Equity Compensation Plans

and

Limited Liability Companies

by

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Introduction

Business enterprises may wish to reward and motivate employees by allowing them to participate in the growth of company value, perhaps created by their efforts. This helps align the interest of service providers and investors. Equity compensation may achieve these goals. These materials discuss the vehicles for equity compensation and their tax consequences. Issues of federal and state securities law are not addressed.

In designing and implementing an equity compensation plan, management must evaluate many factors, some of which will be unique to the particular enterprise, including constraints imposed by investors and lenders. Here are some basic concepts to consider:

Taxation. Both employer and employee should understand the income tax ramifications of the equity compensation plan. Equity compensation will often result in ordinary income to the employee as compensation for services. Such income is subject to state and federal income taxation to the employee, FICA (social security and medicare) taxation to both employer and employee and state and federal unemployment taxation to the employer. The timing of the income recognition to the employee may vary depending on the type of equity award. In some cases, the amount of ordinary income can be minimized and the employee may actually enjoy the favored rate available to long term capital gains. In a limited liability company or other entity whose owners are taxed on income without regard to whether it is distributed, consider whether the company will be able to distribute sufficient cash to allow owners to satisfy the income tax liability arising from income allocations.

Vesting. To reward and motivate future performance, many equity compensation plans defer vesting, meaning that interests will be forfeited if the employee quits or is terminated prior to the vesting event. With options, even if an award is vested, the employee must exercise the award and pay the strike price, within a limited time period. Vesting of an equity award may be over a specific time period subject to continued employment (time-based vesting) or may be based on achievement by the company or employee of certain performance targets (performance-based vesting). Vesting periods typically last two to five years and vesting may happen all at once (cliff vesting) or ratably over time (usually in annual proportional increments). Vesting is often accelerated on the occurrence of certain events such as on an initial public offering (IPO) or other exit transaction (a merger, sale or other similar transaction involving the company). With an option, even following vesting, the employee must exercise before the option lapses.

Alignment of Interests. Because an employee receiving equity compensation will gain more if the company's value increases (*i.e.,* the stock price increases, particularly in a public corporation) or, in the case of performance-vesting, if defined performance goals are achieved, the employee will (in theory) strive to achieve the desired results. Management should set clear goals so that the employee can determine how best to contribute to the enterprise.

Valuation. It is necessary to determine the value of the company in order to implement equity compensation plans. Most equity awards assign a baseline value at the time of award so that the employee receives the benefits of increased value, but not necessarily the value and capital existing on grant. In the case of publicly traded interests quoted prices can be used to determine value, including the strike price of an option. For a private company, valuation is more difficult. Entrepreneurs may overvalue the company, resulting in a higher exercise price or base value. This reduces the benefit an employee may achieve, frustrating the purpose of motivating the employee. Conversely, setting a value that is too low may mean that the initial investors lose some of the value to which they were entitled.

Exit Strategy. Owners and managers may aim for a public offering or an acquisition, to receive cash payments for selling all or a portion of their interest in the company. Equity compensation allows participation the exit transaction. It also provides incentive for the employee to remain with the company, even in situations where future employment is uncertain. On the other hand, granting equity interests dilutes the reward on exit. Management should consider the size of the pool, that is how many people should participate and what percentage each should get.

Traditional Corporate Equity Compensation

Historically, business enterprises have operated as Subchapter C corporations. This is especially true of public companies or companies that had a near term goal of going public or being acquired by a public company. However, over the last decade, limited liability companies have gained significantly in popularity as a structure to conduct business. Limited liability companies ("LLCs") provide a significant degree of flexibility in creating rights and responsibilities between members and managers, as well as in allocating and distributing items of income, while maintaining limited liability for owners and management and avoiding the double tax imposed on a Subchapter C corporation.[1]

Persons familiar with equity compensation plans in traditional corporations often wish to implement similar plans for a limited liability company. Since a limited liability company is treated for federal income tax purposes as a partnership, the rules are different. To avoid unexpected and unintended consequences, these rules should be understood.

Because LLC management often wants to have reward systems similar to those used in corporations, we start with a review of the types of corporate equity compensation.

