

# Equity Compensation in Limited Liability Companies

October 6, 2010

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# Introduction to Limited Liability Companies

- ◆ Limited liability companies were created by statute; Washington law was adopted in 1994
- ◆ Benefits
  - ◆ Provide limited liability
  - ◆ Great deal of flexibility
    - ◆ Allocations
    - ◆ Distributions
    - ◆ Management
  - ◆ Can be taxed as a partnership — no double taxation issues that exist with a C corporation and much more flexibility than an S corporation



# Limited liability company or S corporation?

## ◆ Advantages of LLCs

- ◆ No ownership limits for LLCs (S corporations are limited to 100 owners)
- ◆ Any entity or individual may own an LLC interest
- ◆ LLC member may be allocated LLC losses in excess of her investment
- ◆ Multiple classes of ownership are available
- ◆ LLCs may be used to move assets in tax favored ways
- ◆ LLCs may readily covert to S corporation or C corporation
- ◆ LLCs may grant profits interests to service providers without current income tax consequences



# Taxation of LLCs

- ◆ Single member LLC taxed as a disregarded entity
- ◆ LLC with multiple members taxed as a partnership
- ◆ LLC may elect to be taxed as a C corporation or an S corporation
- ◆ This discussion assumes that the LLC is taxed as a partnership



## LLC – Types of Equity Compensation

- ◆ Capital interest
- ◆ Profits interest
- ◆ Unit options
  - ◆ “nonqualified options”
  - ◆ ISOs are a statutory creation and must be for corporate stock
- ◆ Phantom stock
- ◆ Any of these may be subject to vesting, or not



# Capital Interest

- ◆ A capital interest is an interest that would give the holder a share of the proceeds if the LLC's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the LLC
- ◆ Grant of an ownership interest
- ◆ Interest in the underlying capital of the LLC as well as profits and losses
- ◆ If the LLC were liquidated on the date of grant, the owner would receive a distribution with respect to the LLC's assets
- ◆ May be voting or nonvoting



## Capital Interest – Example

### Example – What is a capital interest?

Bob is employed by Sue and Sons LLC. Existing members, Sue, Rick and Joe each have a capital account of \$100, which is equal to the fair market value of the LLC's assets. Bob is admitted as a member and receives a 10% capital interest in the LLC. This capital interest effectively entitles Bob to \$30 if the LLC were immediately liquidated (10% of the LLC capital of \$300).



## Capital Interest – Tax Consequences on Receipt

- ◆ Upon receipt (or vesting) of a capital interest in exchange for services performed, the service provider will have compensation income
- ◆ **Income = Fair market value** of the interest received, less any amount paid for the interest
- ◆ Fair market value may be determined in a variety of ways:
  - ◆ Value of services rendered
  - ◆ Value of capital shifted from existing LLC members to recipient
  - ◆ What would a willing seller pay a willing buyer in an arm's length transaction
  - ◆ What would service provider receive upon liquidation of the LLC at the time the interest is received



# Capital Interest – Tax Consequences

- ◆ Timing
  - ◆ If fully vested – taxable income on the date of grant unless the interest subject to substantial risk of forfeiture
  - ◆ Otherwise, upon vesting or lapse of substantial risk of forfeiture
  - ◆ Section 83(b) election available
- ◆ Income taxes and employment taxes
- ◆ LLC has the obligation to withhold income taxes, as with any employee compensation
- ◆ LLC entitled to compensation deduction in the year in which the service provider includes the amount in income
- ◆ Difference between value at receipt (or vesting) and price at sale – short term or long term capital gain



## Profits Interest

- ◆ Typically, a profits interest is an **interest** in the profits of the LLC, and a **right to share** in any increase in value of the LLC
- ◆ In a liquidation of the LLC on the date of grant, the recipient would not be entitled to any distribution
- ◆ Requires a valuation of the LLC as of the date of grant



## Profits Interest - Example

Example – What is a profits interest?

