A privately held company organized as a limited liability company ("LLC") often wants
to offer to key employees and consultants the right to participate in the financial success of the
business through an equity incentive compensation plan. The principal owner and key
employees typically think in terms of a plan comparable to the equity incentive compensation
plans commonly used by publicly traded corporations.

This article first describes the four broad types of equity incentive compensation plans
commonly used by publicly traded corporations and most likely to be familiar to business owners
and key employees: restricted stock, phantom stock, stock options, and stock appreciation rights.
The article then explains why certain of these corporate plans may not work well for an LLC
taxed as a partnership, and describes the more tax efficient alternatives for an LLC.2

Key Conclusions:

• For an LLC that wants to award participants a full equity interest in the company’s existing
capital and future profits and appreciation, a phantom equity plan is almost always preferable
to actual equity awards.

• For an LLC that wants to award participants an interest only in future profits and equity
appreciation, a “profits interest” is generally preferable to equity options or equity
appreciation rights, although an equity appreciation rights plan involves much less
complexity and is more attractive if the business generates significant ordinary operating
income (e.g., a professional service business).

• In the right circumstances, an LLC special equity plan (which is a modified form of a profits
interest) may be able to achieve tax benefits not available in a traditional corporate or LLC
equity incentive compensation plan (i.e., deferral of income and capital gains).

I. Common Types of Corporate Compensation Plans

Equity incentive compensation plans offered by a corporation to its key employees are
most commonly variations of one of the following four types of plans:

[1] The considerations for an LLC classified as a partnership for federal tax purposes as discussed in this article
are also applicable to a business organized and taxed as a partnership. Special considerations apply to an LLC that
elects to be taxed as an S corporation and are beyond the scope of this article. This article assumes that the LLC is
engaged in an operating business that would not be affected by the proposed legislation affecting carried interests in
partnerships holding “specified assets” (i.e., securities, commodities, partnership interests, or investment or rental

[2] For a more comprehensive analysis of equity incentive compensation plans for partnerships and LLCs, see
Restricted Stock: The employee is awarded a specified number of shares of company stock, subject to certain restrictions (e.g., vesting and forfeiture).

Phantom Stock: The employee is awarded the right to receive, upon specified events, a cash payment from the corporation equal to the value of a share of the corporation’s stock.

Stock Options: The employee is awarded the right to purchase a specified number of shares of company stock at a specified price (“exercise price”) during a specified option period. Typically, the exercise price is equal to the fair market value of the stock on the grant date.

Stock Appreciation Rights (‘‘SARs’’): The employee is awarded the right to receive, upon specified events, a cash payment equal to the appreciation in the value of a share of stock in excess of a specified price (“strike price”). Typically, the strike price is equal to the fair market value of the stock on the grant date.

As noted, restricted stock and stock options are payable in actual shares of the company’s stock (i.e., they are “real” equity interests), whereas phantom stock and stock appreciation rights are settled in cash (i.e., they are synthetic equity interests, or derivatives). These four plans are sometimes categorized as follows:

<table>
<thead>
<tr>
<th>Capital and Profits</th>
<th>Real Equity</th>
<th>Synthetic Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restricted Stock</td>
<td></td>
<td>Phantom Stock</td>
</tr>
<tr>
<td>Stock Options</td>
<td>Stock Options⁵</td>
<td>Stock Appreciation Rights</td>
</tr>
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</table>

### Table 1 – Classification of Common Corporate Equity Compensation Plans

As discussed in more detail below, the principal tax difference between real equity and synthetic equity in the context of corporate stock plans is that (a) real equity interests present the

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³ In a typical restricted stock plan, the stock awards are forfeited if the employee fails to meet certain service period (vesting) requirements or upon other events (e.g., termination for cause), and may be subject to limitations on sale to third parties. See the discussion of vesting and other restrictions below. For financial reporting purposes, the term “restricted shares” refers to stock that cannot be sold due to contractual or legal restrictions, and the term “nonvested shares” is used for stock for which the agreed upon vesting conditions (such as a minimum service period) have not yet been met. This memorandum uses the term restricted stock to refer to outstanding stock that is subject to vesting or other forfeiture restrictions, and not according to its financial reporting definition.

⁴ Restricted stock (as that term is used in this memorandum) is issued and outstanding at the award date, subject to the applicable restrictions. If the stock is not issued and outstanding at the award date (i.e., the award represents a mere promise to issue shares in the future upon satisfaction of the applicable conditions), the plan is more in the nature of a phantom equity plan that is settled in stock rather than in cash.

⁵ An SAR is considered a cash settled stock option.

⁶ Assumes the exercise price for the stock option is equal to the fair market value of the underlying stock on the grant date.