Stock Options. Stock options remain the most popular form of equity compensation, although they are less favored now than during the Internet stock bubble of the 1990s. A stock option is an agreement by corporation that provides an employee the right to buy a specified number of shares of stock at a specified exercise price within a defined exercise period. The exercise price of an option is typically the fair market value of the stock at the time the option is granted (based on the value of the enterprise and other factors, including whether there are outstanding shares of preferred stock or significant debt that would affect what the holders of common stock would receive on liquidation). The employee does not have any interest in the

[1] A "Subchapter C" corporation is taxed on its income, and its shareholders are also taxed on dividends distributed. A "Subchapter S" corporation is (with exceptions) not taxed, but its shareholders are taxed on their share of corporate income, whether or not distributed. A business entity with more than one owner that is neither a "C" nor an "S" corporation is taxed as a partnership. Partnerships also pass through income, but under different rules from "S" corporations.

underlying shares until the option is exercised and does not have the right to vote, receive dividends or exercise any other right of stock ownership. To exercise an option, the employee must provide notice to the employer and pay the exercise price (although some options may permit 'cashless' exercises where the employee can use previously acquired shares of stock or the difference in the value between the stock and the exercise price to make payment, reducing the total number of shares issuable to the employee).

Stock options may be subject to vesting over time and are usually exercisable to the extent they become vested, although vesting may be accelerated by an exit event. Stock options are classified for income tax purposes as nonqualified stock options (NQSOs)[2] or incentive stock options (ISOs), both of which have different requirements and tax treatment.

NQSOs. Nonqualified stock options may be granted to anyone providing services to the company, including independent contractors and directors. NQSOs do not have the limitations and requirements of ISOs but do not qualify for the benefits either.

NQSOs can be granted with an exercise price that is less than fair market value on the grant date, but since such a grant results in non-qualified deferred compensation subject to Section 409A of the Internal Revenue Code. Further, granting an option "in the money" could result in compensation expense and other accounting charges under GAAP.

NQSOs are taxed as compensation income on either grant or exercise, but not both. NQSOs that have a readily ascertainable fair market value at grant are subject to tax on grant.[3] Otherwise, ordinary income is recognized on exercise on the excess of the value of the interest in the company received over the exercise price. The company is entitled to deduct such excess in the year the option holder recognizes income.

Most optionees exercise only when there is the potential to sell the acquired shares or when the stock is about to expire. Shares acquired by exercise may decline in value. Then the optionee may have large tax liability based on exercise and no means to pay**.**

ISOs. To be treated as an incentive stock option, a stock option award must meet requirements of Section 422 of the Internal Revenue Code.

- Shareholders must approve a plan providing the number of shares available who may participate, how the plan is to be administered and how awards to be made. The written document may cover only ISOs or may authorize the grant of a variety of equity based incentives.

- ISOs may be granted only to employees.

- An option holder must be an employee at exercise or must have been an employee within three months of exercise.

- ISOs are non-transferrable, except in accordance with the laws of descent and distribution on the death of the optionholder.

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[2] NQSOs are also referred to as "nonstatutory stock options" or "NSOs."

[3] Since the *option* must be actively traded on an established market to have readily ascertainable value for this purpose, taxation of NQSOs on grant is rare.

- The exercise period of an ISO must not exceed ten years (five years if the employee holds more than 10% of the outstanding shares).

- ISOs must have an exercise price equal to or greater than the stock's fair market value on the grant date (110% if the employee holds more than 10% of the outstanding shares).

- An ISO may be treated as an NQSO if any ISOs in excess of $100,000 become exercisable by an individual for the first time during a calendar year.

For tax purposes, ISOs are not taxed on grant or exercise. ISOs are not subject to ordinary income taxes, provided the shares acquired on exercise are held for at least one year from the date of exercise of the ISO and two years from the grant date (if that would be a later date). If the holding periods are satisfied, the employee is taxed at long term capital gains rate on disposition of the shares for the amount of income resulting from the difference between the sales price and the exercise price. The company is generally not entitled to a tax deduction for an ISO.

Since an option is seldom exercised unless the optionee intends to sell the shares (except where the optionee wants to exercise an about to expire option or is contemplating termination of employment) the holding periods will not always be met.

If the shares are sold prematurely (a "disqualifying disposition), the holder must recognize ordinary income on the excess of the fair market value of the shares on the exercise date over the exercise price (the "bargain element"). The income is included in the year of disposition. Any additional gain between the date of exercise and the date of sale is taxed at long term capital gain rates, so long as the one year period for long term capital gains is satisfied. The company is entitled to take a tax deduction in the same amount as the ordinary income the optionholder recognizes and in the same year that the optionholder recognizes ordinary income.