Bob is employed by Sue and Sons LLC. Existing members, Sue, Rick and Joe each have a capital account of \$100, which is equal to the fair market value of the LLC's assets. When Bob is granted a profits interest, all future profits and growth in value above \$100 would be shared by Bob as an owner on the same basis as the other owners share. If Bob has a 10% profits interest, he will participate in 10% of all future profits and growth in value.

Assume a sale of the LLC at a time when the value of the LLC is \$400 – at that time, Bob would be entitled to \$10 ( $\$400 - \$300 = \$100 * 10\% = \$10$ )



# Profits Interest – Tax Consequences

- ◆ No income tax consequences if the Safe Harbor is met
- ◆ **Safe harbor** (Rev. Proc. 93-27)
  - ◆ No income tax recognized at any time if three conditions are satisfied
    - ◆ Profits interest is not related to a substantially certain and predictable stream of income
    - ◆ Profits interest is not sold within two years of receipt
    - ◆ Profits interest is not a limited partnership interest in a publicly traded partnership
- ◆ What happens if these requirements are not satisfied?  
Uncertain whether income tax consequences arise from the initial grant – safe harbor is not the only way



## Unvested Profits Interest – Sect. 83(b) Election Available

- ◆ Is it needed?
- ◆ Under Rev. Proc. 2001-43 the determination of whether an interest granted to a service provider is a profits interest is made at the time the interest is granted, even if it is not yet vested
  - ◆ Upon grant of unvested profits interest, the service provider will not be taxed on receipt or vesting if:
    - ◆ Conditions of Rev Proc 93-27 are met
    - ◆ The LLC and the service provider treat the service provider as the tax owner of the interest and the service provider reports its distributive share of partnership tax items for tax purposes
    - ◆ Upon grant or vesting of the interest, none of the LLC or any member takes deductions based on the profits interest at grant or vesting



## Profits Interest – Tax Consequences

- ◆ No income taxes or employment taxes
- ◆ LLC does not have any obligation to withhold income taxes
- ◆ LLC is not entitled to compensation deduction in the year in which the service provider includes the amount in income
- ◆ Redemption or sale of profits interest – short term or long term capital gain



# Profits Interest – Possible Changes - 2005 Proposed Regulations

- ◆ 2005 Proposed Regulations
  - ◆ May not ultimately be adopted
  - ◆ If adopted, safe harbor would be replaced
  - ◆ Can achieve the same favorable results, if the right elections are made:
    - ◆ “Safe harbor” liquidation value election
    - ◆ Section 83(b) election for unvested interests



# Tax Consequences of Membership

- ◆ Payments made to a service provider/member, whether the member holds a capital interest or a profits interest, classified as guaranteed payments
  - ◆ Not subject to withholding
  - ◆ Reported on K-1
  - ◆ Grantee must pay estimated income taxes on all income from LLC
  - ◆ Self-employment taxes on salary



## LLC Unit Options

- ◆ Options are an alternative to an outright grant of an interest in the LLC
- ◆ Options will have an exercise price equal to the fair market value on the date of grant
- ◆ May be an option to acquire a profits interest or a capital interest



## LLC Unit Options

- ◆ As is typical with a nonqualified option, upon exercise of an option to acquire a capital interest, service provider has taxable income equal to the difference between the fair market value of the units acquired and the amount paid for those units; LLC gets a corresponding tax deduction
- ◆ Exercise of an option to acquire a profits interest is not taxable; no deduction for LLC
- ◆ Options may be subject to a plan or freestanding



# Operating Agreement Provisions

- ◆ Any grant of equity compensation to a service provider (capital interest, profits interest, option) may be subject to a **variety of additional provisions**
  - ◆ Profits interests usually created as a new class of Unit
  - ◆ Capital interests granted to service providers may be a different class of units than those granted to founders
  - ◆ Units granted to service providers may have full voting rights (including rights to participate in the election of managers), may have limited voting rights (i.e., just on merger, sale of substantially all of the assets, etc.) or may have no voting rights
  - ◆ Service providers that hold units and do not have voting rights may still be entitled to attend members' meetings and participate in the discussion