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potential for long-term capital gains for the participant on post vesting/exercise appreciation, but
at the cost of no deduction to the company for the capital gain amount, whereas (b) synthetic
equity interests are taxed entirely as ordinary income, but allow the company to take a full
deduction for the income taxed to the participant. These differences are summarized in the
following table.

Table 2 – Key Tax Distinctions Between Real and Synthetic Corporate Equity

<table>
<thead>
<tr>
<th></th>
<th>Real Equity</th>
<th>Synthetic Equity</th>
</tr>
</thead>
</table>
| Participant      | Potential for capital gain on post-vesting/exercise
                  | appreciation              | All ordinary income      |
| Company          | No deduction for post-vesting/exercise appreciation | Full deduction           |

There can be almost infinite variations of the basic arrangements noted above and in
Table 1. One common variation is to adjust the number of shares of stock or options awarded, or
the cash equivalent payments, based on some performance measure over a specified period (so-called “performance based” awards). For example, the number of shares of stock awarded or referenced in the award agreement could be increased or decreased based on the corporation’s earnings or other performance metrics over a specified performance period relative to specified benchmarks for the performance period.

In a typical plan, the equity or equity-linked award would be subject to vesting and
possibly other forfeiture or transfer restrictions. For example, an award might vest ratably over a
period years. Vesting might be accelerated upon certain events, such as a change in control of
the company. If the employee quits before the expiration of the vesting period, unvested shares
would usually be forfeited. If the employee is terminated for cause or breaches post-employment
covenants, both unvested and vested shares might be forfeited.

Special considerations apply if the corporation’s stock is not publicly traded. In such
cases, establishing the exercise price for stock options, or the strike price for SARs, at the grant
date at a price equal to the fair market value of the underlying stock on the grant date is more
difficult if the underlying stock is not publicly traded. In addition, vesting of restricted stock
generally triggers a requirement that the participant recognize taxable income equal to the fair
market value of the vested stock on the vesting date.\(^6\) The lack of a ready market for the stock
makes it difficult to determine the value to be recognized in taxable income, and also generally
makes it impractical to sell some of the vested shares in the market as a means of funding the
related tax liability. Equity incentive plans for a non-publicly traded corporation must be
carefully designed and implemented to deal with these valuation and liquidity issues.

II. Constructing an Equity Incentive Compensation Plan for an LLC

It is possible to construct an equity incentive plan for an LLC that has the same pre-tax
economic terms as the corporate plans listed above. It is in theory as simple as substituting the
term “equity” for “stock” in the description of the plan (to reflect that fact that an LLC’s
ownership or “equity” interests are represented by membership interests, whereas a corporation’s

\(^6\) I.R.C. § 83.

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ownership interests are represented by shares of stock). However, due to the unique tax characteristics of an LLC taxed as a partnership as compared to a corporation, the after-tax consequences of the various plans will be quite different for an LLC than for a corporation. Due to these tax considerations,

1. In cases where key employees and other participants are to receive a full equity interest in capital and profits, it will generally make sense to use a phantom equity plan in lieu of a restricted equity plan.

2. In cases where key employees and other participants are to receive an equity interest only in future profits, a “profits interest” arrangement may have advantages over equity options or equity appreciation rights.

3. For certain types of businesses, a special equity plan might provide an optimal mix of tax and non-tax benefits.

The considerations influencing these choices are discussed below.

III. An LLC Phantom Equity Plan Is Preferable to a Restricted Equity Plan

The discussion below first describes, in very general terms, the most significant tax consequences of a typical corporate restricted stock plan and phantom equity plan. It then explains why a traditional restricted stock plan has potentially significant disadvantages in the context of a private LLC, and why a phantom equity plan is generally a better alternative for an LLC in cases where the objective is to provide participants with a full economic interest in company’s capital and profits.

A. Tax Consequences of Corporate Restricted Stock

In general, the value of restricted stock awarded to an employee or other plan participant as compensation for services is included in the participant’s taxable income, as ordinary compensation income, when the stock becomes “substantially vested” (i.e., the stock is either transferable or is not subject to a substantial risk of forfeiture).\(^8\) The amount included in income is adjusted for any amount paid for the stock.\(^9\) Any appreciation in the value of the stock after the date the stock is substantially vested (the “vesting date” or “vesting”) is generally taxed as capital gain.\(^10\)

Alternatively, the participant can make a “section 83(b) election” to have the value of the stock on the grant date (less any amount paid for the stock) included in taxable income on the grant date.\(^11\) If a section 83(b) election is made, any appreciation in the value of the stock after the grant date is taxed as capital gain, but the participant generally cannot claim a deduction for any loss in value of the stock after the grant date.\(^12\)

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\(^7\) References in this article to an LLC assume that the LLC is classified as a partnership for federal income tax purposes under Treas. Reg. § 301.7701-3 and is not a publicly traded partnership as defined in I.R.C. § 7704.

