[54] on income and gains attributable to the profits interest. However, there are significant complexities associated with a profits interest plan. Where the nature of the business is such that the opportunity for capital gain is not great (e.g., a professional services business that does not generate significant gain from goodwill or other sources), or where the complexities of a profits interest plan are otherwise untenable, an equity appreciation rights plan may be preferable from an overall tax and simplicity standpoint. An equity option plan is generally not a preferred alternative because it requires payment of the exercise price for the option and valuation of the underlying equity at exercise, can have tax disadvantages relative to a profits interest, and has somewhat uncertain tax consequences.

IV. Hybrid Interests

A. Profits Interest With "Catch Up" Allocation

As previously noted, whereas a restricted equity interest represents a specified share of both existing capital and future profits, a traditional profits interest involves a specified percentage of future profits only, and no share of the existing capital. However, it may be possible to structure an LLC profits interest that mimics the economics of a restricted equity interest. For example, if the LLC wants to award a participant a full 5% interest in capital and profits of the LLC (similar to a 5% restricted equity interest), but does not want to saddle the participant with the tax burden associated with vesting of a restricted equity interest, the LLC might award the participant a 5% nominal profits interest, but with the added right to receive 100% (or some other disproportionate percentage) of future LLC profits until the participant's capital account is equal to 5% of the total capital accounts on the award date, after which time the participant would be allocated 5% of LLC profits. In this manner, assuming the LLC generates sufficient future profits to "catch up" the participant's capital account to its nominal

[53] Under a profits interest plan, long-term capital gains (if any) allocated to profits interest holders reduce long-term capital gains of regular members, thereby producing a tax benefit to regular members at long-term capital gain rates. In contrast, under a equity appreciation rights plan, payments to rights holders produce an ordinary compensation deduction to regular members. Provided the regular members have sufficient ordinary taxable income to fully utilize the ordinary compensation deductions, their more favorable tax treatment under an equity appreciation rights plan could, if desired, be used to fund a more generous profit sharing percentage for the participants. In practice, this may be difficult to achieve precisely because of uncertainty regarding the portion of the company's future profits constituting long-term capital gain and uncertainty regarding the regular members' future ordinary income. There may also be tax "leakage" associated with employment taxes on equity appreciation rights payments.

[54] Potentially applicable surtaxes are the employment taxes imposed by I.R.C. §§ 3101 and 3111, the tax on self-employment income imposed by I.R.C. § 1401, and the net investment income tax imposed by I.R.C. § 1411. The surtaxes are mutually exclusive, so that the income or gains can be subject to only one such surtax.

percentage interest, the profits interest will produce the same pre-tax return as a restricted equity interest, but with tax due only as profits are earned.

B. Gain Sharing Interests

A gain sharing plan is designed to grant participants the opportunity to share in capital gains on a sale of the business without being subject to the complexities of being a partner during the operating phase of the business. This is accomplished by granting participants equity interests that share solely in profits from a sale of the business or other "capital transactions." Like a regular profits interest, a gain sharing interest is not taxed on the grant date or the vesting date because the equity interest has no current liquidating value (i.e., no capital interest) at the grant date. However, unlike a regular profits interest (which is allocated a share of all company profits starting immediately after the grant date), a gain sharing interest is only allocated profits associated with capital transactions. Accordingly, while participants will receive a Schedule K-1 and be treated as an equity owner in the business from the grant date forward,[55] the Schedule K-1 will not reflect any tax items until such time as there is a capital transaction. This significantly simplifies the participant's interim tax reporting and avoids the need for special tax distributions to participants and state tax filings. When there is a capital transaction, the participant should generally recognize capital gain with respect to his gain sharing interest to the extent the gain from the underlying transaction is capital gain.[56]

A gain sharing plan is easiest to implement when the operating income of the business is expected to be relatively modest or negative, and the financial success of the business is expected to be realized by selling or refinancing the business at a gain. For example, such a plan might be used for an LLC conducting oil and gas operations, where the objective is to do enough drilling to prove out the reserves, and then sell the business for reserve value rather than current operating income. Likewise, certain private equity businesses that are focused on turn around investments might use such a plan for a portfolio company.