# Operating Agreement Provisions

- ◆ Additional Operating Agreement provisions
  - ◆ Service providers may or may not be required to share in guaranty obligations and make additional capital contributions
  - ◆ Restrictions on transfer
    - ◆ Right of First Refusal
    - ◆ Redemption on termination of employment/provision of services





# Operating Agreement Provisions

- ◆ Redemption on Termination of Employment or Termination of Services
  - ◆ Valuation and purchase price
    - ◆ Fixed formula or appraisal
    - ◆ Termination for cause could result in lower purchase price on redemption
    - ◆ Possibly forfeiture of interest in the event of termination for bad conduct
  - ◆ Redemption terms may apply solely to those units granted to services providers; may have different terms applicable to founders and investors



# Operating Agreement

- ◆ Additional Operating Agreement provisions
  - ◆ Noncompete
  - ◆ Nondisclosure
  - ◆ Nonsolicitation
  - ◆ Distributions for payment of taxes – “Phantom Income” issue



## Proposed Tax Legislation - Carried Interest

- ◆ A carried interest is a share of the profits of a successful **partnership** that is paid to the **manager** of the partnership (a **private equity fund** or **hedge fund**) as a form of compensation that is designed as an incentive to the manager to maximize performance of the investment fund
- ◆ Under current law, because the manager is compensated with a profits interest in the fund, the bulk of its income from the fund is taxed, not as compensation for services, but as a **return on investment**

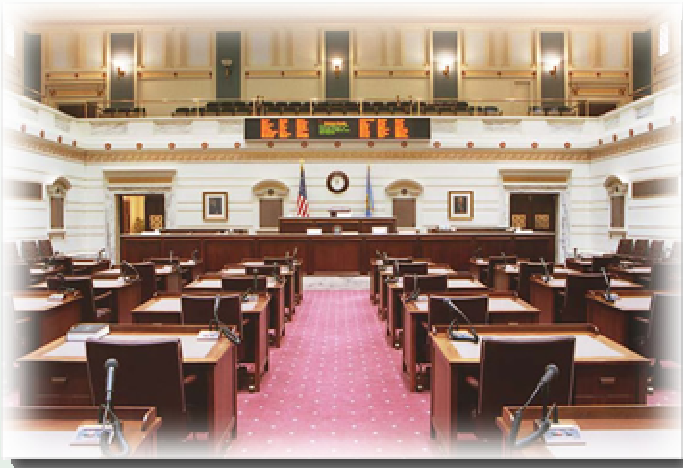


## Carried Interest

- ◆ Private equity funds typically invest on a long horizon, with the result that income earned by the funds is long-term capital gain, taxable to individuals at a maximum 15% rate
- ◆ Because the manager's profits share (20% or more) typically is the bulk of the manager's compensation and because this compensation can reach, in the case of the most successful funds, enormous figures, concern has been raised, both in Congress and in the media, that managers are taking advantage of tax loopholes to receive what is effectively a salary without paying the ordinary 35% marginal income tax rates that an average person would have to pay on such income



# Carried Interest



Pending legislation would treat net income allocable to the carried interest, gain from the disposition of carried interest, and distributions in kind of appreciated property attributable to the carried interest taxable as **ordinary income** and subject to **employment taxes**



# Carried Interest

- ◆ The rules are broad and, if enacted, could have far reaching effect
  - ◆ Applies to persons (or related persons) who
    - ◆ Directly or indirectly provide any of the following services with respect to assets held by the partnership
      - ◆ Advising on, investing in, purchasing, or selling a “specified asset”
      - ◆ Managing, acquiring, or disposing of a “specified asset”
      - ◆ Arranging financing with respect to a “specified asset”, or
      - ◆ Any activity in support of any of the previously described activities



# Carried Interest

- ◆ **“Specified asset”** means:
  - ◆ Securities
  - ◆ Real estate held for rental or investment
  - ◆ Partnership interests
  - ◆ Commodities
  - ◆ Options or derivative contracts with respect to these assets
  
