Equity Interests in Limited Liability Corporations

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The usual advice to clients with limited liability corporations (LLCs) that want to share equity with employees is "switch to another corporate form." In fact, however, LLCs can share equity with employees, although very little has been written on this topic. This article looks at the two most common ways to share equity in an LLC: capital interests and profits interests. Both can provide favorable tax treatment for the employee, although there are still some remaining uncertainties about these rules. These arrangements can also be structured so that they are very similar to restricted stock or stock options in conventional corporations.

The limited liability corporation (LLC) is a relatively recent form of corporate organization, but one that has become increasingly popular. LLCs are similar to corporations in that they provide owners with liability protection but are taxed as partnerships. Because ownership in an LLC is evidenced by membership interests rather than stock, LLCs cannot have employee stock ownership plans (ESOPs), give out stock options, provide restricted stock, or otherwise give employees actual shares or rights to shares.

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But many LLCs want to reward employees with an equity stake in the company. The proper tax treatment of these equity interests to the recipient and the LLC is not always clear. For this reason, LLCs frequently face formidable challenges in providing employees with an equity interest in the company. This article explores the types of equity interests that an LLC can issue and how such interests are treated for tax purposes.

LLCs in Brief

Like S corporations and partnerships, profits from the operation of an LLC are attributed to the individual owners who pay income tax on them at personal tax rates. Unlike S corporations, however, LLCs, within certain limits, are not required to allocate distributions to members in proportion to their individual ownership interests, provided these "special allocations" have economic substance. IRS rules governing distributions from LLCs are fairly complex, and thus LLC operations generally require guidance from experienced advisors. Although the income taxation of equity interests that are issued by LLCs remains uncertain and complex, with good advice, these challenges should not in themselves be a sufficient reason for a business that is interested in issuing equity incentives to automatically switch to S corporation status.

LLCs have a number of advantages over S corporations besides flexibility in distributions:

- S corporations can have no more than 100 owners; there are no such requirements for LLCs.
- Only individuals, certain trusts, and estates can own S corporation stock, but any entity or individual can have an LLC partnership interest. S corporations can have only one class of stock; LLCs can have varying rights attached to membership interests.
- LLC members are allocated a tax basis for the debt of the company, meaning losses can be passed through for more than what is invested by a member. The member must actually be liable for the debt repayment, however, if the LLC defaults.
- LLCs can have multiple classes of ownership interests; S corporations can only have one kind of stock. Wholly owned

subsidiaries can have their assets, liabilities, and profits treated separately from the LLC.

- LLCs are often used to move assets around in tax-favored ways, such as gifting interests to heirs without providing any attached control rights or moving appreciated property into an LLC without tax consequences. In a corporation, once the assets are taken out, there is a taxable gain.
- LLCs can usually be readily converted to S or C status.
- Some states that have entity level taxes on S corporations do not on LLCs.
- LLCs do not have the same obligations as S or C corporations to keep board minutes, have shareholder resolutions, and otherwise follow rules for governance in S or C corporations.

LLCs also have disadvantages as well:

- If an LLC is purchased by another corporation, unlike with a C or S company, it is not possible to do a tax-free combination.
- Profits in an S corporation are usually not subject to employment taxes (FICA and FUTA); profits in an LLC generally are for certain employees (see below for details).
- LLCs are state law creatures of recent provenance, so there is not the kind of developed, relatively uniform corporate law guidance that exists for S or C corporations.
- Amounts attributable to inventory and accounts receivable are taxed as ordinary income on the sale of a company; in an S corporation, they are taxed as capital gains.
- Most venture capital firms, because of restrictions imposed by their trust funds, cannot invest in LLCs.
- Fringe benefits paid to members are not deductible.

Purchases or Gifts of Equity Interests in LLCs

The simplest approach is to have employees purchase an equity interest in the company or be granted an interest. The question here is whether this really is an equity incentive rather than simply an employee investment. Some companies see the opportunity to buy ownership as an incentive, but many, if not most, employees will either not have the resources to make the investment, will decide other investments are more prudent (especially given the added taxes involved), or will have expectations resulting from the investment, such as a say in how the company is managed, that the other partners may not want to cede.

