

Equity Incentive Compensation for Management

~ Michael J. Wilson

Privately held businesses provide equity incentive compensation to their management teams for many reasons. According to a February 2014 survey by WorldatWork and Vivient Consulting, the most common reasons are for management retention and recruiting, and to align management incentives with the long-term goals of the business. Here we will explain some of the primary characteristics, including tax impacts, of the most common equity incentive compensation methods used by privately held businesses for their management teams. These methods are also commonly used for directors of corporations or managers of limited liability companies.

The equity incentive compensation methods discussed in this article are restricted shares or units, profits interests, phantom equity or interests (also known as “synthetic equity”), and non-qualified options. Each of these methods has its own advantages and disadvantages, and there is no one-size-fits-all solution. You should give careful consideration and analysis to each before selecting any method and understand that not all methods are available to all businesses under the tax code. Moreover, none of the methods is exclusive—sometimes businesses may use more than one method and sometimes they may combine methods for the same employee. This overview assumes that the company providing the equity incentive compensation is, like most privately held companies, taxed as either a partnership or an S corporation for federal income tax purposes, not as a C corporation.

Restricted Shares or Units

Restricted shares, in the case of a corporation, and restricted units (or a capital interest), in the case of a limited liability company or partnership, involve the granting of an equity interest that is subject to certain restrictions. These restrictions typically relate to vesting, transferability, and forfeiture. For example, an equity award might vest ratably over a certain number of years, and vesting might accelerate upon a change of control. If one of your employees quits, then he or she would typically forfeit any unvested shares or units and would either be able to retain or be forced to sell his or her vested shares or units. If you terminate an employee for cause or for breaching a post-employment covenant, such as a non-compete or non-solicitation provision, both vested and unvested shares or units might be forfeited.

A major obstacle in granting restricted shares or units is the tax impact to the employee. In general, the fair market value of the restricted shares or units granted to your employee or other person as compensation for services is taxable to the employee as ordinary income when the shares or units become “substantially vested,” which generally means the shares or units are either transferable or not subject to a substantial risk of forfeiture. At that time, the value of the shares or units, and thus the tax impact to the employee, could be very large.

If the value of the restricted shares or units is relatively low at the time of grant, the employee may want to consider making a so-called “section 83(b) election” to have the value of the shares or units taxable as of the grant date, instead of at the later date when the shares or units become substantially vested and potentially have a much greater value. The appreciation in the value of the shares or units after the grant date would be taxable as capital gain upon a sale or other realization event, but the employee generally cannot claim a deduction for any loss in value after the grant date. The employee would not be eligible for a tax loss if he or she forfeited the shares or units prior to vesting. Consequently, the employee must carefully weigh the tax impact of making a section 83(b) election to accelerate the gain recognition at the time of grant against not being able to take a tax loss if the unvested shares or units are later forfeited.

Your company may claim a compensation deduction at the time the employee recognizes compensation income from the grant of the shares or units. The company does not receive a deduction for the amount taxed to the employee as capital gain.

One structure that is sometimes used to mitigate the tax impact of granting restricted shares or units is for your employee to purchase the ownership interest at its fair market value in exchange for a promissory note with a modest amount of cash paid upfront. By structuring the acquisition of the ownership interest as a purchase instead of it being granted in exchange for services, the employee is not taxed upon the receipt of the interest. In these circumstances, the promissory notes often have a relatively long term and a low interest rate, and they provide for annual, interest-only payments with a balloon at maturity. Often, these notes would be repaid using cash or a portion of the cash that would otherwise be distributed to the employee. However, you must give careful consideration when structuring these transactions to increase the likelihood that the IRS will respect the transaction as a true purchase of the ownership interest. This structure is more commonly used by S corporations because, as explained below, they cannot grant profits interests.