- ◆ **Covered partnerships will include**
  - ◆ Private equity funds
  - ◆ Hedge funds
  - ◆ Venture capital funds
  - ◆ LBO funds
  - ◆ Real estate funds and partnerships
  - ◆ Marketable securities funds and partnerships



# Carried Interest

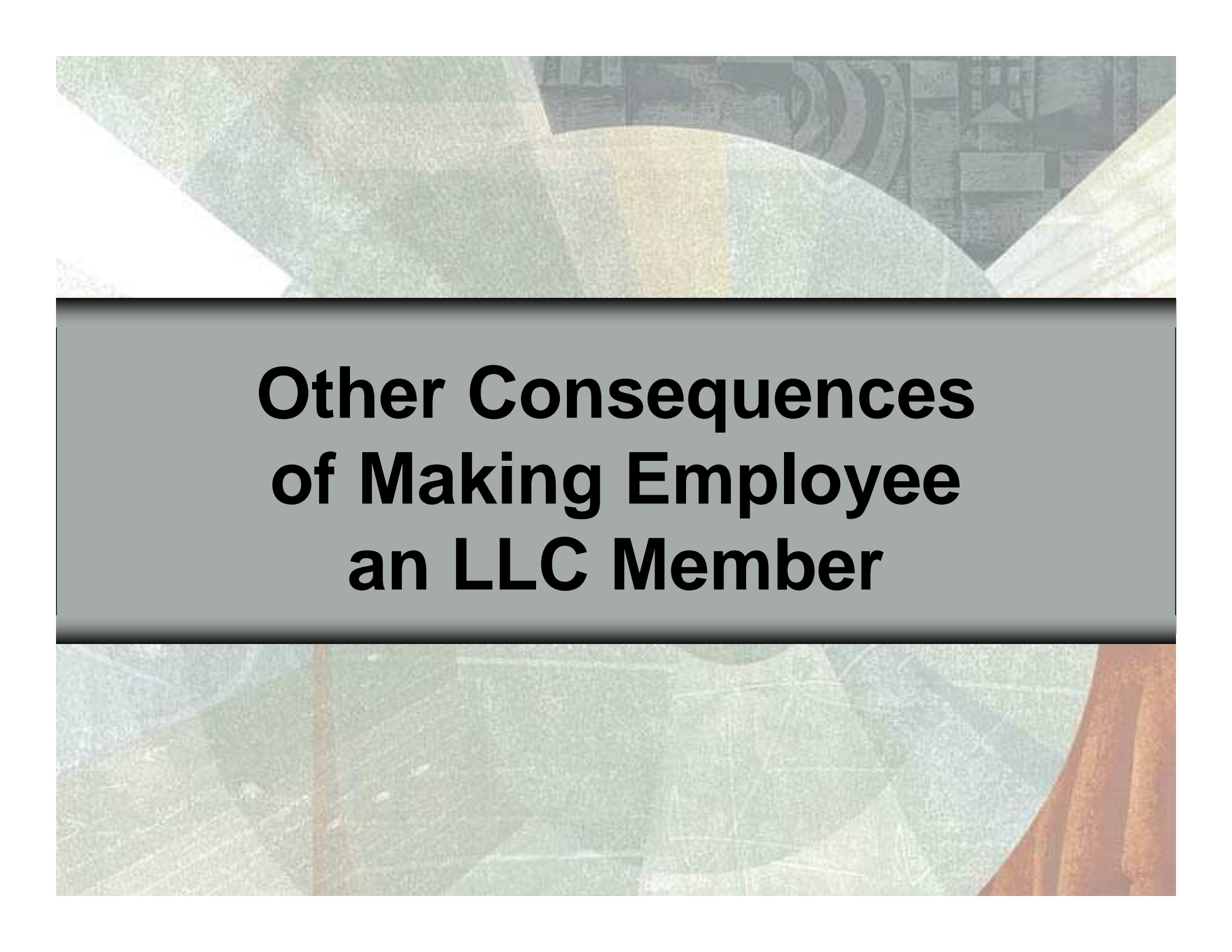
## ◆ Exceptions

- ◆ “**Qualified Capital**” – capital invested by the manager
  - ◆ There must be an unrelated investor who contributes cash in exchange for a capital interest on the same basis as the carried interest holder
- ◆ Carried Interest rule does not apply if all allocations, distributions and capital contributions have been pro rata



