Designing Equity Compensation and Employment Agreements for Startup and Emerging Growth Companies

Drafting Confidentiality and Non-Disclosure Provisions; Structuring Employee Stock Options, Restricted Stock and Deferred Comp

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Today’s faculty features:

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1. **OVERVIEW**

Individuals often desire to invest in an LLC by performing services instead of paying cash. In other cases, the Company may want to award a key employee with an ownership interest in the LLC. Both of these scenarios are common in the corporation context. However, in the LLC context, whether the Service Provider’s investment is characterized as a “Capital Interest” or as a “Profits Interest” will have significant tax consequences for the Service Provider and the Company. In addition, receiving an either type of LLC ownership interest will have major consequences on the Service Providers employment status.

These tax and employment consequences are so major that I typically advise founders to form new companies as corporations if they expect periodic equity grants to be an important part of their compensation plan, in the absence of compelling other reasons to be an LLC. Existing LLCs that desire to provide periodic equity compensation to non-member Service Providers should give serious consideration to either converting to a corporation or using a cash-based program that tracks increases in the Company’s value (called Value Appreciation Rights or Equity Appreciation Rights), much like a stock appreciation right plan.

That being said, there are many cases where an LLC desires is to award or sell a Service Provider an interest in the LLC in order to bring them in as an owner for reasons that are not purely compensatory. In those cases, or where the corporate form is more disadvantageous on balance, it is very important for the business attorney to have a working knowledge of the pros and cons of each of the available structures and methods for awarding equity compensation or sweat equity, in order to avoid very unpleasant surprises.
2. **EMPLOYEE VS. OWNER**

If the intended recipients of LLC equity grants are employees, your clients should first consider the employment tax and benefits issues, before getting bogged down in the myriad of structuring and income tax issues. In my experience, these issues too often get overlooked until after the grants are made and then your clients may have very some unhappy (ex)employees. If these issues are significant enough to derail the idea of actual equity compensation, you can avoid going through all of the income tax issues with them.

Under partnership tax law, when an LLC employee receives an equity award, regardless of how small a percentage the employee receives, the employee become an owner for tax purposes. The consequences of being characterized as an owner include the following:

- The Service Provider will now receive their gross pay without withholdings, and will be responsible for computing and paying quarterly estimated taxes and other required withholdings, as would an independent contractor. This will probably require the Service Provider to engage a tax accountant if they do not already have one.

- The Service Provider will be responsible for all 12.5% of the employment taxes on their wages, which includes the 6.5% paid by the Company for employees. In addition, it is possible that the IRS may characterize any non-wage distributions from the LLC’s profits as subject to the unemployment tax as well, although proper structuring of the Service Provider’s wages as a guaranteed payment may avoid that result.

- The Service Provider will no longer be eligible to participate as an employee under any ERISA cafeteria benefit plans, including any employee health insurance programs. In a small LLC without health insurance benefits, this may not be an issue. However, if the Service Provider is currently insured under a Company health plan, and now has to purchase a private plan, the differences in cost and available coverages could be significant.
Some LLC’s agree to increase a Services Provider’s compensation when they become an owner in order to cover these additional taxes and costs; however, that increase also will be taxable income to the Service Provider. Particularly where the equity award is a very minority interest, or does not include voting rights, these consequences simply may not be worth it to the Service Provider.

3. NATURE OF THE EQUITY AWARD

When considering equity compensation in the LLC context, the most important question is what will the Service Providers receive: a Capital Interest or a Profits Interest? In order to understand this threshold issue, I will recap the nature of an LLC Interest.

Basically, an “LLC Interest” is composed of three parts which can be computed separately: voting rights and two categories of economic interests: an interest in the Company’s existing capital accounts (“Capital Interest”) and rights to future profits (“Profits Interest”). In a corporation, the economic interests cannot be separated. Voting rights can be removed for a specified class of stock, but within a class all voting rights must be the same. However, in an LLC, all three components can be different, on a class or an individual basis, depending on how the LLC Agreement is written, and on the terms of the equity incentive plan or the Service Provider’s individual award agreement.

3.1 Capital Interest. A Capital Interest in the LLC’s capital accounts represents an undivided percentage ownership in the LLC’s underlying assets, plus any currently unrecognized appreciation in the value of those assets. The amount in each member’s capital account is equal to (a) the member’s investment, plus (b) the amount of any Company profits allocated to the member, and minus (c) any Company losses allocated to the member. The relative percentages of the members’ capital accounts are generally the basis for distributing the LLC’s assets on liquidation, but may also be used to determine voting, and other rights, depending on how the LLC Agreement is written.