\(^8\) Treas. Reg. §§ 1.83-1(a)(1) and 1.83-3(b).


\(^10\) I.R.C. §§ 1222, 1221.

\(^11\) I.R.C. § 83(b).

\(^12\) Treas. Reg. § 1.83-2(a). A loss can be claimed only if the stock is sold for less than the amount (if any) paid for the stock.
The corporation may claim a compensation deduction at the time the participant recognizes taxable compensation income in an amount equal to the amount recognized as compensation income by the participant (plus any applicable employer taxes). The corporation has no deduction for any amount taxed to the participant as capital gain.

B. Tax Consequences of Corporate Phantom Stock

A participant in a corporate phantom stock plan is generally taxed only as and when the participant receives payments with respect to the phantom stock, and the entire amount received by the participant is taxed as ordinary compensation income. The corporation may claim a compensation deduction at the time the participant recognizes taxable compensation income in an amount equal to the amount recognized as compensation income by the participant (plus any applicable employer taxes).

The participant in a phantom stock plan forgoes the ability to obtain capital gain treatment on appreciation in the value of the stock after the vesting date. In this respect, a phantom equity plan is generally considered less attractive to participants than a restricted equity plan. In addition, a restricted equity plan gives participants “real” equity in the corporation, typically with real voting rights and other rights associated with ownership, rather than a synthetic or derivative equity interest that does not carry those rights. However, a phantom equity plan solves certain valuation and liquidity issues associated with non-traded restricted stock. In addition, whereas the corporation obtains no tax deduction for restricted stock appreciation taxed to the participant as capital gain, the corporation obtains a deduction for the entire amount of income recognized by the participant with respect to phantom equity, typically making phantom equity a more tax efficient alternative for the corporation and overall.

C. Tax Consequences of LLC Restricted Equity

Awards of restricted equity (membership interests) in an LLC classified as a partnership for federal income tax purposes are generally taxed in the same manner as restricted stock in a corporation. As noted above, because the LLC is not a publicly traded entity, it can be difficult to fund the participant’s tax liability upon vesting (or upon making a section 83(b) election). The company may need to make arrangements to buy back a portion of the equity or to provide loans to the participant to cover the participant’s tax liability.

Due to the nature of an LLC as a tax transparent entity, once the LLC restricted equity is taxed to the participant (i.e., upon the equity awarded becoming substantially vested or upon the participant making a section 83(b) election with respect to the equity awarded), the participant is considered a member of the company for tax purposes and must be issued a Schedule K-1 for the participant’s share of company tax items each year, whether or not any cash distributions are made to the participant. The participant’s share of company tax items will generally be taxed as ordinary income or as capital gain depending on the character of the income to the company. Special tax distributions to participants may be required to fund their tax liability on company

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14 Treas. Reg. § 1.83-3(e) (property does not include an unfunded and unsecured promise to pay money or property in the future).
16 See footnote 7 (for purposes of this memorandum, an LLC is assumed to be classified as a partnership for federal tax purposes and is assumed to not be a publicly traded partnership).
17 I.R.C. § 702.
tax items allocated to them for tax purposes. LLC income taxed to the participant is effectively deductible by the other LLC members in that the income is “deflected” to the participant. In contrast, a holder of corporate restricted stock is generally not taxed on company profits until distributed as a dividend, such dividends are (under current law) taxed entirely at favorable long-term capital gain tax rates, and the corporation does not obtain any deduction for dividends paid to the participant.

Upon disposition of LLC restricted equity, the participant’s gain is capital gain except to the extent attributable to the participant’s share of company “hot assets” (generally defined as assets that would produce ordinary income if sold). An LLC can increase the basis of its assets to account for any gain recognized by the participant on the disposition of the participant’s restricted equity. This effectively creates a deferred deduction for the LLC equal to the gain recognized by the participant. In contrast, in the case of a sale of corporate restricted stock, there are no “hot asset” rules (all gain is capital gain), and there is no basis adjustment (deferred deduction) available for gain recognized by the participant on the sale of the restricted stock.

Once LLC restricted equity is taxed to the participant, the participant may also be subject to state tax filing requirements in all states in which the LLC does business, and may be subject to state income tax on the participant’s share of company income and on the participant’s gain from the disposition of the LLC restricted equity. In contrast, a holder of corporate restricted stock is generally not subject to tax on income from the stock in any state other than the state in which the participant’s maintains his or her domicile.

The IRS view is that a person that owns an equity interest in an LLC classified as a partnership for federal income tax purposes cannot also be an employee of the LLC. Accordingly, under the IRS view, participants who are employees of the company must have their regular compensation and bonuses reported as a guaranteed payment on Schedule K-1 rather than as compensation income on Form W-2. Similarly, it is possible that an independent contractor might have his compensation reported on Schedule K-1 rather than on Form 1099. Some participants may be confused by this reporting, and certain employees may be subject to modestly less favorable tax rules as a partner.