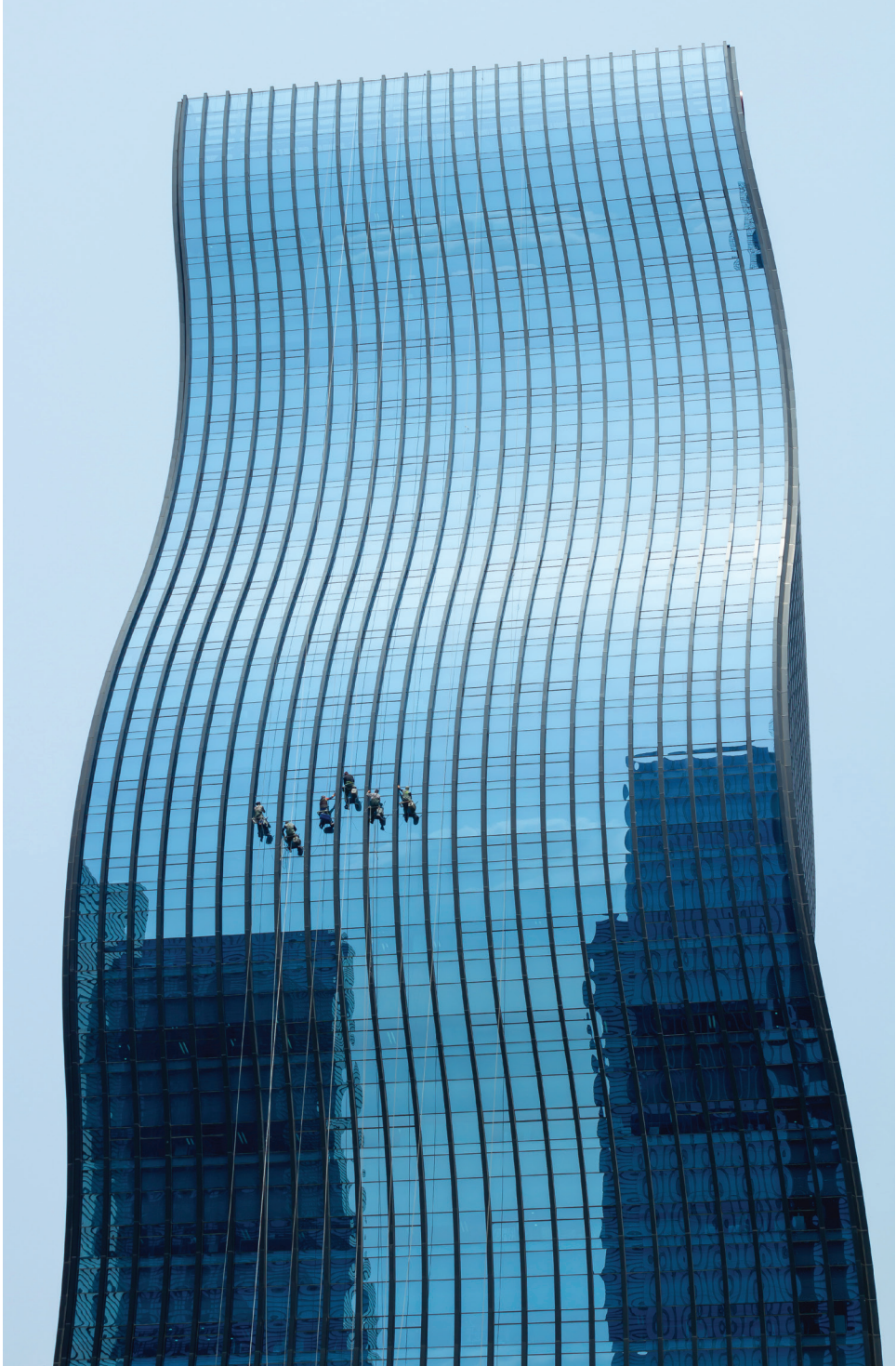
Profits Interests

Profits interests are an extremely popular method for limited liability companies taxed as partnerships and state law partnerships to provide equity incentive compensation to management and other employees. While a regular ownership interest (known as a capital interest) entitles the holder to a share of the current assets and future profits and appreciation, a profits interest entitles the holder only to a share of future profits and appreciation. The special distribution rights limiting the holder of a profits interest to only future profits and appreciation are normally described in the operating agreement or partnership agreement of the issuing entity.

Because a profits interest only provides for the right to future profits and appreciation, the grant of the interest is generally not taxable to the employee at the time of receipt or at vesting. More precisely, the grant of a profits interest is generally not taxable to the employee at grant if (1) the profits interest is not related to a substantially certain and predictable stream of income, (2) the profits interest is not sold within two years of grant, and (3) the company is not publicly traded. The grant of a profits interest is not deductible by the business.

Before a holder of a profits interest is entitled to any distributions, the pre-existing owners must first receive cumulative distributions at least equal to the fair market value of the business immediately prior to the grant of the profits interest. It is helpful to look at an example that illustrates the mechanics of the distribution rights of a profits interest. If a limited liability company has three members, with members A and B each owning 40 percent and each having contributed \$250,000 in cash to the business, and if the business granted a 20 percent ownership interest to C in exchange for services at a time when the fair market value of the business was \$1,000,000, then after the grant to C, members A and B would be entitled to receive the first \$1,000,000 of distributions made by the business (sometimes referred to as a “hurdle amount” or “participation threshold”), and every dollar distributed after that \$1,000,000 would be distributed to the members in proportion to their ownership interests: 40 percent to A, 40 percent to B, and 20 percent to C.