If operating income may be a significant source of free cash flow that the LLC will periodically distribute to owners, a gain sharing interest that shares only in profits from capital transactions will not allow holders of the gain sharing interests to fully participate in profits from the business. In such cases, it might be desirable to allow participants in the gain sharing plan to share in ordinary distributions through a bonus plan for the participants. The bonus plan would grant to participants a right to receive bonuses (taxed as ordinary compensation income) tied to distributions paid to (or profits earned by) the owners of the LLC's regular equity.

Another way to deal with operating cash flow distributions is to distribute to gain sharing interest holders additional gain sharing interests in lieu of cash distributions. The additional gain sharing interests would be payable only to the extent of income or gain recognized in a capital

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[55] See text and authorities at footnote 30. Even though the holders of gain sharing interests would not have a current interest in the LLC's realized profits, it is likely that they would be treated as partners for tax purposes on account of their interest in profits from capital transactions. *Cf.* C.C.A. 201326018 (June 10, 2013) (partner that holds only an interest in future profits or capital appreciation is a partner that can serve as a tax matters partner as defined in I.R.C. § 6231(a)(7). *See generally* Richard Lipton, *General Partners Who Only Share in Capital Appreciation*, 119 J. Tax'n 102 (Aug. 2013).

[56] So-called "i-Units" issued by some publicly traded partnerships appear to have a similar deferred income allocation arrangement (with the apparent objective of avoiding recognition of unrelated business income by tax exempt investors). *See* Kinder Morgan Management, LLC, *Prospectus Supplement* (Aug. 7, 2012) p. 23, http://www.sec.gov/Archives/edgar/data/888228/000104746912008058/a2210603z424b2.htm.

transaction, and therefore should not be taxable upon issuance and should not attract any distributive share of operating income or gains.[57]

A gain sharing arrangement can be combined with a "catch up" allocation of net gains from capital transactions so that, assuming there are sufficient net gains, the gain sharing interest holder's returns are equivalent to the returns to regular equity interest holders. The participant is effectively given a 100% share of such net gains until the participant's capital account is equal to his or her nominal (proportionate) share of members' equity. If desired, members' equity could be calculated taking into account all operating cash flow distributions to regular equity interests (as described in the preceding paragraph). A catch up allocation approach will achieve the objective of harmonizing returns to regular equity holders and gain sharing holders only if sale gains are sufficient to achieve the intended relative capital account balances.[58]

V. Holding Company

The restrictions on issuing an equity owner a Form W-2 for regular compensation income[59] can be avoided using a holding company to hold equity interests on behalf of participants. In addition to simplifying the tax reporting with respect to the participants' regular compensation payments, a holding company arrangement may have collateral non-tax business benefits[60] and may increase available tax benefits under I.R.C. § 199A (temporary 20% deduction for qualified business income).[61] An arrangement using a holding company to hold profits interests is shown in Illustration 1. Note that this arrangement can also be used with gain sharing interests or other types of real equity interests issued by the operating company. A holding company arrangement is not needed if the participants are properly regarded as employees of a separate management company (other than a management company that is a disregarded subsidiary of the operating company that issues equity interests to the participants).[62]

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[57] See footnote 56 regarding i-units issued by some publicly traded partnerships.

[58] *Id.*

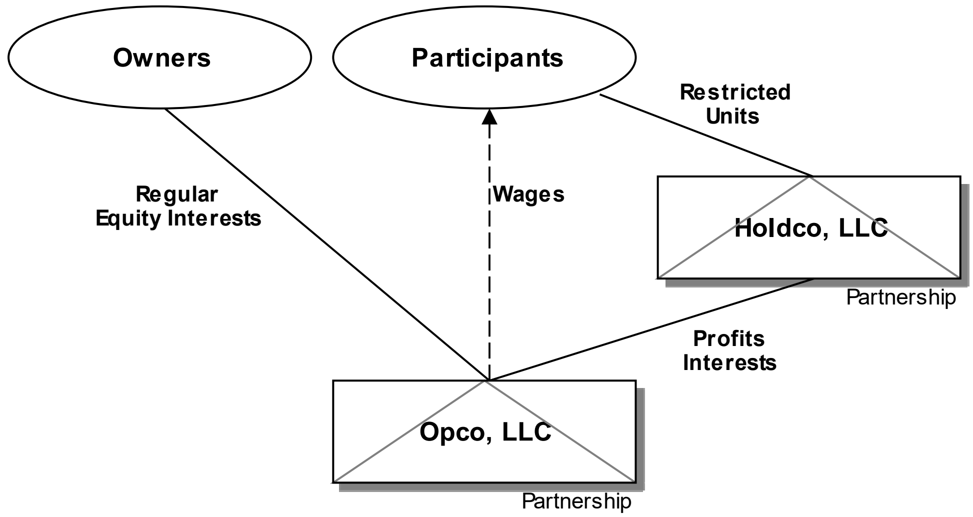
[59] See text and authorities at footnote 30.