In summary, the tax reporting for the holding and sale of vested shares of corporate restricted stock is much simpler than the tax reporting for the holding and sale of vested LLC restricted equity, and the issuance of corporate restricted stock does not interfere with the participant’s existing employment relationship with the company. For these reasons, a restricted equity plan is generally not be the best choice for an LLC equity incentive compensation plan.

D. Tax Consequences of LLC Phantom Equity

Under a phantom equity plan, participants are awarded nominal equity units (“Phantom Units”) that represent a contractual right to receive a cash payment equal to the value of a unit of LLC membership interest upon defined payment events. An LLC phantom equity plan has

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18 I.R.C. § 1(h). The special rate for corporate dividends is scheduled to expire December 31, 2012.
19 I.R.C. § 751.
20 I.R.C. §§ 734, 743, 754.
22 It may be possible to avoid having the employee classified as a partner with respect to wage income by forming a holding company to own the equity interests of participants. See Swartz, supra n. 2, pp. 21-23 for a discussion of these issues.
essentially the same tax consequences as a corporate phantom equity plan (i.e., taxation deferred until payment, and all payments taxed as compensation income).

For an LLC, a phantom equity plan has several advantages over a restricted equity plan, including:

1. Whereas owners of LLC restricted equity are taxed on their allocable shares of the LLC’s income after vesting or an 83(b) election, whether or not the income is distributed, Phantom Units are taxed more like restricted stock in that the holder of Phantom Units is only taxed as and when cash is distributed to the holder.

2. Because owners of Phantom Units are not considered equity owners, their status as employees of the company is not affected by the issuance of Phantom Units. Accordingly, they can continue to be issued a Form W-2 for their wages, bonuses, and other compensation and benefits (including payments in respect of the Phantom Units).

3. Owners of vested restricted equity are generally deemed to be doing business wherever the partnership is doing business, and are therefore required to file state (and local) income tax returns everywhere the LLC does business, and pay tax on their share of LLC income attributable to other states and cities imposing an income tax. The company can usually arrange to file composite tax returns on behalf of its equity owners, but the equity owners are typically still responsible for payment of the taxes. In contrast, assuming the participant works exclusively in his or her state of domicile, amounts received with respect to Phantom Units would not be subject to any state or local income tax outside the participant’s state of domicile, and neither the participants nor the company would be required to file any additional state or local income tax returns for the participants.

4. Awards of restricted equity are generally taxed to the participant upon vesting, whereas Phantom Units are not taxed to the participant until the specified payment date. A phantom equity plan therefore eliminates the need for special provisions to either defer vesting or to provide liquidity for payment of taxes on vested restricted equity.

5. If a restricted equity plan includes arrangements to allow participants to sell a portion of the restricted equity at vesting in order to pay the tax due, the participant has a smaller percentage interest in any future appreciation in the value of the business. There is no similar need to reduce the invested balance of a holder of Phantom Units.

6. The issuance of restricted equity can trigger taxable income to other LLC members (including participants that have previously vested restricted equity) to the extent the LLC has debt and holds hot assets. These deemed income rules don’t apply to the issuance of Phantom Units.

7. Although not of direct concern to participants, all payments by the company with respect to Phantom Units are immediately deductible by the company. In contrast, any payment made to retire restricted equity is generally not immediately deductible by the company but must instead be added to the basis of undistributed company assets and recovered through depreciation or other basis recovery provisions.

8. A phantom equity plan avoids significant accounting complexities for the LLC associated with recalculating all equity owners’ capital accounts, sharing ratios, and tax basis allocations every time additional equity interests vest or are retired. These administrative costs

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23 I.R.C. §§ 751, 752.
can drain significant value and resources from the business without producing any value for the participants or the other investors.

One disadvantage of a phantom equity plan as compared to a restricted equity plan is that the entire amount received by a participant with respect to Phantom Units is taxed as compensation income; none qualifies as tax favored capital gain. In contrast, a significant portion of the appreciation in the value of restricted equity might qualify for capital gains tax. This tax detriment associated with Phantom Units is mitigated by (a) the fact that the participant hasn’t had to pay tax on the vesting of the Phantom Units, and therefore may have larger percentage interest in any such appreciation under a Phantom Unit plan, and (b) the LLC obtaining an ordinary compensation deduction for the compensation income recognized by the participant (see paragraph 7 above).