Types of Equity Interests Available in LLCs

Where the company wants to award ownership interests to an employee, there are two primary types of equity interests available:

1. "Capital interests" give the owner a right to share in the value of LLC assets through the receipt of a share of the proceeds upon sale of the LLC assets.
2. "Profits interests" entitle the owner both to capital appreciation and profits of the business.

Either type of interest may be subject to restrictions, such as a vesting requirement that is satisfied by the employee's service for a specified period of time or by satisfaction of certain performance standards. Either type of interest may be forfeited if the employee engages in criminal activity that results in direct harm to the company, such as embezzlement. Many companies will also want employees to forfeit their interest if they go to work for competitors. While these anti-compete agreements can be written into grant agreements, they may be difficult to enforce.

The grant of either a capital or profits interest is a contractual matter. Companies need to have a written plan under which awards can be issued as well as individual agreements with employees detailing each party's rights and obligations. It is essential that these be developed by qualified counsel and that they define all terms and requirements unambiguously.

Tax Consequences of Granting a Capital Interest in an LLC

An employee who receives a capital interest in an LLC in exchange for services rendered recognizes compensation income in the year of the grant equal to the fair market value of the interest. The market value of this interest, for purposes of computing the employee's income and the LLC's deduction, may be determined in one of several ways: by reference to the value of the services rendered to the LLC's assets; by determining the value of the capital that was shifted from existing LLC members to the new grantee;[1] by determining the value according to what a willing buyer and willing seller would agree upon as a purchase price in an arm's-length sale (i.e., the willing buyer/willing seller test); or by determining the amount the employee would receive upon a liquidation of the LLC at the time the interest is issued (i.e., liquidation value). Regardless of the method used to determine fair market value, income and employment tax withholding will be required.

If the interest is subject to a substantial risk of forfeiture and is nontransferable, then the taxable event can be delayed until the restriction lapses unless the employee makes a Section 83(b) election. An 83(b) election must be made by the employee within 30 days of the grant's award. The election states that the employee agrees to be taxed immediately upon receipt of the capital interest at ordinary income rates, with any subsequent appreciation in the interest taxed at capital gain rates upon disposition. An employee who receives a restricted capital interest will not be treated as a partner for tax purposes until the restriction lapses, unless the Section 83(b) election is made.

If a Section 83(b) election is not made, then ordinary income tax is paid on the value of the award at the time it vests. Note that this is not the same as when the employee actually sells the capital interest, which may be later. Any difference between the price at vesting and the price at sale would be subject to long or short-term capital gains taxes, depending on how long the capital interest is held.

The LLC is entitled to a deduction for the value of the capital interest that the employee reported as income at vesting or upon making the Section 83(b) election. Despite the fact that the capital interest is being exchanged for the employee's services, there is

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1. An LLC will frequently "revalue" its assets immediately before the grant of a capital interest to a new member to prevent a "capital shift" of pre-grant appreciation of LLC assets in favor of the grantee. A shift in an LLC member's share of company liabilities would result in an increase in basis for the new owner's membership interest in the LLC.

a risk that the LLC may still be required to recognize gain for a "deemed sale" consisting of the sale of an interest in its assets for cash, payment of the cash to the employee who rendered services to the LLC, and a subsequent contribution of the cash by the employee back to the LLC in exchange for the capital interest. Any gain resulting from the deemed sale would be taxable to the other LLC members but offset in part by a deduction for compensation paid to the employee.

Tax Consequences of Granting a Profits Interest in an LLC

Under an IRS provided safe harbor, an employee's receipt of a profits interest in exchange for services is not taxable upon grant, even if the interest if fully vested, if each of the following three requirements are satisfied:[2]

1. The profits interest is received as, or in anticipation of becoming, a member;
2. The receipt of a profits interest is not related to a substantially certain and predictable stream of income; and
3. The interest is not sold within two years of receipt.