It is important to note an optionholder may have to pay alternative minimum tax ("AMT") at exercise on the bargain element of the ISOs. At the end of the Internet stock bubble, this resulted in AMT liabilities to shareholders of depressed stock. The capital losses that could be realized in this situation would not offset AMT.

Options that fail to be ISOs (except for the rule on disqualifying dispositions) are taxed as NQSOs.

Restricted Stock. Restricted stock is a grant of actual shares of stock to an employee, subject to time-based or performance-based vesting. On the grant date, the employee becomes the owner of the shares and is entitled to vote, receive dividends and exercise other stockholder rights although the shares are non-transferrable and subject to forfeiture until the vesting conditions are met.

Vesting has additional importance when considering the issuances of restricted stock by a corporation. Since stock is treated as property under the Internal Revenue Code, grants of unrestricted (vested) stock will be taxable to the recipient on grant as ordinary income at the time of grant. However, the grant of shares of restricted stock with vesting requirements has different results. A recipient is not taxed at the time of grant unless he or she makes an affirmative election to be taxed under Section 83(b) of the Internal Revenue Code. The election results in deemed vesting. The shares interests will (it is hoped) have a lower value than when the risk of forfeiture lapses. However the employee bears the risk that the shares will be forfeited even though the taxes have already been paid on grant. No deduction is then allowed. If a recipient does not elect

to be taxed at grant under Section 83(b), the holder will be taxed when the shares vest and the risk of forfeiture lapses.

The recipient must make the 83(b) election within thirty days of the stock grant. Otherwise shares will be taxable when the vesting occurs and the forfeiture lapses with the value determined as that later time.

Restricted stock has the advantage that the employee is not required to pay for shares. Employees may prefer restricted stock if the stock has limited value at the time of grant and the employee makes an election to be taxed at such time.

Restricted Stock Units. RSUs are a promise to transfer shares in the future if vesting conditions are met. After vesting, RSUs are usually settled in stock but may also be settled by payments of cash. RSUs do not represent actual ownership interests in the underlying shares and the holder is therefore not entitled to rights of ownership. RSUs are not subject to taxation until the underlying shares are delivered.

Stock Appreciation Rights (SARs). SARs are rights allowing a holder to receive cash or stock equal to the appreciation of the value of the shares between the grant date and the date the SAR is exercised. SARs are customarily subject to vesting. When exercised, SARs are customarily settled in cash, but may also be settled in stock. SARs are generally taxable when exercised, provided that the exercise price is not less than the fair market value of the underlying stock on the grant date and the SAR does not include any additional deferral features. SARs that do not meet these conditions are subject to rules on deferred compensation under Section 409A.

Phantom Stock. Phantom stock is not an interest in the entity, but an account for the benefit of the recipient credited with "phantom" shares. The account's value changes based on the appreciation or depreciation of the underlying shares, as well as crediting of phantom dividends. Awards of phantom stock are generally subject to vesting and, on vesting, the full value of the phantom stock account is paid to the employee in cash or stock. Unlike SARs, phantom stock entitles the employee to the full value at the time of vesting, rather than only the appreciation in value. Phantom stock is taxable on vesting, or if payment is deferred, on actual payment. Deferrals may be subject to Section 409A.

Employee Stock Purchase Plan (ESPP). An ESPP is typically used in a public company and is a stock option plan that allows an employee to buy the employer's stock at up to a 15% discount. Like ISOs, ESPPs receive tax-favorable treatment and, like ISOs there are a number of restrictions and requirements in structuring an ESPP. An ESPP typically allows an employee to elect to make payroll contributions during a certain period that are used to exercise a certain number of options at the end of the period.

<u>Limited Liability Companies and Profits Interests</u>

LLCs Generally

While a corporation is mainly a creature of law, with obligations and duties imposed on its directors, officers and shareholders by detailed statutes and a widely developed body of case law, an LLC is a creature of contract. Owners of an LLC (usually called members) enter into an LLC agreement or operating agreement (referred to herein as an "operating agreement") that sets forth the rights, privileges and obligations of the members with respect to the LLC and their ownership in the LLC. An LLC may be managed by its members or the members may delegate

such authority to managers, who may also be, but are usually not required to be, members. The duties and responsibilities of a manager in an LLC may be broad or may be narrowly tailored within the scope permitted by the applicable limited liability company statute, which allow for far greater flexibility and customization than counterpart corporate statutes.