Another potential disadvantage of a phantom equity plan as compared to a restricted equity plan is that a phantom equity plan is subject to the deferred compensation rules of I.R.C. § 409A, whereas a restricted equity plan is not subject to those rules. I.R.C. § 409A specifies permissible payment events, restrictions on funding, requirements for deferral elections, and other applicable requirements. Failure to comply with the requirements can subject participants to acceleration of income and penalties. Nevertheless, with careful drafting an LLC phantom equity plan can comply with I.R.C. § 409A without undue interference with the company’s compensation objectives.

E. Summary

Considering all of the factors discussed above, an LLC phantom equity plan is generally preferable to an LLC restricted equity plan for both the participants and the LLC.

IV. An LLC Profits Interest is Generally Preferable to Equity Options or Equity Appreciation Rights

This section describes, again in very general terms, the most significant tax consequences of corporate stock options and corporate stock appreciation rights (“SARs”), and compares those tax consequences to the tax consequences of the LLC equivalent plans. The discussion also describes a “profits interest,” which is a special form of equity appreciation right available to LLCs.

A. Tax Consequences of Corporate Stock Options

In general, no taxable income is recognized upon the grant or vesting of a corporate stock option (assuming the option does not have a readily ascertainable fair market value). Rather, when the option is exercised, the participant recognizes ordinary compensation income equal to the excess of the value of the stock on the exercise date and the amount paid to acquire the stock.

\[ \text{Taxable Income} = \text{Value of Stock} - \text{Price Paid} \]


24 Treas. Reg. § 1.409A-1(b)(6), (7).

25 See the discussion in Sections IV(E) and V below regarding profits interests and special profits interests. It may be possible to structure a profits interest that has no capital account value upon issuance, but which is allocated a preferential share of future profits (either from all sources, or solely from capital transactions) equal to the capital interest that is forgone at the issue date (sometimes referred to as a “catch up” allocation). In this manner, a profits interest or special equity interest can mimic the effects of a phantom equity plan while conferring capital gains treatment on the participant.
(i.e., the exercise price). Any appreciation in the value of the stock after the exercise date is generally taxed as capital gain.

There is no ability to accelerate gain recognition (i.e., no section 83(b) election) with respect to the receipt of a compensatory corporate stock option.27

The corporation may claim a compensation deduction at the time the participant recognizes taxable compensation income, and the amount of the corporation’s deduction is equal to the amount recognized as compensation income by the participant.28 The corporation has no deduction for any amount taxed to the participant as capital gain.

Stock options were at one time the favored form of equity incentive compensation for emerging growth companies because the corporation was not required to recognize any expense for financial reporting purposes with respect to the issuance or exercise of the options. That favorable financial reporting treatment was changed in 2005,29 and the financial reporting treatment for restricted stock is now generally considered more favorable than for stock options (because the real value of stock options tends to be overstated by applicable valuation models). As a result, beginning in 2006 many publicly traded corporations began preferring restricted stock to stock options as a means of providing equity incentive compensation to key employees.

B. Tax Consequences of Corporate SARs

A corporate SAR is taxed in the same manner as a corporate phantom equity plan (described above). Payments are taxed as ordinary income only when paid to the participant, and the corporation can deduct the payments as compensation expense at that time.

C. Tax Consequences of LLC Equity Options

The IRS has not issued definitive guidance on the tax consequences of LLC equity options. Until definitive guidance is issued, the tax rules for LLC equity options are generally assumed to be the same as for corporate stock options. That is, there are no tax consequences associated with the grant or vesting of equity options, but if and when the option is exercised, assuming the equity received on exercise is substantially vested, the participant recognizes ordinary compensation income equal to the spread between the value of the underlying equity on the exercise date and the exercise price, and the LLC has a deduction for the amount included in the participant’s income. Following exercise, the participant becomes an equity owner with a capital account equal to the value of the underlying equity taken into account in determining the

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26 Treas. Reg. § 1.83-7. The discussion in text deals with “non-qualified” stock options, meaning options that are not “incentive stock options” covered by I.R.C. § 422. The advantage of an incentive stock option is that there is potentially no tax on exercise of the option (rather, tax is due only when the underlying stock acquired upon exercise of the option is ultimately sold) and the entire gain on the sale of the stock acquired upon exercise of the option may qualify for long-term capital gain treatment. The disadvantage (which generally outweighs the potential advantages) is that the company is not allowed any tax deduction for the grant or exercise of the option or for the sale of the underlying stock. See I.R.C. § 421(a).

27 Treas. Reg. § 1.83-7(a). If the stock acquired upon exercise of the option is restricted (i.e., not substantially vested), a section 83(b) election can be made upon exercise of the option.