# Carried Interest

- ◆ Unintended consequences
  - ◆ All partners of a family limited partnership or LLC investing in real estate or marketable securities could be subject to the rule converting capital gains to ordinary income
  - ◆ Loss limitation rule that could apply to partnerships of related parties, even if there are no profits



# **Other Consequences of Making Employee an LLC Member**



## LLC Governance



- ◆ When employee becomes member, LLC operating agreement should be modified to address
  - ◆ Any fixed “salary” that the service provider is entitled to
  - ◆ Any right the LLC has to terminate the services of the service provider and which member(s) can exercise this right
  - ◆ Any rights the service provider will have upon termination
  - ◆ What happens to the membership interest of the service provider upon termination (i.e. buy-sell provisions)
- ◆ The employee manual may also need to be revised to cover non-employee service providers



## Partner for Federal Tax Purposes



- ◆ Because LLC is taxed as a partnership, service provider/member is treated as a **partner** rather than an **employee**
- ◆ IRS has proposed regulations under IRC Section 1402 addressing whether member is a general partner or limited partner
- ◆ If member can contract on behalf of the LLC, or if he works for the LLC more than 500 hours per year, he will be deemed a general partner



# Tax Consequences of Being Treated as General Partner

- ◆ If the service provider is a **general partner**:
  - ◆ LLC issues service provider a K-1 rather than a W-2
  - ◆ “Salary” is taxed as a “guaranteed payment” under IRC Section 707(c)
  - ◆ LLC does not withhold income taxes
  - ◆ LLC does not withhold or pay employment taxes
  - ◆ Service provider must pay estimated taxes quarterly
  - ◆ Service provider must pay self-employment taxes of up to 15.3% (16.2% starting in 2013) on all self-employment income from the LLC



# Unemployment Insurance

- ◆ LLC members are not reported for Washington unemployment insurance purposes
- ◆ Members cannot voluntarily elect coverage for themselves
- ◆ LLC does not pay FUTA with respect to its members
- ◆ Terminated member cannot collect unemployment



# Status of Service Provider Under Other Laws

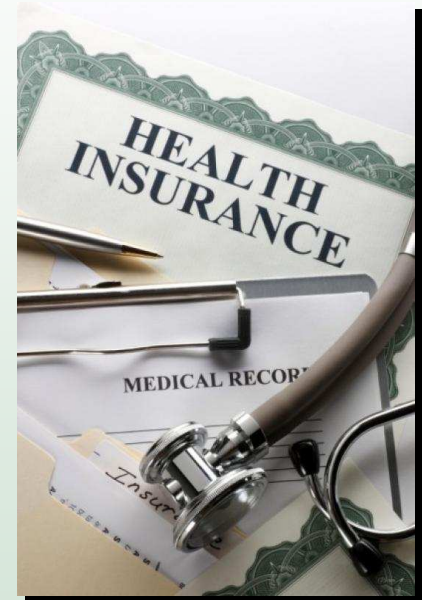
- ◆ Many unresolved issues
  - ◆ Is service provider an employee for purposes of anti-discrimination laws?
  - ◆ Will LLC be liable for double damages and attorney's fees under RCW 49.52.070 if it fails to pay all wages due?