S. Corporation v. Partnership Status

An LLC is, unless the members elect otherwise, treated as a partnership for US federal income tax purposes. This allows the LLC to avoid double taxation. Alternately, members may elect Subchapter S corporation status. This provides for pass through of income and loss, avoiding double taxation, as well as certain additional benefits with regard to self employment taxes. However an S corporation may have no more than 100 shareholders, none of whom may be partnerships multi-member LLCs, corporations or non-resident aliens. An S corporation can have only one class of membership interest (stock) (eliminating the possibility of preferential returns or special allocations. Corporate borrowing does not increase member basis (a disadvantage to investors). Interestingly an LLC treated as a Subchapter S corporation can issue ISOs while a partnership cannot.

LLCs Cannot Grant ISOs

An LLC that is treated as a partnership for taxes does not meet requirements for certain statutory benefits available only to corporations. In the context of equity compensation, the most relevant difference between LLCs/partnerships and corporations is that these entities may not issue ISOs which are, as discussed above, the favored corporate equity compensation tool. Although an LLC taxed as a partnership cannot issue ISOs, it can issue profits interests, which may achieve certain desired results. Although a profits interest may appear at first blush to be more like a share of restricted stock since the recipient acquires the benefits of ownership on grant, it is actually significantly different because the recipient only receives a share of future profits/appreciation and does not acquire an interest in any existing capital or value of the LLC at the date of grant.

Capital Interests and Profits Interests

Partnerships and LLCs treated as partnerships for taxes can generally issue two types of interests: (i) capital interests and (ii) profits interests. Within these two broad categories, specific rights and privileges may be tailored to achieve different desired economic benefits and effects. For example, interests issued to significant investors may include liquidation preferences that entitle the holders to receive preferential distributions, or even a multiple of the capital actually invested. An interest may confer voting rights or no voting rights at all.

A capital interest includes the right to a share of proceeds from liquidation. A capital interest is usually issued to an investor in exchange for a contribution of cash or other property and the holder has a capital account with an initial value equal to the value of the property or money contributed. This capital account is then adjusted based on allocations of profits and losses, as well as distributions made to the holder.

A profits interest, on the other hand, gives the holder the right to receive a percentage of future profits (but not existing capital) of the LLC. Most commonly, a profits interest is granted in exchange for a contribution of future services. In such case, the recipient does not contribute any capital and therefore has no capital at risk—further, the recipient usually does not have any obligation to contribute any capital in the future. When the recipient does not contribute any

capital, the interest is often referred to as a 'carried interest' because the equity owners who in fact contribute capital are 'carrying' the non-contributing equity owners with their contributions.

Profits Interests Represent Ownership

As noted above, a profits interest is an actual ownership interest in the LLC. As such, it includes all the rights and obligations that apply to ownership interests in the LLC under applicable state law and as set forth in the LLC's operating agreement. Under most state laws, these rights include rights of inspection of the LLC's books and records, including the LLC's member and manager information, articles of organization and amendments, tax returns, financial statements, operating agreement and amendments, minutes, information regarding the contributions of equity owners, and similar information.

An owner of a profits interest who is also treated as an employee runs the risk that the profits interest will be treated as employment compensation. Regardless, the owner of a bona fide capital or profits interest in a partnership is a partner. Planners generally recommend that an employee granted either a capital or profits interest in an LLC, be treated as a new equity owner in and a former employee of the entity. This could result in adverse tax consequences for the employee because payments that formerly constituted salary payments to the equity owner may now be treated as self-employment income, meaning that the entity does not withhold taxes and the individual must pay the applicable self-employment taxes. Additionally, an individual who receives an interest in an LLC may not meet applicable qualification for employee-only benefits such as tax-free cafeteria plans and flexible spending accounts. Further, because certain fringe benefits that are excluded from employee compensation may not be excluded from the income of self-employed persons the individual may have self-employment income for such benefits.