3.2 Profits Interests. An LLC member’s Profits Interest is the percentage of the LLC’s future income and losses allocated to that member, although the amount actually distributed to the investor will be
governed by the LLC Agreement. A Service Provider who receives Profits Interest only will start with a capital account of zero, which is then only increased as the Company allocates more profits than losses to the member.

4. TYPES OF EQUITY AWARDS

In the corporate context, there are several types of equity awards that have evolved: (a) Incentive Stock Options1 (“ISOs”), (b) stock options that do not qualify as Incentive Stock Options (“Nonqualified Stock Options” or “NSOs”), (3) stock grants and bonuses, and (4) stock appreciation rights. In my materials at Appendix A is a memorandum that provides an overview of these equity compensation vehicles and their tax consequences (the “Stock Incentive Plan memo”). In the LLC context, ISOs are not available are they only apply to corporate stock, and each of the other awards has to be adapted significantly to conform to partnership accounting.

4.1 Non-Qualified Options. Granting true options to purchase a specified LLC interest at some point in the future is particularly problematic, if not, as some commentators hold, impossible, given the nature of partnership accounting.

4.1.1 Capital Interest Options. Granting an option that grants the Recipient the right to purchase a specified percentage of the Company’s Capital Interests in the future would not only cause the undesirable transfer tax issues discussed in Section 7 upon exercise, but the actual magnitude of the tax impact on the Company, its then-existing members, and on the exercising option holder, would be impossible to determine in advance.

4.1.2 Profits Interest Options. LLC options are therefore typically structured as a right to purchase a specified percentage Profits Interest in the future for a specified exercise price. If exercised, the option exercise price would become the amount of the exercising option holder’s initial

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1 Options that meet the requirements of Sections 421 and 422 of the Internal Revenue Code.
capital account. However, setting the exercise price is inherently problematic because by definition a Profits Interest is worth zero at exercise (assuming the Company “books up” its assets immediately before the option exercise – see Section 5 below), unlike the shares purchased upon exercise of a stock option. However, if the Company does not “book up” its assets, the exercising option holder would also receive its percentage of the unrecognized increase in the LLC’s underlying asset value, effectively purchasing some the existing members’ Capital Interests; an unintended and taxable “capital shift”.2

The stated goals of most option plans include retention and aligning the Service Provider’s goals with the interests of the enterprise, through current or potential equity ownership. Without a book up, the Service Provider would receive some portion of the asset value increase between the option grant date and the option exercise date, even though taxable at exercise. However, if a book up is done to avoid a capital shift and its attendant taxable events, it is hard to see how a Service Provider would be very incentivized by receiving an option to pay cash to purchase a Profits Interest worth zero upon exercise, with no assurance of distributions or that the Profits Interest will ever be worth even the exercise price.

4.2 Restricted Interest Grants and Bonuses. In my view, the better approach to accomplish retention and incentivization goals is to grant restricted interest bonuses or grants, which are subject to vesting over the specified period of years. All recipients of a Restricted Interest Bonus or Grant should be required to sign the LLC Agreement and a Buy-Sell Agreement if the LLC Agreement does not contain sufficient buy-sell provisions. See the Buy-Sell Provisions discussion included as Appendix B.

4.2.1 Restricted Profits Interests. For an existing LLC, granting restricted Profits Interests no more than once a year after a book up of the LLC’s assets, would give the Service Providers the ability to begin receiving allocations of profits even during the vesting period. If they leave the Company before fully vesting, they would forfeit the unvested portion and the Company would repurchase any vested portion under the formula stated in the award agreement.

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2 The IRS has confirmed that it will consider these options as bifurcated between an option to purchase the stated Profits Interest and the unintended Capital Interest.

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(a) **Section 83(b) Election.** Since the awarded Profits Interest is subject to forfeiture during the vesting period, the Recipient could elect, under IRC Section 83(b), to be immediately taxed on its value, which is zero at issue, rather than its value upon vesting. See the Stock Incentive Plan memo regarding the benefits and risks of the recipient making a Section 83(b) election. In Rev. Proc. 2001-43, IRB 2001-34, the IRS concluded that the vesting of a Profits Interest will not lead to a further taxable event when the vesting event occurs, provided (i) the partnership or LLC doesn’t take a deduction in connection with the vesting, and (ii) none of the exceptions in Rev. Proc. 93-27 apply.