# Health Insurance for Members – Income Tax Treatment

- ◆ Under Revenue Ruling 91-26, premiums that an LLC pays for health insurance for its members are treated as guaranteed payments
- ◆ The members must report these premiums as income on their tax returns
- ◆ Under IRC Section 162(l), members are allowed an above-the-line deduction for the amount of the premiums





## Health Insurance for Members – Self Employment Tax Treatment

- ◆ The Section 162(l) deduction is only for income tax purposes – it does not permit the amount of the premiums to be deducted for self employment tax purposes
- ◆ **Example**: LLC in 2009 provided a member health insurance coverage at a cost of \$15,000. The member's income from self-employment was less than \$100,000 for that year. The member must pay an additional \$2,295 in self employment taxes on account of the health insurance coverage.
- ◆ For 2010 only, the Small Business Jobs Act of 2010 allows the premiums to be deducted in computing self employment taxes



## Other Taxable Fringe Benefits

- ◆ The following fringe benefits are excluded from employee compensation but not from the income of self-employed persons:
  - ◆ Up to \$50,000 of group term life insurance (IRC Section 79)
  - ◆ Benefits received under a cafeteria plan (IRC Section 125)
  - ◆ Qualified transportation fringe benefits such as transit passes and paid parking (IRC Section 132(f))
  - ◆ Lodging and meals furnished for the convenience of the LLC (IRC Section 119)



## Excludible Fringe Benefits

- ◆ There are a number of statutory fringe benefits that are excludible for both employees and self-employed persons:
  - ◆ Dependent care assistance programs (IRC Section 129)
  - ◆ Education assistance programs (IRC Section 127)
  - ◆ Qualified moving expense reimbursements (IRC Section 132(g))
  - ◆ On-premises athletic facilities (IRC Section 132(j)(4))
  - ◆ Qualified group legal services (IRC Section 120)
  - ◆ Employee achievement awards (IRC Section 74(c))
  - ◆ Working condition fringe benefits (IRC Section 132(d))



## Alternatives

- ◆ LLC can elect to be classified as a C corporation
- ◆ LLC can elect to be classified as an S corporation, if it qualifies
  - ◆ Not more than 100 owners
  - ◆ All owners must be U.S. citizens or resident aliens (with certain exceptions)
  - ◆ Only one class of equity is allowed
- ◆ Fringe benefits provided to more than 2% owners of S corporations are taxed under the same rules that apply to partnerships
- ◆ Use phantom equity instead



# Phantom Equity

- ◆ Gives the employee contractual rights that look and feel like equity but are not
- ◆ Allows the employee to participate in the financial rewards of ownership without having voting and other rights usually associated with true equity
- ◆ Phantom equity is really a bonus plan under which the bonus amount is calculated using a formula related to the LLC's financial results
- ◆ Phantom equity is often subject to vesting



## Phantom equity – valuation formulas

- ◆ The formula can be virtually anything that the LLC and its advisors deem appropriate
  - ◆ The value could be based on how much the book value of the LLC increases after the phantom equity is awarded
  - ◆ It might also be based on the book value of a certain percentage of the LLC
  - ◆ The value could also be based on profits, e.g., an account to which the LLC credits 5% of its profits and which is distributed to the employee if she remains with the LLC for five years



## Tax consequences of phantom equity

- ◆ Phantom equity is taxed like any other non-qualified deferred compensation plan. If set up correctly –
  - ◆ The employee is only subject to income tax when he receives payments under the arrangement
  - ◆ The LLC receives a tax deduction for the payment



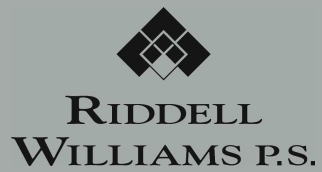
## Beware of IRC Section 409A

- ◆ If Section 409A rules are not followed, then as soon as an employee's rights in the phantom equity vest
  - ◆ The employee is taxed on that compensation at normal rates, **plus**
  - ◆ The employee must pay an additional 20% penalty tax on the compensation, **plus**
  - ◆ The employee must pay interest for the deferral period



## Section 409A – permissible payment triggers

- ◆ Separation from service (termination of employment)
- ◆ Death
- ◆ Disability
- ◆ Change of control
- ◆ Unforeseeable emergency
- ◆ Specified date or a payment schedule under which neither the employer nor the employee can affect the timing of the payments



# Questions?

Please contact us any time with additional questions

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