# Equity Interests in Limited Liability Companies

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The limited liability company (LLC) is a relatively recent form of business organization available in many, but not all, states 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. 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

As in S corporations and partnerships, profits from the operation of an LLC are attributed to the individual owners (referred to as "members"), 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

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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.

## Advantages and Disadvantages of LLCs vs. S Corporations

When determining whether an LLC should convert to an S corporation, the uncertainties of equity compensation in LLCs should be only one of many considerations to influence the decision.

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 ownership limits for LLCs.
- Only individuals, certain trusts, and estates can own S corporation stock, but any entity or individual can have an LLC partnership interest, including a non-resident alien.
- 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 have entity-level taxes on S corporations but not on LLCs.

- LLCs do not have the same obligations as S or C corporations to keep board minutes or have shareholder resolutions, and they otherwise have fewer compliance burdens than S or C corporations.
- LLCs can provide a profits interest to a service provider tax-free, whereas receipt of an unrestricted stock interest in an S corporation by a service provider results in taxable income on its fair market value upon receipt.

LLCs also have a number of disadvantages compared to S corporations:

- Unlike the case with S or C corporations, if an LLC is purchased by another company, it is not possible to do a tax-free combination.
- Profits in an S corporation that are distributed to shareholder-employees may avoid some self-employment taxes (FICA and FUTA), whereas self-employment taxes on such profits in an LLC may be unavoidable for certain employees.
- LLCs are relatively recent creatures of state law, so the kind of developed, relatively uniform corporate law guidance that exists for S or C corporations is not available.
- Amounts attributable to inventory and accounts receivable in an LLC are taxed as ordinary income upon sale of the 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. This is not the case with private equity firms, however, many of which are structured as LLCs.

## Purchases or Gifts of Equity Interests in LLCs

The simplest approach is to have employees purchase an equity interest in the company. 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. Alternatively, employees can be granted an interest, but some owners think that unless employees have "skin in the game," they will not really act like owners (evidence in this is unclear).

## 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 (usually called an operating agreement). It is essential that these be developed by qualified counsel and that they define all terms and requirements unambiguously.

As noted in the previous chapter, another form of compensation that is common to many LLCs (particularly private equity and hedge funds) is the "carried interest," a perceived form of equity. Essentially, a carried interest is a profits interest. Although the carried interest is not actually equity in the LLC, it can be designed in a manner that provides the holder with an ongoing right to future income and that can be sold

or otherwise transferred to others, depending on its terms and the operating agreement of the LLC.

## Tax Consequences of Granting a Capital Interest in an LLC

An employee who receives a capital interest without a substantial risk of forfeiture (that is, a vested 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., the 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. A Section 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.

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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.

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 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 is fully vested, if each of the following three requirements are satisfied:[2]

1. The profits interest is received as a member 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.

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2. Revenue Procedure 93-27 and Revenue Procedure 2001-43. In May 2005, the IRS issued Notice 2005-43 and proposed Treasury regulations that would make Rev. Proc. 93-27 and Rev. Proc. 2001-43 obsolete. Until the new rules are finalized, Rev. Proc. 93-27 and Rev. Proc. 2001-43 will continue to apply.

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 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.

Because a carried interest is the equivalent of a profits interest in the LLC, it has the same tax ramifications as the profits interest as discussed above. It should be noted that some LLCs use the term "carried interest," but in reality they are simply providing bonuses to employees. Each situation should be separately evaluated to determine whether the employee actually has a profits interest in the LLC.

## 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. An employee who exercises an option acquires an immediate interest in the underlying assets and future revenues of 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. The amount of taxable income equals the excess of the fair market value of the LLC interest received over the exercise price, if any. 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 on Equity Interests in LLCs

Section 409A of the Internal Revenue Code requires deferred compensation plans with amounts deferred on or after January 1, 2005, to comply with various rules that are designed to place reasonable operational limits on the timing of an election to defer income as well as the events that entitle a participant to receive a plan distribution. This income tax provision was enacted in response to abuses perceived to have occurred in deferred compensation arrangements that had previously allowed many executives to determine the timing and form of payment from these plans. As a result of the enactment of Section 409A, virtually any plan, arrangement, or agreement that defers income tax on compensation is subject to its stringent requirements.

A failure to comply with either its documentation or operational requirements results in immediate income taxation on amounts previously deferred by plan participants as well as the assessment of 20% excise taxes and late payment interest. The IRS provides a procedure for correcting inadvertent operational errors, which generally involve either deferred amounts that should have been paid or amounts that should have been deferred.[3]

Although IRS Notice 2005-1[4] does not specifically mention LLCs, it states that Section 409A "is not limited to arrangements between an employer and employee" and "may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferral compensation plan." The reference to partnerships should also apply to LLCs taxable as partnerships.

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3. The current version of this program appears in IRS Notice 2008-113.

4. Section III.G of the preamble to the final regulations under Section 409A states that Notice 2005-1 continues to provide interim guidance regarding the application of Section 409A until further guidance is issued. There are many unresolved issues with respect to the application of Section 409A to transfers of compensatory interests in LLCs. Until such further needed guidance is issued, LLCs should strive to structure their equity arrangements to comply with Section 409A to the greatest extent possible.