[60] Some practitioners routinely use a holding company to hold real equity interests that would otherwise be issued directly to service providers, not as a means of avoiding the IRS restrictions on treating partner compensation as wages, but as a means of insulating the operating company from claims of service providers based on their status as members in the operating company. Accordingly, while it should not be necessary to have a non-tax business purpose for issuing gain sharing interests or other real equity interests to a holding company (*cf. Keller v. Commissioner*, 77 T.C. 1014 (1981) (professional services corporation formed for the primary purpose of reducing federal income taxes)), there may be a material non-tax benefit in doing so.

[61] What would otherwise be guaranteed payments that are not counted as W-2 wages for purposes of the limitations under I.R.C. § 199A(b)(2) are converted to employee compensation that generally should be classified as W-2 wages for such purposes.

[62] See Treas. Reg. § 301-7701-2T(c)(2)(iv)(C)(2) and T.D. 9766 (May 3, 2016) (compensation paid by disregarded subsidiary of a partnership to an employee who is a partner in the partnership is treated as a guaranteed payment or distributive share income and is not treated as wages).

Illustration 1 – Holding Company Arrangement for Profits Interests



VI. Conclusion and Summary

A client operating a business as an LLC taxed as a partnership will often try to design an equity incentive compensation plan to mimic what publicly traded corporations provide for their key executives. However, because of the tax differences between a private LLC/partnership and a publicly traded corporation, an LLC involves special considerations. In many cases, it is possible to achieve results for an LLC that are superior to those available in a corporate context.

Table 3 below summarizes the LLC equity compensation plans discussed in this article, and Table 4 summarizes the key tax differences between real equity and synthetic equity to the company and the participants.

Table 3 – Classification of LLC Equity Compensation Plans

	Real Equity	Synthetic Equity
Capital and Profits	Restricted Equity	Phantom Equity
Profits Only	Equity Options (Not Recommended) OR Profits Interest	Equity Appreciation Rights
Hybrid	"Catch Up" Allocation AND/OR Gain Sharing Interest[63]	Various[64]

[63] An interest in profits only from capital events.

Table 4 – Key Tax Distinctions Between Real and Synthetic LLC Equity

	Real Equity	Synthetic Equity
Participant	Capital gain possible post-inclusion	All ordinary income
	No surtaxes?	FICA applies
Company	Deflection of income and gains post-inclusion	Ordinary deduction

Synthetic equity plans generally offer the best *overall* mix of tax efficient and simple LLC equity incentive awards. While the payout to the participant (if any) is taxed entirely as ordinary compensation income, the tax event is deferred until payout (avoiding any mismatch of income inclusion and cash payments), and the company obtains an offsetting ordinary deduction for the full amount included in the participant's income at payout. Because of the tax advantage to the company, it can generally afford to be more generous with respect to the equity awards. And because all payments under a synthetic equity plan are generally processed through the company's regular payroll reporting systems, it is typically a very simple plan to administer.

Real equity plans offer participants the potential for capital gains and, in some cases, the potential for eliminating employment taxes (FICA), but these advantages come at the cost of greater complexity.[65] In addition, the tax benefit to participants from capital gains treatment is often muted by the fact that other equity owners obtain a reduction in capital gains, rather than an ordinary deduction, for capital gains accruing to the participants. If participants place a high emotional value on the opportunity for capital gains and can live with the associated complexity, a profits interest plan or a gain sharing plan should be considered.

Disclaimer

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[64] Any type of real equity plan can be replicated (on a pre-tax basis) using a contractual arrangement requiring a cash payout equal to the economic return of under the corresponding real equity plan. Phantom equity units and equity appreciation rights are merely two specific examples of such contractual arrangements.

[65] One business owner insisted that participants be issued "real" restricted equity so that they would fully appreciate and share the tax headaches he faced as an owner of the business.