The example above assumed that once the \$1,000,000 participation threshold was achieved, A, B, and C would share distributions in proportion to their ownership interests. However, sometimes businesses want to provide profits interest holders with economics that are closer to a regular ownership interest (or capital interest). To achieve this goal, the operating agreement could provide that once the participation threshold is satisfied, special distributions (sometimes referred to as “catch-up” or “fill-up” distributions) would be made only to the profits interest holders to catch them up to the distribution amount they would have received if they were entitled to receive their proportionate share of the participation threshold. For example, if the limited liability company in our previous example was going to make a distribution of \$1,300,000 and a catch-up allocation was used for C, then the first \$1,000,000 (the participation threshold) would be distributed: \$500,000 to A and \$500,000 to B. Then the next \$250,000 would be distributed solely to C, and the remaining \$50,000 would be distributed to A, B, and C in proportion to their ownership interests—40 percent to A, 40 percent to B, and 20 percent to C. This distribution scheme results in C receiving the same amount of cash (\$260,000) as if C had participated in the entire \$1,300,000 distribution at C’s 20 percent ownership interest. Therefore, if the business generates sufficient profits, the profits interest holder can realize the same economic value as the holder of a capital interest.



The tax advantage of a profits interest is that the grant of the interest is generally not taxable to the employee at the time of receipt. If, in the example above, the company granted member C a regular 20 percent ownership interest (assuming the interest was substantially vested), then, ignoring any applicable valuation discounts, the \$200,000 of value (20 percent of the \$1,000,000 fair market value of the business) granted to C would be treated the same as if the company paid C \$200,000 in cash. This means that C would be subject to ordinary income tax and self-employment tax on the \$200,000 even though C did not receive any cash at the time of the grant. C would generally not be happy with a large tax bill and no cash.

All ownership interests in an S corporation are required by applicable tax law to have the same distribution and liquidation rights. Consequently, S corporations cannot issue profits interests.

Phantom Equity

Phantom or synthetic equity is not truly an ownership interest in the business. Instead, it is a contract between the business and the employee designed to mimic all or part of the economics of having a true equity interest in the business. Phantom equity arrangements are usually structured by granting the employee a certain number of “award units” that mirror the value of a true ownership unit in the business. Payments made under the phantom equity agreement can be triggered by various events, including a sale of the company or upon termination of employment without cause. Like true equity, phantom equity can also be subject to a vesting schedule so that employees receive the benefit over time instead of all at once.

Because phantom equity is not true equity, it does not have voting rights and does not give the holder statutory inspection rights of the business’s book and records. Furthermore, the majority owners, officers, and manager/directors of the business do not owe fiduciary duties to phantom equity holders as they do to holders of true equity interests.

Phantom equity arrangements are not taxable upon receipt or vesting. Employees are taxed when they receive payment pursuant to the phantom equity arrangement. Such payments are treated just like any other cash compensation paid to employees, so the payments are ordinary income to the employees (reported on the employees’ W-2s), deductible by the company, and subject to payroll and withholding taxes.

In our experience, phantom equity is more commonly used by S corporations, rather than by tax partnerships, to provide equity incentive to their management. This is primarily because S corporations cannot issue profits interests under applicable tax law and because of a general desire to avoid the potential negative tax implications of granting restricted shares or units.

Options

While stock options are commonly used by public companies, over the past decade, stock and other options to acquire equity have become much less frequently used by privately held businesses. One reason for their prevalence in public companies is that the public company employee has a ready market to sell some of the stock upon exercise to pay the resulting tax. The reason options are not common for privately held businesses is that, for tax reasons, the exercise price is generally equal to the fair market value of the underlying equity on the date the option is granted. This often means that employees have to pay a large sum to exercise the option, which can significantly limit their incentive and economic benefit.

Generally, an employee is not taxed on the receipt or vesting of an option to acquire stock or other ownership interest in a privately held business. However, when the option is exercised, the employee recognizes ordinary compensation income on the excess of the fair market value of the stock or other ownership interest on the exercise date over the exercise price. Any appreciation in the value of the stock or ownership interest after the exercise date is generally taxed as capital gain.

The business is entitled to a deduction at the time of exercise (i.e., when the employee is taxed) equal to the amount taxable to the employee. The business does not get a deduction for any amount taxed to the employee as capital gain.

Summary

In our experience, businesses taxed as partnerships (most limited liability companies and state law partnerships) that anticipate having significant capital gain upon a future sale generally prefer a profits interest as their method of providing equity incentive compensation to management. One primary reason for this is that a profits interest permits capital gain treatment to the employee. On the other hand, where significant capital gain is not anticipated and the business wants simplicity in its ownership structure and agreements, then phantom equity is typically the best method. Because businesses taxed as S corporations cannot issue profits interests, phantom equity is often the best method for them to provide equity incentive compensation to their management team.



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