Incentive Compensation Arrangements:
Attract, Motivate and Retain Key Employees

LLC Equity Incentive Compensation

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Agenda

• Advantages of LLCs
• Taxation of LLCs
• Types of LLC equity incentive compensation
• Capital interests
• Profits interests
• Tax consequences of being an LLC member
• Operating agreement provisions
• LLC equity options
• Phantom equity / equity appreciation rights
Advantages of LLCs

- Partnership is the default classification for federal income tax purposes if more than one LLC member
- No limitation on number of owners
- Any individual (e.g., non-U.S. resident) or entity may own as LLC interest
- LLC member is allocated share of LLC debt allowing loses in excess of investment
- Multiple classes of membership interests are permissible
- Assets can generally be distributed on a nontaxable basis
- LLCs can usually convert to “S” or “C” corporation status without significant tax cost
- LLCs can grant profits interests to key employees
Taxation of LLCs

- Disregarded as an entity separate from its owner if only one LLC member
- LLC with more than one member is taxed as a partnership
- LLC may elect to be taxed as a “C” or “S” corporation
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Types of LLC Equity Incentive Compensation

- Capital interests
- Profits interests
- LLC equity options
- Phantom equity
- Equity appreciation rights
Capital Interests

- A capital interest is an interest that gives the employee, in addition to a share of future profits and equity appreciation in the LLC, a share of the existing value of the LLC.
- The employee would receive a distribution with respect to the LLC’s assets if the LLC were to be liquidated on the date of grant.
- A capital interest represents an ownership interest in the LLC.
- May be voting or nonvoting.
Capital Interests (Tax Consequences)

- Employee recognizes compensation income upon receipt (or vesting) of a capital interest in exchange for services performed or to be performed for the LLC.

- Income is measured by the FMV of the capital interest less any amount paid for the interest by the employee.

- If capital interest is fully vested, employee recognizes compensation income on the date of grant (unless the interest is subject to a substantial risk of forfeiture):
  - Employee otherwise recognizes compensation income upon vesting (or, if later, lapse of substantial risk of forfeiture).
  - Section 83(b) election.
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Capital Interests (Tax Consequences)

- Compensation income to employee is subject to income and employment taxes
- LLC has withholding obligation
- LLC entitled to compensation deduction equal to amount taxed as compensation income to employee
- Employee generally recognizes capital gain on sale of the capital interest to the extent of the appreciation in value over and above amount reported as compensation income
Profits Interests

- A profits interest is an interest that gives an employee a share of future profits and equity appreciation in the LLC (but not a share of existing value of the LLC)
- Employee would not be entitled to any distribution if the LLC were to be liquidated on the date of grant
- A profits interest represents an ownership interest in the LLC
- Grant of a profits interest requires valuation of the LLC on the date of grant to determine the capital accounts of existing members
Profits Interests (Tax Consequences)

- Grant of profits interest is nontaxable to employee if:
  - The profits interest is not related to a substantially certain and predictable stream of LLC income
  - Profits interest is not sold within two years of receipt
  - Profits interest is not a limited partnership interest in a publicly traded partnership

- Profits interest subject to vesting will not be taxable to employee if:
  - The above requirements are satisfied
  - LLC and employee treat employee as tax owner of interest with employee reporting its distributive share of LLC net income and net losses
  - Neither LLC nor any member claims deduction for profits interest either at grant or vesting of interest
Profits Interests (Tax Consequences)

- Employee not subject to income or employment taxes
- LLC not entitled to compensation deduction
- Employee generally recognizes capital gain on sale of the profits interest to the extent of the appreciation in value over and above amount reported as compensation income
Tax Consequences of Being an LLC Member

- Salary to employee classified as “guaranteed payment”
- Not subject to wage withholding
- Reported on schedule K-1
- Employee required to pay quarterly estimated taxes on income from LLC
- Self-employment taxes on salary and distributive share of LLC income
Operating Agreement Provisions

Class of Membership Interests / Units

- Profits interests usually created as new class of membership interest / units
- Capital interest may be a different class of membership interest / units than those issued to founding members and investors
- Profits interest may be voting, limited voting or non-voting
  - Election of managers
  - Extraordinary actions such as merger, sale of assets, etc.
Operating Agreement Provisions

Vesting of Membership Interests / Units

- Vesting of membership interests or units can be structured in any number of way
  - Immediately
  - Years of services
  - Targets/achievements
  - Occurrence of certain events
 Operating Agreement Provisions