(b) **Sample Agreement.** Appendix C is a sample Restricted Interest Bonus Agreement awarding an employee a 20% future profits interest. This agreement is structured as an outright grant of a 20% LLC interest, which the recipients will forfeit incrementally if they don't stay a full four years. This structure is referred to a "forfeiture" schedule rather than the term "vesting" that you hear in the stock option context. This sample has the forfeiture risk being released annually, on 25% of the Award (equates to 5% of the Company's total LLC interests). You could set a biannual, quarterly, or even monthly schedule, but I generally recommend annual release schedule because they are easier to administer at the same time as the Company's books are being done, and in order to avoid mid-year book ups.

Once the forfeiture period has passed, termination of employment will be an Event of Withdrawal under the LLC Agreement, which will trigger the Company's repurchase rights. If the recipient is terminated for "cause", the Company’s repurchase price would be the lower of the fair market value of the Profits Interest on the date of grant, or the fair market value on the termination date. The Company’s repurchase price if termination is for any other reason would be fair market value on the termination date.

4.2.2 **Restricted Capital Interests.** Awarding a restricted Capital Interest to a Service Provider would cause the same undesirable transfer tax issues as discussed in Section 7. However, restricted Capital Interests can be a good way to include sweat equity members at the formation of an
LLC, so long as the initial capital accounts are set up in the desired ultimate percentages, in order to prevent taxable capital shifts. Capital contributed by the investor members would need to be structured as a separate class of interests or as loans. The sweat equity members’ Capital Interest would be subject to forfeiture over a specified period or as the investor members’ loans are repaid. A sample of a very complex arrangement of this nature is attached as Appendix D.

4.3 Value Appreciation Rights. Value Appreciation Rights or Equity Appreciation Rights plans and awards are cash-payment programs that pay Recipients a bonus computed using a formula based on increases in the Company’s value), much like a stock appreciation right plan. See the Stock Incentive Plan memo regarding the mechanics of appreciation rights awards. In the LLC context, these plans are often set up as “unit” plans for ease of tracking incremental increases in value, but percentage based plans also work. Since these plans are not actual ownership interests, they do not risk inadvertent capital shifts or taxable events, other than the tax due upon actual payment. But caution: These plans may easily run afoul of the new Section 409A deferred compensation rules, so must be structured very carefully in order to avoid Section 409A’s extremely onerous penalties.

5. BOOKING UP THE LLC’S ASSETS

A “book up” involves increasing the existing capital accounts to be equal to the actual value of the assets. This is a taxable event to the existing members, but then causes an increase in their basis in their LLC interests. Often, an LLC agreement provides for book ups "in connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership," as described in the regulations, §1.704-1(b)(iv)(f).

To give a Service Provider a Profits Interest (either a restricted grant or upon exercise of an option) it is generally necessary to value the LLC’s assets, and "book up" the capital accounts of the existing members. While the concept of doing a book up in connection with the performance of services
makes excellent sense and complies with the concept of regulation §1.704-1(b)(iv)(f), (it refers to "adjustments [that] are made principally for a substantial non-tax business purpose"), however, no reference is made to adjustments in connection with contributions for services.

6. SECURITIES ISSUES

LLC interests are generally considered securities for purposes of the federal Securities Act of 1933 (the “Securities Act”) and state securities laws. See the Securities Law Issues discussion included as Appendix E. The issuance of LLC interests to Services Providers therefore would be an offering of securities.

Fortunately there are exemptions from registration available under the federal Rule 701 of the Securities Act and in Washington under RCW 21.20.310(10). No filing is required under federal Rule 701. Washington, however, requires that the plan, or award agreement if it is a stand-alone grant, be filed 30 days before the first grant. Fortunately, the Washington securities division usually responds well before the 30 days has expired, that the grants can commence. A sample filing letter and response is attached as Appendix F.

Unfortunately, each state has different exemptions and requirement governing employee equity plans. One of the first questions for any client is what states their proposed recipients reside, in order for you to check the blue sky laws of each of those states for available exemptions and filing requirements.

7. PROS AND CONS OF CAPITAL INTEREST VS. PROFITS INTEREST GRANTS

The following discussion is a very simplified discussion of complex and unresolved tax issues, and is intended to give you a general understanding of the issues when advising clients to involve their CPA and tax counsel in the equity compensation structuring process. For the most understandable discussion I have read covering the full scope of the issues, I recommend you to “A Layman’s Guide to LLC Incentive Compensation” by Linda Z. Swartz, which you can download from:

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Once you read it, I suspect you will be as amused by the title as I was!