The exercise of an LLC equity option leads to an equity interest that is more complicated than the stock ownership interest acquired upon the exercise of a corporate stock option. Whereas a holder of corporate stock recognizes income only to the extent of actual dividends and gains received, the holder of LLC equity is subject to the complexities and associated with equity ownership as described above in section III(C) with respect to restricted equity. On the other hand, unlike in the case of a corporate stock option (where the corporation gets no deduction for gain realized by the participant after the exercise date), all post-exercise income or capital gain allocated to the participant reduces income or gain that would otherwise be allocated to the remaining LLC members, with the effect that the LLC effectively obtains a deduction (deflection of income) for the post-exercise income or gain realized by the participant with respect to the LLC equity option.

**D. Tax Consequences of LLC Equity Appreciation Rights**

Because equity appreciation rights are merely a contractual obligation to make a future cash payment by reference to the change in value of the underlying LLC equity, the tax consequences of an LLC equity appreciation rights plan are the same as the tax consequences of a phantom equity plan; i.e., the payments are taxed as ordinary compensation income to the participant as received, and are deducted by the LLC as they are included in the participant’s income. An equity appreciation rights plan also has some of the same advantages over an LLC equity option plan that an LLC phantom equity plan has over an LLC restricted equity plan. For example, an equity appreciation right never leads to an equity ownership interest, so the complexities of having the participant as a member of the LLC are avoided. Potential drawbacks of a equity appreciation rights plan are (a) the entire amount paid to the participant is ordinary compensation income, and (b) the plan is subject to the requirements of I.R.C. § 409A.

**E. Tax Consequences of LLC Profits Interest**

A “profits interest” is a special class of LLC equity that entitles the holder to a share in the LLC’s future profits, but no share in the LLC’s asset values as of the date the award is granted (i.e., no “capital interest”). Under current IRS rules, a profits interest is not taxable either at the grant date or at the vesting date. In effect, the participant is deemed to make a section 83(b) election and include zero value in income at the grant date.

A profits interest is economically equivalent to an equity appreciation right, but it has some unique features. In contrast to an equity appreciation right where any value paid to the participant is taxed as compensation income, a profits interest causes the participant to be a

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30 **Cf.** Prop. Treas. Reg. § 1.721-1(b), 70 Fed. Reg. 29675, 29683 (May 24, 2005) (treating receipt of a compensatory equity interest, including an equity interest acquired upon exercise of an option granted in connection with the performance of services for the LLC, as taxable to the participant (service provider) under I.R.C. § 83, without giving rise to gain or loss to the LLC). See also Karen C. Burke, Taxing Compensatory Partnership Options, 100 Tax Notes 1569 (Sep. 22, 2003).

31 See Rev. Proc. 93-27, 1993-2 C.B. 343, and Rev. Proc. 2001-43, 2001-2 C.B. 191. Note that the tax treatment prescribed in Rev. Proc. 93-27 does not apply if (a) the interest relates to a substantially certain and predictable stream of income from partnership assets, (b) the service provider “disposes” of the interest within two years of receipt; or (c) the partnership is a publicly traded partnership. In cases where a profits interest may not comply with the requirements of the IRS safe harbors, it is generally advisable to file a protective section 83(b) election with respect to the receipt of a profits interest. See Rev. Proc. 2012-29, 2012-28 I.R.B. 49, regarding sample language for section 83(b) elections.
partner as of the grant date, and the participant’s income (if any) with respect to the profits interest depends on the character of the LLC’s income or gains (or the character of its assets upon a sale or redemption of the profits interest). A profits interest therefore generally creates a greater opportunity for the participant to recognize capital gains.

A profits interest is also economically equivalent to an equity option, except that there is no exercise price to be paid for the profits interest. And whereas the appreciation in value of an equity option prior to exercise is taxed as compensation income, a profits interest creates a greater opportunity for capital gains with respect to such appreciation.

There are a number of potential drawbacks associated with a profits interest. One potential drawback is that the participant receives an actual equity interest in the LLC and is considered a member on and after the grant date regardless of any vesting restrictions. Consequently, the participant faces the complexities associated with equity ownership discussed above in paragraph III(C) (relating to restricted equity interests), including taxation of LLC income without regard to cash distributions, impact on employee status, state income tax implications, and liability allocation and tax basis implications for other members. In contrast, an equity option defers issuance of an actual equity interest until the option is exercised, and a equity appreciation right never involves issuance of an actual equity interest.