In 1997, the IRS had adopted proposed regulations that would have clarified that an LLC member could be treated as a limited partner (and not subject to self-employment taxes) if the member was not liable for obligations of the LLC, had limited authority to manage the LLC and provided less than 500 hours of service to the LLC in a year—however, these regulations were never adopted and the current IRS guidance is that an equity owner in an LLC cannot simultaneously be an employee.

Service providers granted an interest in the employer are often incorrectly treated as soley employees.

Allocations of Income and Loss

Since an LLC that is taxed as a partnership is a "pass-through" entity for US federal income tax purposes, the LLC itself does not pay an entity level tax. Instead, its profits and losses are computed and allocated and passed through to its equity owners who include their respective share of those items on their income tax returns (whether or not distributed). Therefore a recipient of a profits interest will be allocated items of income and loss from the entity and the tax characteristics of the item allocated maintains such character—for example a capital gains income item to the corporation maintains its status for capital gains treatment when allocated to the equity owners.

In its early stages, the LLC may wish to retain money in the entity for development of its business and therefore may not pay distributions. Therefore, allocation of the LLC's income may not be advantageous or desired to an equity owner because he or she may not have sufficient funds to pay the applicable taxes on the allocated income. This means that the service provider

could have an income tax liability and be required to pay it from other sources of income. The LLC's obligation as to whether it is required to make distributions, including distributions to its equity owners to cover their respective taxes, is usually described in the LLC's operating agreement. It is important to note that even if the LLC is required to make distributions to its members, it may not be able to lawfully do so under state law if making the distributions would impair the solvency of the entity.

In addition to the 'phantom income' problem resulting from allocations of income, some recipients may not want to be treated as an equity owner because of state income tax consequences. Absent accommodation from the states, each equity owner must file a state income tax return with each state that has an income tax in which the LLC does business. Some states, such as Utah, impose a flat withholding obligation on the entity and excuse the individual equity owner from filing if he/she has no other connections with the state.

It is important that an LLC maintain a member's capital account. As a member in an LLC is allocated gain or loss, the member's basis in his or her shares is adjusted. This is reflected by a capital account. Allocations of income must have substantial economic effect. In general, a tax allocation to partner will have economic effect to extent that partner realizes the economic benefit or bears the economic burden of the allocation

Tax Consequences of Grant

Generally, for federal income tax purposes, under Rev. Procs. 93-27 and 2001-43, the issuance of a profits interest in exchange for the contribution of services to an LLC is tax-free to the recipient and to the LLC both at the time of grant and at the time of vesting. These revenue procedures provide guidance on what constitutes a profits interest and the associated tax interests. To qualify for this tax favorable treatment to the recipient, the grant transaction must satisfy the following requirements:

- The profits interest must be granted to a person (not an entity) for the provision of services to the LLC, not other property or capital.

- The recipient must receive only a profits interest and no share of current capital so that if the LLC were completely liquidated at the time of grant, the individual would not receive any distribution.

- The profits interest cannot relate to a "substantially certain and predictable stream of income" such as from treasury bonds or a secure net lease.

- The recipient must generally hold the interest for two years (with some exceptions for transactions at the entity level not contemplated at the time of grant such as a conversion to a corporation or exit event).

- Profits interests are not available in any entity that is treated as a corporation or a "publicly traded partnership."

Book Ups of Capital Accounts

As mentioned, one characteristic of a profits interest is that the recipient of the interest would not receive anything if, on the date of grant, the LLC liquidated and distributed proceeds from the sale of all its assets. This is because the recipient has no interest in the capital of the

entity. This is reflected in the fact that the capital account of the recipient is not credited with any value at the grant. However, if the LLC has more value than is included in the then current members' capital accounts and if liquidation of the LLC is based on capital accounts, then those members need to 'book up' their capital accounts to the then value of the enterprise. By way of example, if two members had capital accounts of $50,000 and wanted to provide a profits interest to a new equity owner they could do so, but to ensure that the new equity owner would not have any interest in the capital of the entity, then the capital accounts of the existing members would need to be increased to reflect the then value of the LLC. If the LLC at the time of grant of the profits interest had a value of $1,000,000, then each member's capital account would need to be increased by $450,000 to $500,000 dollars. This prevents shifting caused by new equity owners being admitted to the LLC.

Treating a Profits Interest Holder as a Partner

It is generally advisable to treat the recipient of a profits interest as an equity owner in the LLC at the time of grant in order to achieve favorable tax consequences. If the interest is structure too much like a bonus, or the recipient takes the position that he/she is not an equity owner, then the interest may be recharacterized by the IRS.