**Capital Interest**

*Cons.* If the value of the services invested is characterized as a Capital Interest, the IRS looks at it as if Company or its existing members have paid the Service Provider cash for the services, and then the Service Provider has used that cash to purchase a Capital Interest from the Company or the existing members. The Service Provider will receive a Schedule K-1 from the LLC that reports a guaranteed payment equal to the value of the employment or other services provided to the Company by the Service Provider. This amount is taxable income to the Services Provider in the year the services were provided, even if the LLC did not distribute any cash to the Services Provider, i.e. it is “phantom income”. Also, the IRS may tax the other LLC members on the spread between the book value of the purchased Capital Interest and its current Fair Market Value on the date of issuance.

*Pros.* Since the Service Provider receives a Capital Account balance equal to the amount of the services rendered, the Service Provider will also receive an allocation of the LLC’s profits or losses equal to its Capital Account percentage. Any allocated losses may offset some part of the Services Provider’s taxable phantom income from the services investment, since the amount of those losses will reduce the Service Provider’s capital account balance.

**Profits Interest**

*Pros.* The receipt of a Profits Interest is generally not a taxable event.3 If the Services Provider received a Future Profits Interest in exchange for the services, its initial Capital Account will be zero and

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3 *Sol Diamond*, 56 TC. 530, aff’d. 492 F.2d 286 (7th Cir. 1970); *Campbell v. CIR*, 943 F.2d 815 (8th Cir. 1991), and Rev. Proc. 93-27, 1993-2 C.B. 343.

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it will not have taxable phantom income for the year the services were provided. Each year that the LLC has profits, the Services Provider will be allocated its stated percentage of those profits, which will increase its Capital Account above zero. The Service Provider will have taxable income equal to the amount of the profits allocated to it.

Cons. The Service Provider who receives only a Profits Interest generally will not be allocated any of the LLC’s losses so long as its Capital Account is zero. Those losses are instead allocated among the investors who contributed cash in proportion to their Capital Accounts percentages. As a result, the Services Provider will not realize any benefit from its investment until the LLC becomes profitable and begins to issue distributions. In some cases, the value of the Services may be booked as an account payable, but in other cases this not feasible for various reasons.

Example. Here is the analysis for a Service Provider who received a 2.08% Class A Interest in an LLC instead of cash for its $18,000 fee. The Class A Interests were capital account investments and were entitled to a 10% preferred return before pro rata distributions to the Class A and Class B investors. The Class B Interests were future profits interests only issued to non-cash investors.

1. If the $18,000 fee is accounted for as the purchase price of a 2.08% Class A Interest, then Service Provider will start with a capital account equal to $18,000 as if it had paid cash for the Class A Interest. Each year, Service Provider's capital account will be increased by its percentage of the LLC's profits and accrual of the preferred return, and decreased by The LLC's losses and payments against the accrued preferred return. For 2006 tax year, Service Provider will receive its percentage of the losses allocated to the members. When the LLC liquidates, Service Provider will receive a maximum of its entire $18,000 capital account back, plus its pro rata share of the cash available after all of the capital

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Rev. Proc. 93-27 does not apply to the receipt of (a) a profits interest that is "certain and predictable", (b) profits interests that are disposed of within two years of receipt, or (c) a profits interest in a publicly traded partnership.

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accounts have been paid back, including whatever amount has accumulated in its capital account from profits allocations.

2. The IRS considers the value of Service Provider's capital account, ie. $18,000, as taxable income. Service Provider will then have to include this "phantom" income in its tax return and pay tax on it even though it did not receive any cash distributions from the LLC this year. In order to address this cash flow issue, the LLC could make a cash "tax distribution" equal to an agreed-upon tax rate multiplied by the $18,000, so that he has the cash to pay that tax. The amount of the distribution is also taxable, so the LLC could round up the tax distribution to approximate the actual tax burden.

In this case, if the LLC can't or doesn't elect to pay Service Provider a cash tax distribution, then the choices are for (a) Service Provider to accept the tax burden and retain its Class A Interest, or (b) for Service Provider's fee to be booked as an account payable, and for Service Provider to receive a Class B interest that starts with a zero capital account, i.e. a 2.08% "profits interests" as additional compensation.

With a "profits" only interest, Service Provider will only be taxed on (1) payments it actually receives on the $18,000 account payable, and (2) 2.08% any profits which the LLC earns and allocates to its members in future years. Service Provider will not receive the preferred return. In addition, Service Provider will have to wait to use any losses allocated to the LLC's members until its capital account has been increased above zero by profit allocations in future years.