Another potential drawback of a profits interest is the valuation and accounting complexities associated with issuing such interests. Because a profits interest, by definition, cannot be entitled to share in any portion of the value of the business on the date the profits interest is issued, the company must determine the value of the business on the issuance date and must keep an accounting of that value for the benefit of the existing members. This is generally not a significant problem for a newly formed business with having no significant non-cash assets and wishing to award profits interests to a predetermined class of participants only upon formation or shortly thereafter. But in the case of business that wishes to award profits interests on an ongoing basis, the valuation and accounting issues can be more problematic. Even if the value of the company’s assets can be ascertained with reasonable accuracy on any grant date, the company must adjust the capital accounts of the existing members to reflect that value prior to the issuance of the profits interest. This is commonly referred to as “booking up” the capital accounts and creating “Section 704(b)” capital accounts. This booking up process creates significant accounting complexity, as the company is thereafter tracking three different capital account balances (financial accounting or “book” balances, tax balances, and Section 704(b) balances). Accordingly, where the company contemplates issuing equity interests on an ongoing basis, the valuation and accounting complexities associated with profits interests will often militate against using profits interests as equity incentive awards.

A third potential drawback of a profits interest is the handling of forfeitures (if the interest is subject to vesting conditions or other forfeiture provisions). Complex special allocations of tax items may be required for the year of the forfeiture to account for prior allocations of profits or losses with respect to the forfeited interest. There is also an unsettled question whether the participant is entitled to a deduction for the tax basis of the forfeited interest. In a worst case, the IRS might argue that the participant is not allowed any deduction for the tax basis of the forfeited interest. 32

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for the tax basis of the forfeited interest, and the existing members have an immediate income recognition event (i.e., a “capital shift”) upon the forfeiture of the interest. 33

Because of these drawbacks, an equity appreciation rights plan is sometimes preferable to a profits interest plan. Note that the company might be able to offer a more generous equity appreciation rights plan to account for the fact that participants are not allocated underlying LLC tax items under an equity appreciation rights plan. 34

F. Profits Interest With “Catch Up” Allocation

As previously noted, whereas a restricted equity interest represents a specified share of existing capital and future profits, a traditional profits interest involves a specified percentage of future profits only, and no share of the existing capital. However, it should be possible to structure an LLC profits interest that mimics the economics of a restricted equity interest. For example, if the LLC wants to award a participant a full 5% interest in capital and profits of the LLC (as in the case of a restricted equity interest), but does not want to saddle the participant with the tax burden associated with vesting of a restricted equity interest, the LLC might award the participant a 5% nominal profits interest, but with the added right to receive 95% (or some other disproportionate percentage) of future LLC profits (e.g., gain on a sale of the business) until the participant’s capital account is equal to 5% of the total capital accounts on the award date, after which time the participant would be allocated 5% of LLC profits.

G. Summary

In the case of a business that generates most of its income in the form goodwill and other sources of capital gain, a profits interest preserves the participant’s opportunity for sharing in capital gains generated upon a disposition of the company’s capital assets or upon a sale of the equity interests. However, there are significant complexities associated with a profits interest plan. Where the nature of the business is such that the opportunity for capital gain is not great (e.g., a professional services business that does not generate significant gain from goodwill or other sources), or where the complexities of a profits interest plan are otherwise untenable, an equity appreciation rights plan may be preferable from an overall tax and simplicity standpoint. An equity option plan is generally not a preferred alternative because it requires payment of the

33 Cf. REG–105346–03, 70 Fed. Reg. 29670, 29677 (May 24, 2005) (“Comments are also requested as to whether section 83(b)(1) should be read to allow a forfeiting service provider to claim a loss with respect to partnership income that was previously allocated to the service provider and not offset by forfeiture allocations of loss and deduction and, if so, whether it is appropriate to require the other partners in the partnership to recognize income in the year of the forfeiture equal to the amount of the loss claimed by the service provider. In particular, comments are requested as to whether section 83 or another section of the Code provides authority for such a rule.”). See also Schwartz, supra n. 1, p 44 (noting that forfeiture of a profits interest could raise capital shift issues) and pp. 8-9 (discussing tax consequences of capital shifts).

34 Under a profits interest plan, the company’s long-term capital gains (if any) are allocated among the existing members and profits interest holders, so the ultimate payout to profits interest holders will effectively be taxed at long-term capital gain rates to the extent of their share of such gains earned by the company. In contrast, under an equity appreciation rights plan, the existing members recognize 100% of such gains and other company income, and then obtain an ordinary deduction for the amount paid to the participants. The existing members’ more favorable tax treatment under an equity appreciation rights plan (ordinary deductions versus a reduced share of long-term capital gains) could, if desired, be used to fund a more generous profit sharing percentage for the participants (i.e., they could effectively be “grossed up” for the tax cost of the equity appreciation rights plan). In practice, this may be somewhat difficult to achieve precisely because the portion of the company’s future profits and appreciation constituting long-term capital gain, rather than ordinary income and short-term capital gain, is not generally known on the grant date.
exercise price for the option, does not offer significant tax advantages, and has somewhat uncertain tax consequences.