Vesting

It is common for a profits interest to either have vesting requirements and be subject to forfeiture, or to increase over time to a larger percentage, in accordance with a vesting schedule through time-based or performance-based vesting. Because the grant of profits interests subject to vesting is traditionally considered to be a transfer of restricted property under the Internal Revenue Code, recipients typically make an election under Section 83(b) of the Internal Revenue Code for the grant of interests to be taxed at the time of grant. However, it is unclear whether this is actually required or expected under the Internal Revenue Code. Rev. Proc. 93-27 provides that profits interests are not property for purposes of Section 83 of the Internal Revenue Cod. However, the May 24, 2005 Proposed Regulations REG-105346-03 and Notice 2005-43 proposed a different system, so that both profits and capital interests would be treated as property subject to Section 83. The precatory comments to the proposed regulations make it clear that the IRS is reversing its prior position on this point, but the proposed regulations have not actually been formally adopted. It is uncertain then whether the IRS actually intends profits interests to be treated as property. In light of this uncertainty, the general practice is for recipients to make the Section 83 election since there is no downside in making the election and because the profits interest has limited value at the time of grant (since there is no right to capital of the entity).

If profits interests are forfeited because vesting requirements are not met, there are negative effects to the LLC and to the other equity owners. Items of expense are pushed to the service provider's account to reduce it to zero. This takes items of loss and deduction from the other equity owners and causes them to be allocated more income than they would have otherwise received. This is intended to have the effect of reversing any allocations previously made to the service provider to put the other equity owners in the same position they would have been if the service provider had never been issued the profits interest.

In determining a vesting schedule, particular care must be given to the desired results. For example, if it is intended that a service partner receive a 10% profits interest from the date of grant, but the interest vests 2% over five years, for example, then each year there will need to be a catch up to allocate profits from future years for amounts that would have been allocated in prior years if the interests had been vested.

Disposition of a Profits Interest

Upon the disposition of a profits interest, the holder will generally realize capital gain (taxable at long-term rates if the applicable holding periods are met). To qualify for this treatment, the interest must have been held for at least two years, although there are exceptions to this rule that may apply if the disposition is the result of a change of corporate circumstance (conversion to corporation, merger, etc.)

Comparing ISOs and Profits Interests

The following table illustrates the similarities and differences between ISOs and profits interests:

Event	**ISOs (in compliance with Section 422)**	**Profits Interests (assumes well drafted provisions)**
Grant	No tax on grant	No tax on grant because the profits interest does not entitle the holder to any capital of the LLC on grant
Exercise	The exercise price per share of an ISO must be at least the fair market value per share of the underlying stock on the date of grant (110% if the holder owns more than 10% of the outstanding stock of the corporation). The optionee must make an affirmative election to exercise the option and pay the exercise price while an employee (or within 90 days of employment) within the option exercise period. A cashless exercise is sometimes available, but unless the value of the stock has grown substantially since grant, this will require cancellation of a large number of shares in order to put the optionee in the desired economic position (no actual outlay of cash to pay for taxes on shares cancelled in connection with the exercise). This means that the ultimate benefit to the holder will be minimized.	There is no exercise or payment required by the holder to receive the profits interest.
Disposition	On sale of the shares received on exercise, the holder will have capital gains on the difference between the sales price and the exercise price, if the shares are held for the requisite holding period (2 years from the date of grant and 1 year from the date of exercise). As a practical matter, ISOs are usually exercised only when the optionee has a desire to sell the underlying shares, so this often becomes irrelevant.	On sale of the profits interest, generally the holder will have capital gains on the difference between the sales price and the holder's basis if the interest has been held long enough to satisfy the one year requirement for capital gains and the disposition either satisfies the two year safe harbor for profits interests or an exemption is available. However the gain arising from unrealized receivables or inventory of the entity will produce ordinary income.
Distributions	No dividends will be paid or payable until the ISO is exercised. Any dividends received by the holder after exercise will be taxable. Currently the maximum federal dividend rate is 15% but beginning in 2012 dividends are scheduled to be taxed as ordinary income.	There is no tax on distributions to the holder, if the holder has sufficient basis. This will be the case when the LLC has been profitable and has allocated income to the holder.