As a result, Notice 2005-1 may be interpreted to permit taxpayers to treat the issuance of an equity interest (including a profits interest), or an option to purchase an equity interest, granted by an LLC in connection with the performance of services, under the same principles that govern the issuance of stock under Section 409A. A closer look at how such interests would be treated for 409A purposes follows.

## Restricted and Unrestricted Capital Interests

In the context of LLC interests, Notice 2005-1 would permit the issuance of compensatory capital interest to be treated in the same manner as the issuance of stock, i.e., not resulting in the deferral of compensation because its value (and any subsequent income earned in respect of the capital interest) would be included in the recipient's income upon issuance. As such, the issuance and holding of a compensatory capital interest would be excluded from Section 409A's requirements. However, the receipt of a restricted capital interest (typically, one subject to a vesting schedule), is not a taxable event at the time of transfer (unless a Section 83(b) election has been made by the recipient).

It may be appropriate for Section 409A to apply to a transfer of a compensatory restricted capital interest, or a promise to deliver a capital interest in the future, where such interest or promise is not contingent on the performance of substantial future services, if the transfer or promise is considered to be a form of deferred compensation.

## Profits Interests

Notice 2005-1 specifically exempts profits interests from Section 409A if the recipient of the profits interest is not required to include the value of the interest in income at the time of issuance under applicable guidance. Current tax guidance provides that neither the receipt nor vesting of a compensatory profits interest is a taxable event.[5] Since no income is recognized, none can be deferred under Section 409A.[6]

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5. Once vested, the service provider recognizes income on his or her allocable share of the LLC's future income when earned.

6. Current rules do not address exemption of a profits interest from Section 409A where the profits interest has a readily ascertainable value at the time of grant.

## LLC Options to Acquire Capital or Profits Interest and Equity Appreciation Rights

Notice 2005-1 provides that the treatment of compensatory issuances of LLC-based awards other than capital or profits interest may be governed, by analogy, under the Section 409A rules covering equity-based awards. Thus, the treatment of LLC options to acquire a capital or profits interest can be determined by reference to Section 409A's treatment of nonqualified stock options, and the treatment of LLC appreciation rights can be determined by reference to Section 409A's treatment of stock appreciation rights.

### *LLC Options to Acquire Capital or Profits Interest*

Notice 2005-1 states that the grant of a nonqualified stock option with respect to stock of a service recipient does not result in a deferral of compensation, and therefore avoids Section 409A, only if (1) the option exercise price is never less than the fair market value of the underlying stock on the grant date; (2) the receipt, transfer, or exercise of the option is subject to taxation under Section 83; and (3) the option does not include any additional deferral features. It may be impractical in certain circumstances to value LLC assets in connection with each option grant, due to the intangible or illiquid nature of the assets involved. For this reason, an LLC interested in issuing option grants may wish to do so when other valuation events occur.

If the Section 409A requirements applicable to nonqualified stock options are not satisfied with respect to an option to acquire an LLC capital or profits interest, the option holder would likely recognize income upon option vesting equal to the excess of the fair market value of the LLC interest underlying the option over the amount of the exercise price, plus the additional 20% tax with interest under Section 409A.

### *LLC Equity Appreciation Rights*

Notice 2005-1 provides that stock appreciation rights are treated as deferral compensation subject to Section 409A unless (1) the rights relate to the stock of a service recipient, (2) the exercise price of the right is equal to fair market value of the stock on the date of grant, (3) the right settles only

in stock, (4) the stock is traded on an established securities exchange, and (5) the right does not contain any additional deferral features. Using the foregoing criteria, LLC appreciation rights granted by most privately held LLCs would be subject to Section 409A because such LLC appreciation rights could not satisfy the "publicly traded" requirement.

It is possible for an LLC appreciation right to comply with Section 409A's requirements if the exercise date of such an appreciation right is fixed as of the grant date. In such a case, the appreciation right may provide that exercise will occur on the earlier of a date certain or termination of employment.

## Earned Income and Availability of Tax-Favored Fringe Benefits

Not all LLC members may be treated for income tax purposes as common law employees. As such, only LLC members who are providing a service to the company, and thus receive earned income, may—but not always will—be considered for tax-favored treatment with respect to the company's benefit programs.

One example involves the income tax rules governing supplemental unemployment benefit (SUB) trusts, which provide that a service member of an LLC may not receive benefits from a SUB plan unless such individual is classified as an "employee" under the state or federal unemployment compensation laws covering employment.[7] Members who are compensated for services through guaranteed payments, considered to be earned income, will qualify to deduct 100% of their health insurance premiums to the extent of their pro-rata share of net profits.[8] The members' share of net profits is not considered earned income, and therefore inactive members who receive solely a distribution of profits will not qualify for the health insurance premium deduction.

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7. Treas. Reg. §1.501(c)(17)-1(b)(2).

8. Guaranteed payments are defined in Treas. Reg. §1.707-1(c) and understood as "payments made by a partnership to a partner for services." As such, these payments are treated as self-employment income and therefore render the recipient eligible for deduction of his or her self-employed health insurance expenses.

## Expert Advice Required

Due to their relative flexibility, LLCs may develop equity plans that fit their business objectives and align the interests of employees with the company to promote further growth of the enterprise. Taxed at capital gain rates, the capital interest or profits interest may provide the incentive needed for employees while minimizing dilution of ownership in the company. However, the limited guidance issued in this area poses unique challenges that must be handled with skill by an experienced advisor.

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.