V. An LLC Special Equity Plan May Achieve Tax Benefits Superior to Other Forms of LLC Equity Compensation Plans

A special equity plan is designed to grant participants the opportunity to share in capital gains on a sale of the business without being required to recognize a distributive share of operating income. This is accomplished by granting participants equity interests that share solely in profits from a sale of the business or other “capital transactions.” Like a regular profits interest, a special equity interest is not taxed on the grant date or the vesting date because the equity interest has no current liquidating value (i.e., no capital interest) at the grant date. However, unlike a regular profits interest (which is allocated a share of all company profits starting immediately after the grant date), a special equity interest is only allocated profits associated with capital transactions. Accordingly, while participants will receive a Schedule K-1 and be treated as an equity owner in the business from the grant date forward, the Schedule K-1 will not reflect any tax items until such time as there is a capital transaction. This significantly simplifies the participant’s interim tax reporting and avoids the need for special tax distributions to participants and state tax filings. When there is a capital transaction, the participant should generally recognize capital gain with respect to his special equity interest to the extent the gain from the underlying transaction is capital gain.

The restrictions on issuing an equity owner a Form W-2 for regular compensation income can be avoided using a holding company to hold the special equity interests on behalf of participants. This can be illustrated as follows:

**Illustration 1 – Special Equity Plan**

A special equity plan is easiest to implement when the operating income of the business is expected to be relatively modest or negative, and the financial success of the business is expected to be realized by selling or refinancing the business at a gain. For example, such a plan might be used for an LLC conducting oil and gas operations, where the objective is to do enough drilling to prove out the reserves, and then sell the business for reserve value rather than current
operating income. Likewise, certain private equity businesses that are focused on turn around investments might use such a plan.\textsuperscript{35}

If operating income may be a significant source of free cash flow that the LLC will periodically distribute to owners, a special equity interest that shares only in profits from capital transactions will not allow holders of the special equity interests to fully participate in profits from the business. In such cases, it might be desirable to allow participants in the special equity plan to share in ordinary distributions through a bonus plan for the participants. The bonus plan would grant to participants a right to receive bonuses (taxed as ordinary compensation income) tied to distributions paid to (or profits earned by) the owners of the LLC’s regular equity.

As discussed above with respect to regular profits interests, if there is a desire to provide participants with a full interest in existing capital as well as future profits (and not just future profits), it should be possible to achieve this through a “catch up” allocation (i.e., a limited, disproportionate allocation) of net gains from capital transactions. The idea is to grant the participant a disproportionate (greater) share of gains until the participant’s capital account is equal to his or her nominal (proportionate) share of equity. This approach will achieve the objective only if sale gains are sufficient to achieve the intended relative capital account balances.

VI. Conclusion and Summary

A client operating a business as an LLC taxed as a partnership will often try to design an equity incentive compensation plan to mimic what publicly traded corporations provide for their key executives. However, because of the tax differences between an LLC/partnership and a corporation, an LLC involves special considerations. In many cases, it is possible to achieve results for an LLC that are superior to those available in a corporate context.

The following table summarizes the LLC equity compensation plans discussed in this article. Recall that only “real equity” offers the participant the opportunity for tax favored capital gains.

\textsuperscript{35} But see footnote 1 regarding potential legislation affecting “carried interests” in certain investment partnerships.
### Table 3 – Classification of LLC Equity Compensation Plans

<table>
<thead>
<tr>
<th>Capital and Profits</th>
<th>Real Equity</th>
<th>Synthetic Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Restricted Equity (Not Recommended)</td>
<td>Phantom Equity</td>
</tr>
<tr>
<td>Profits Only</td>
<td>Equity Options (Not recommended) OR Profits Interest OR Special Equity(^{36})</td>
<td>Equity Appreciation Rights</td>
</tr>
<tr>
<td>Hybrid</td>
<td>Profits Interest with “Catch Up” Allocation OR Special Equity with “Catch Up” Allocation</td>
<td>Hybrid Synthetic Equity(^{37})</td>
</tr>
</tbody>
</table>

Synthetic equity plans offer the most *overall* tax efficient and simple type of LLC equity incentive plan. While the participant’s income is entirely ordinary compensation income, the company obtains an offsetting ordinary deduction for the full amount included in the participant’s income, and the company can therefore generally afford to be more generous with respect to the equity awards.

Real equity plans offer participants the potential for capital gains. However, the offset is that the amount taxed as capital gain to the participant represents a reduction in capital gains realized by the other equity owners, rather than an ordinary deduction. If participants place a high emotional value on the opportunity for capital gains, a profits interest or a special equity plan should be considered.

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\(^{36}\) An interest in profits only from capital events.

\(^{37}\) Any type of real equity plan can be replicated (on a pre-tax basis) using a contractual arrangement requiring a cash payout equal to the economic return of under the real equity plan. Phantom equity units and equity appreciation rights are merely two specific examples of such contractual arrangements.