MANAGEMENT EQUITY INCENTIVES IN LLCs

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OVERVIEW
Limited liability companies (LLC) are the preferred choice of entity for business lawyers since LLCs combine the limited liability benefits of a corporation with the significant tax advantages and flexibility available to partnerships. Equity incentive compensation for the management team is as critical to the success of the entity in the LLC context as in the corporate setting. However, unlike corporations, ownership interests in an LLC take the form of membership interest rather than stock. Thus, traditional equity compensation arrangements such as restricted stock, stock options and ESOPs are not available to LLCs. Fortunately, the flexibility inherent in LLCs offers an attractive way to deliver equity-based incentives to management on a tax-advantaged basis.

A typical feature of equity plans is to align the interests of ownership and management by allowing management to share in the future growth in the value of the business. A “profits interest” in and LLC accomplishes that core objective since it represents an interest in the increase in the value of the LLC over time. The key feature that distinguishes a profits interest from a traditional membership interest in the LLC is that the profits interest must have no value if the LLC was liquidated and its assets distributed immediately after the grant of the interest. Thus, a profits interest is similar to a stock appreciation right or a fair market value stock option since it has no value if the LLC does not increase in value. In addition, if the management team is not required to purchase the profits interest, like an SAR or stock option plan, there is no downside risk to the recipient of the profits interest if the LLC decreases in value.

Sometimes ownership will want management to have some “skin in the game” by requiring the management team to purchase the equity. The purchase price should be at equal to a supportable fair market valuation of the LLC in order to avoid adverse tax consequences. If equity values are high, the LLC can fund a portion of the purchase price through a non-recourse note secured by the membership interest. Care must be taken under such an arrangement to comply with applicable securities laws since the management team risks losing its investment if the value of the LLC decreases. Unlike the issuance of a profits interest, the equity purchased by the management team has current value upon an immediate liquidation. If the executive leaves the LLC before a liquidity event, the documentation should provide that, at a minimum, the executive gets back the money he paid to purchase the membership interests (less any interest owed to the LLC in connection with any financing provided to purchase the interests).
TAX AND ACCOUNTING CONSIDERATIONS

As compared to the various traditional corporate equity incentive plans offering “free equity” to management, the grant of an LLC profits interest has a number of tax benefits. Holders of Incentive Stock Options (“ISOs”), Nonqualified Stock Options (“NQOs”) and Stock Appreciation Rights (“SARs”) typically get taxed at ordinary income rates upon a company liquidity. SARs are always taxed at ordinary income rates and so are options since the options are typically cashed out concurrently with the liquidity event and the one year capital gains holding period is not satisfied. In contrast, the owner of an LLC profits interest always receives capital gain upon an LLC liquidity event if the holding period is satisfied. While the owner holder of restricted stock that filed and 83(b) election would also typically receive capital gain treatment upon a company liquidity event, if the company has equity value at the time of the grant, and the restricted stock is granted for less than fair market value, the recipient is taxed at the grant at ordinary income rates.

From an overall tax efficiency perspective, it should be noted that the corporation gets a corresponding deduction equal to the amount of the ordinary income received by the holder of an NQO or SAR upon a liquidity event. In contrast, the LLC does not receive a deduction with respect to liquidity proceeds received by the holder of an LLC profits interest. Accordingly, depending on the tax situation of the issuing company, it may make sense to give holders of NQOs/SARs additional compensation to offset the incremental tax cost of the ordinary income treatment, since the company will be able to take advantage of the corresponding tax deduction. However, in the case of a privately-held company, the value of the deduction to the company may not be compelling if the company does not have meaningful taxable income to shelter.

One should also be cognizant of the differing accounting treatment applicable to the various types of incentive plans. For stock option plans (ISOs and NQOs), the accounting charge is based upon the Black Scholes value at grant. The charge to the corporation for restricted stock is calculated based upon the spread between the fair market value of the stock at grant and the amount paid for the stock. The calculation of the accounting charge for LLC profits interest is based on a binomial model and other complex factors.

FLEXIBILITY

The beauty of LLCs is that the terms of the profits interest can be designed in any way that the LLC wants. Distributions of earnings do not have to be made in proportion to the owner’s equity stakes and are not governed by statutory rules. For example, an LLC can structure profits interests so that once the holders of invested capital have gotten their money back, all equity holders shall proportionately in any liquidity proceeds. The LLC could also be structured so that the holders of the profits interests do not participate until
the holders of invested capital have been paid a preferred return on their invested capital. The LLC could also create multiple classes of profits interests which reflect a “kicker” in the event that the management team meets certain outsized performance targets.

LLC profit interests can be structured with any vesting terms desired by the LLC; however, performance-based vesting may require variable accounting (adjusting the charge to earnings each year to take into account value changes and vested amounts). Profits interests can be structured to participate only upon a liquidity event or to participate in distributions of current LLC earnings. Generally, distributions of earnings are based on vested units.

Unlike in the corporate context, it is important to keep in mind that if a regular membership interest is issued to management (as opposed to a profits interest), the holder is treated as a partner for tax purposes and will receive a K-1 and be subject to self-employment taxes (FICA and FUTA). Generally the issuance of a profits interests will not result in the employee being subject to self employment taxes.

The flexibility of issuing LLC profits interests can be taken advantage in almost any acquisition context. For example, in a transaction where a buyer intends to purchase a target that is a C corporation or operate the business as a C corporation in order to exit via IPO or reorganization, an LLC holding company can be formed to hold the C corporation stock. In such case, unrelated business taxable income and effectively connected income should generally not be an issue. If the target is a flow-thru entity, various structures can be utilized, such as C corporation blockers, to address the issue of UBTI and ECI.

CONCLUSION

The enormous flexibility of LLCs creates suburb planning opportunities to craft management equity plans that are tailored to the unique attributes of the business and align the interests of ownership and management to grow the enterprise value of the business. Whether through an equity purchase plan or the issuance of a profits interest tied to the future growth of the business, an LLC’s flexibility allows the management team to build equity that will be taxable at capital gains rates while at the same time enabling the LLCs ownership to limit dilution and focus management on initiatives that will grow the equity value of the business.