**LLC Management**

- LLC may be managed by:
  - Its members (i.e., “member” managed)
  - Manager(s) (i.e., “manager” managed)

- Preferable to make the LLC manager managed in most cases
  - Manager(s) need not be member(s)
Operating Agreement Provisions

Capital Calls

- Employee may or may not be required to participate in capital calls
  - Employee not required to participate
  - Employee required to participate
  - Employee required to participate subject to cap

- Failure to participate may or may not have dilutive effect on employee’s interest
  - Capital interest
  - Profits interest
Operating Agreement Provisions

Distributions

• Employee’s share of ordinary distributions are usually based on percentage interest represented by capital or profits interest

• Timing of ordinary distributions
  – may be fixed
  – may be subject to discretion of manager (or managing members)
Operating Agreement Provisions

Tax Distributions

- Tax distributions are distributions to allow members to pay taxes on distributive share of LLC net income

- Tax distributions may be:
  - Mandatory
  - Elective

- If elective, employee could have phantom income
Operating Agreement Provisions

Capital Accounts

- Tracks economic entitlements of the members
- If profits interest is granted, capital accounts of existing members must be “booked-up” to FMV
- If capital interest is granted, share of capital from existing members is transferred to the capital account of employee
Operating Agreement Provisions

Allocations of Net Income / Net Losses

- Employee’s share of net income or net loss of the LLC is usually based on percentage interest represented by capital or profits interest.

- If profits interest is granted, employee generally may not receive an allocation of net losses.
Operating Agreement Provisions

Restrictions on Transfer

- Absolute prohibition
- Transfer with consent of manager and/or other members
- Permitted transfers
- Right of first refusal
- Put/call options
Operating Agreement Provisions

Drag-Along/Tag-Along Rights

• Drag-along rights allow the founding members to force employee to sell his capital or profits interest if a prospective buyer proposes to purchase the equity interests in the LLC
  – Alternative to a sale of assets by the LLC followed by a distribution of sale proceeds to members
  – Purchase price may be allocated ratably based on percentage interests, capital account balances or on some other basis

• Tag-along rights allow employee to participate in any sale of LLC equity interests to a prospective buyer
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Operating Agreement Provisions

Guaranty Obligations

• Founding members may have been required to guarantee loans to the LLC
  – Employee may be required to share in the obligation
  – Pro rata obligation by employee
  – Structure as indemnification to founding members
Operating Agreement Provisions

Buyout on Severance of Employment

- There are various scenarios that may require different terms
  - Termination for cause
  - Termination without cause
  - Leaving for good reason
  - Leaving without good reason
  - Death / disability
- Different terms for employees, as compared to founding members and/or investors
Operating Agreement Provisions

Redemption / Purchase Price

- Appraisal
- Formula (e.g., multiple of EBITDA)
- Book value
- Forfeiture
- Different terms for employees, founding members and investors
Operating Agreement Provisions

Anti-Competition Provisions

• Non-compete
• Non-solicitation
• Non-disclosure
LLC Equity Options

- Alternative to grant of a capital or profits interest
- Options have exercise price equal to FMV of underlying LLC interest on date of grant
- Grant of options nontaxable to employee
- On exercise, employee generally recognizes compensation income equal to amount by which FMV of interest exceeds exercise price
  - No compensation income on exercise of option to acquire a profits interest
- LLC receives deduction equal to compensation income recognized by employee
Phantom Equity / Equity Appreciation Rights

- Alternative to grant of a capital or profits interest
- Phantom equity is a contractual right to receive a cash payment equal to the FMV of an LLC equity interest upon the occurrence of one or more specified events
- An equity appreciation right is a contractual right to receive, upon the occurrence of one or more specified events, a cash payment equal to the appreciation in value of an LLC equity interest
- Not an ownership interest in the LLC
- Employee not an LLC member
Phantom Equity / Equity Appreciation Rights

- Employee’s status as an employee does not change for tax purposes
- Form W-2 issued for wages, bonuses, and other compensation and benefits
- Employee generally taxed only as and when he receives payment from the LLC
  - Entire amount received by employee taxed as compensation income
  - No portion taxed as capital gain to employee
  - LLC receives compensation deduction at the time employee recognizes compensation income
- Subject to 409A
Questions?
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