Tax Considerations for Employee Equity Incentive Compensation

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For companies seeking to attract and retain key employees, there often comes a time when discussions turn to granting equity-based incentive compensation. Employee equity grants are often done on an individual basis or through a formalized plan. The tax impact of equity incentive compensation on employers and employees differs depending on the type of entity issuing the compensation.

For both C corporations and LLCs taxed as partnerships, there is a tension between the employer and employee regarding the tax character of equity grants: Employers prefer to grant equity taxed as ordinary income, which would result in a deduction on the part of the company, while employees prefer to receive equity that will provide long-term capital gains treatment in whole or in part. Below is a discussion of some common forms of equity compensation for both C corporations and LLCs as well as their tax considerations and practical implications.

Equity Incentives Offered by C Corporations

Stock Options

For C corporations, the tax impact of stock option grants– the most common type of employee equity compensation – are relatively straightforward and depend on whether the options are an incentive stock award (ISO)[1] or a nonqualified stock option (NQSO) [2]: In general, ISO grants are not deductible by the corporation and there is no tax event for the employee at the time of receipt or at the time of exercise.[3] Upon the sale of stock, recipients of ISOs are also entitled to capital gains treatment on the appreciation of stock if the employee holds the stock for the requisite long-term holding period (currently one year) prior to sale. [4] Grants of NQSOs are generally not a tax event for either the company or the recipient at the time of the grant. However, the excess of the fair market value of the stock acquired on the exercise of NQSOs over the exercise

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price is ordinary income to recipients and corporations may deduct the amount of such ordinary income.[5]

Restricted Stock Awards

A restricted stock award (RSA) is a grant of stock, subject to vesting, which is taxed as ordinary income upon vesting and is deductible by the corporation, based on the fair market value of the stock at the time of vesting. Alternatively, a recipient of an RSA may make an irrevocable election under IRC § 83(b) to recognize taxable income immediately upon receipt of the grant equal to the fair market value of the stock at the time of the grant of the RSA. In the case where an election under IRC § 83(b) is made, the corporation would also be able to deduct the fair market value of the RSAs at the time of the grant.

Restricted Stock Units

A restricted stock unit (RSU) is a promise from the corporation to deliver stock or cash to the employee at a specific time in the future. RSUs are treated as deferred compensation rather than property, so there is no tax event at the time of grant.[6] When RSUs are actually or constructively paid, the recipient recognizes ordinary income, reportable as W-2 wages, and the corporation may deduct the amount of such compensation.[7]

Equity Incentives Offered by LLCs

Unlike C corporations, things are not so straightforward for LLCs taxed as partnerships. In addition to the tax character of gains, other frequent issues arise relating to the admission of new partners, restrictions on employee-owners, and myriad other complications. Key issues for LLCs to keep in mind prior to granting equity-based incentives to employees are set forth below.

Profits Interests

A profits interest represents a full ownership interest in the future growth of an LLC (both its profits and assets) beginning on the date of the grant. Put another way, the recipient of a profits interest

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would not be entitled to any distribution from the LLC if the LLC were to liquidate on the date of the grant. However, if the LLC were to liquidate at a later time, the holder of a profits interest would be entitled to a distribution to the extent the value of the LLC had increased after the date of the grant. The grant of a profits interest is generally not taxable at the time of the grant or at the time of vesting (in the case of restricted profits interests) for either the recipient or the LLC.[8] Gains from the sale of a profits interest are generally taxed as capital gains.[9]

Granting profits interests to employees can create a host of additional complications. For example, holders of profits interests are considered partners in the LLC for tax purposes and will receive a Form K-1. A holder of a profits interest cannot be treated as an employee for federal employment tax purposes[10] and is also ineligible to enroll in benefit plans offered by the LLC to employees. [11] Instead of wages, any payments made to holders of the profits interests by the LLC are characterized as guaranteed payments for services. Holders of profits interests must self-withhold FICA and make estimated tax payments on any income allocated to them by the LLC; holders of profits interests may also may trigger state tax nexus requiring filing obligations in states outside of their state of residence.

Because profits interests are frequently created as a new class of units, the issuance of profits interests will likely require an amendment to the LLC's operating agreement. Additional considerations for amendments to the operating agreement include any voting rights, access to financial information, and special restrictions on transfer for the new class of units. The LLC will also need to establish the value of the enterprise as of the date of the grant for the purposes of establishing the profits interest is not taxable to the recipient at the time of grant.

Equity Options

Unlike C corporations, LLCs cannot issue ISOs. While there is no final guidance from the IRS on how compensatory options of an LLC will be treated from a tax standpoint, practitioners generally assume they are treated the same as NQSOs are treated in the corporate

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context. Thus, there should not be a tax event at the time of grant for either the recipient or the LLC so long as the strike price is equal to the fair market value of the LLC interests at the time of the grant. Once the LLC options are exercised, the recipient would recognize ordinary income to the extent of any difference between the strike price and the fair market value of the LLC interests at exercise, and the LLC would be entitled to deduct such amounts.

Once LLC options are exercised, the holder would become a partner of the LLC and the same complications arising from the prohibition on employee-owners of LLCs described above would come into play.

Phantom Equity

Phantom equity, also known as an equity appreciation right, represents an LLC's promise to pay cash equal to the value of a unit of membership interest upon the occurrence of a defined event, typically a change in control. Like RSUs in the corporate context, phantom equity in an LLC is considered deferred compensation and is accordingly subject to the rules under IRC § 409A. Grants of phantom equity are not taxable at the time of the grant and payments made upon the triggering event are treated as ordinary income for the recipient and are tax deductible by the LLC.[12]

Because phantom equity is synthetic, holders of phantom equity are not members or owners of the LLC. Employers and employees can thereby avoid complications arising from restrictions on LLC members serving as W-2 employees. LLCs do not have to issue K-1s to holders of phantom equity and there are no management, governance, voting, or information rights accruing to holders of phantom units under the LLC's organizational documents. The LLC does not have to value the business at the time of the grants and can avoid the additional accounting complexities of maintaining or recalculating the capital accounts of different classes of owners.

For more information, contact Drew Hill or any attorney with Frost Brown Todd's Tax Practice Group.

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[1] ISOs are governed by IRC § 422, which sets forth various requirements regarding issuances, hold periods, and caps on value.

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[2] NQSOs are any stock options that are not ISOs.

[3] For certain taxpayers, there is a potential alternative minimum tax adjustment at the time of exercise for the difference between the exercise price and the fair market value of the stock.

[4] IRC § 421.

[5] Income on NQSOs is generally determined pursuant to IRC § 83(a); it is uncommon for an election under IRC § 83(b) to be available unless the stock acquired is subject to a risk of forfeiture.

[6] Accordingly, RSUs are governed by IRC § 451, and likely IRC § 409A, rather than IRC § 83.

[7] *See* IRC § 451.

[8] *See* Rev. Proc. 93-27; Rev. Proc. 2001-43.

[9] *See* IRC §§ 741 and 751.

[10] *See, e.g.* Rev. Rul. 69-184; Rev. Rul. 71-502; Rev. Rul. 81-300.

[11] *See* Rev. Proc. 2001-43.

[12] Rev. Rul. 80-300.

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