There is no current deduction allowed to the other members of the LLC where the new member is not taxed on issuance of the profits interest.

If the safe harbor requirements are not satisfied, there is some uncertainty as to the employee's income tax consequences arising from the grant of a profits interest to an employee.

Where the profits interest is not vested at the time of grant, the employee will not be considered as the owner of the interest until it is fully vested unless a Section 83(b) election is made or the employee is treated as having made such an election (see below). If the employee cannot be treated as the owner of the interest, then

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2. Regulations concerning profits interests are laid out in IRS Revenue Procedure 93-27 and Proposed Revenue Ruling 2005-43. The proposed ruling was never finally adopted, but, lacking any other guidance, is generally relied on.

the employee cannot be allocated profits or losses of the LLC until the interest vests. Once vested, however, the employee would be entitled to receive appreciation on the property for the period running between grant of the interest and its vesting unless there is an adjustment that allocates the built-in appreciation to existing members instead. It is worth noting that the receipt of an allocation of appreciation may convert the profits interest into a capital interest that is taxable at the time of vesting.

When the employee does redeem the profits interest, the gain is taxed as either short or long-term capital gain.

How an employee should deal with making a Section 83(b) election is not entirely resolved, particularly in light of the IRS safe harbor, which allows for receipt of a vested profits interest to escape tax. IRS guidance has indicated that a restricted profits interest would be treated as received on the grant date rather than the vesting date if the recipient is treated as owner of the interest (receiving a distributive share of LLC items attributable to the interest) and the LLC does not claim a tax deduction for the value of the interest in the year it was granted or in the year it vests. In other words, the profits interest is treated as if a Section 83(b) election were made. As a result of this further guidance, there may no longer be a need to file a Section 83(b) election to include in the current year's income the value of a restricted profit interest, although many advisors would urge that an election be made anyway to protect against some unforeseen circumstance making this treatment inapplicable.

In addition, profits interest holders must receive a K-1 statement attributing their respective share of ownership to them. That means they will have a tax responsibility for the current income or gains of the LLC even though vesting rules for the award of LLC distribution policies do not entitle them to any distributions with which to pay these taxes. In an S corporation, distributions must be made pro-rata to owners, but, as noted above, this is not true in an LLC, so the LLC is not obligated to make sure the profits interest holder receives a distribution sufficient to pay taxes. Profits interest holders, of course, will want these "tax distributions." If they are paid, then they would be treated as advances against any future distributions to which the profits interest holder would be entitled.

Employees with profits interests are taxed as partners rather than employees, so their income is reported on a K-1 and is not subject to withholding. Holders must pay estimated income taxes on all their income from the LLC and self-employment taxes on salary.

Options to Acquire a Capital Interest or Profits Interest

As stated previously, there are two types of equity interests available in LLCs. However, as an alternative to the grant of an outright interest, LLCs can issue options to acquire either a capital interest or a profits interest. The advantage in doing so is that the grant of an option in such case is not taxable to the employee or to the LLC.

The exercise of an option on a capital interest will result in taxable income for the employee and a deduction for the LLC. At exercise, the LLC would also need to address the "deemed sale" issue discussed previously.

The exercise of an option on a profits interest would not be taxable for the employee or LLC if the safe harbor rules are satisfied. At exercise, the appreciation in value issue discussed above would also need to be addressed.

Impact of Section 409A

Section 409A of the Internal Revenue Code requires deferred compensation plans to comply with various rules that are designed to place reasonable limits on the ability of employers and participating employees to defer compensation. The final regulations for Section 409A provide that profit interests in LLCs shall be treated the same as stock plans, indicating that their treatment would parallel that of stock appreciation rights.

Expert Advice Required

While it is always important to have expert advice on any equity plan, the complexity of the tax treatment that equity incentives in LLCs involve, as well as the more difficult planning issues, makes it even more important to engage people who know the field very well.