Allocations of income and losses	No allocations.	Income and losses will be allocated to the holder of the profits interest. The character of this profits and losses (i.e., capital gains) will be passed through as well.
Forfeiture	If an ISO is forfeited or expires, there is no consequence to either the optionee or the company.	If a profits interest is subject to forfeiture and is forfeited, there will be consequences to the holder and to the other equity owners of the LLC. If the holder has previously been allocated income, then expenses and losses will be allocated to the holder on forfeiture to reduce the holder's account to zero.

LLC Equity Compensation Alternatives

Although profits interests achieve a number of desirable results for both the issuer and the recipient, there are other equity compensation alternatives to consider as well.

Capital Interests. An LLC may simply issue a capital interest to a service provider if management wants to provide the holder to share in the capital of the LLC and the liquidation proceeds if the LLC were liquidated. The tax consequences of a grant of a capital interest are similar to the tax consequences related to the grants of shares of stock in a corporation. The recipient will recognize income equal to the fair market value of the interest (less any amounts paid for the interest by the recipient) at grant if the capital interests are not subject to forfeiture or, if they are subject to forfeiture, if the recipient makes a Section 83(b) election. If the capital interests are subject to vesting and no election is made, the service provider will recognize income at the time of vesting based on the value at that time. The LLC gets a deduction equal to the amount included in the service provider's income. The basis to the recipient will be the amount of income recognized plus anything paid by the individual to acquire the interest.

Options. An LLC may issue options to acquire capital interests or profits interests. In the case of a capital interest, upon exercise, the service provider and the LLC will have the same tax treatment as occurs on the grant of a capital interest (the individual has ordinary income to the extent of the value of the capital interest, less any amounts paid, and the LLC will be able to take a corresponding deduction). In the case of a profits interest, there is no income to the service provider at the time of exercise—therefore, there is no deduction for the LLC. The obvious downside to the option approach is that the recipient does not have any income allocations or distributions until exercise. Further, there may be deferred compensation implications under Section 409A of the Internal Revenue Code if the exercise price of the option was not equal to the fair market value of the interest at the grant of the option.

Phantom Interests. These interests are similar to phantom stock. Like phantom stock, the recipient recognized ordinary income at the time of payment, and the LLC gets a corresponding deduction equal to the amount paid. Payments in connection with phantom interests may be subject to scrutiny under Section 409A if exceptions are not met.

The Future of LLCs

LLCs are increasingly popular partly due to the flexibility permitted by LLC statutes in structuring the relationship between members, including providing for special allocations and distributions. However, the main perceived advantage of the LLC remains the avoidance of the double tax generally applicable to Subchapter C corporations. If proposed decreases in the corporate tax rates occur LLCs could lose their luster.

If you assume that the applicable corporate tax rate for a corporation is 35%, then the corporation would pay $35,000 on $100,000 in income, leaving $65,000 for distributions to shareholders. If the shareholders pay 15% of dividends, then that means they will pay $9,000 on a $65,000 dividend, leaving a net of $56,000 for the shareholders. In the LLC context, if the pass-through entity received $100,000 in income it would not pay any taxes and could distribute the full $100,000 to its members. The members, if they pay a 35% rate, would then pay $35,000 in taxes, leaving a net of $65,000.

If the corporate rate were 25% (as currently proposed in Congress), the foregoing example would change. On $100,000 in income, the corporation would pay $25,000 in taxes, leaving $75,000 available for distribution. If the shareholders pay 15% on such amount, or $11,250 in taxes, the net of $63,750 would be left to the shareholders. This represents a difference of only $1,250 between the corporation and the limited liability company scenario. This may be a small price to pay in light of the deferral of a 10% tax on income, the exemption of dividends from individual AMT, the ability of corporations to avoid at-risk and passive investment limitations, the ability to defer tax on foreign source income using subsidiaries and other corporate attributes. However this is not a one way street. Corporations do not enjoy a favored rate on capital gains and their charitable deduction is more limited than that for individuals.

Conclusion

Although uncertainty continues concerning tax consequences, businesses that want the flexibility of an LLC may use equity compensation. Because this may have the effect of making the service provider a partner instead of an employee, it is important that both the company and the individual carefully consider the goals and tax requirements before adopting any course of action. With careful planning, the negative affects may be minimized while the parties achieve their goals.