A SUMMARY OF COMMON TAX-FAVORABLE TYPES OF INCENTIVE EQUITY: CORPORATIONS AND PARTNERSHIPS/LLCs

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Incentive equity can be a great tool for businesses to reward and motivate key employees and service providers and, also, to align their interests with those of investors and founders. There are various tax-favorable ways to grant incentive equity, depending on whether the business is taxed as a corporation or a partnership (this includes many LLCs) for federal tax purposes.[1]

If a business is taxed as a corporation for federal tax purposes, two of the more common types of incentive equity are (1) restricted stock, and (2) stock options. So-called "phantom equity" can also be used, but for tax purposes, is a contractual right and, therefore, always compensatory in nature resulting in ordinary income.

A corporation that awards restricted stock issues actual shares in the corporation to the recipient at the time grant; these shares, however, are subject to a risk of forfeiture if certain time-based and/or performance-based metrics are not met (also known as "reverse vesting"). The default tax rule is that the recipient is not taxed in the year of receipt – but rather as the shares vest (and the risk of forfeiture lapses) – and recognizes compensation income (subject to ordinary income rates) equal to the fair market value of the shares at the time of vesting. However, the recipient may make a Section 83(b) election within 30 days of the date of grant to alternatively recognize compensation income equal to fair market value of the shares at the time of grant. In either event, the recipient often has a real tax cost and, accordingly, restricted stock is generally used only early in the life cycle of a company before significant value has accrued.

As a corporation appreciates in value, it is therefore more common to see awards of stock options than restricted stock. Notably, stock options fall into two categories: incentive stock options (ISOs) or non-qualified stock options (NSOs). ISOs are considered the more tax-favorable type of stock option because they are only taxed on the sale of the stock (not at the time of grant or exercise),[2] and the entire gain is taxed at long-term capital gains rates. The tax benefit of ISOs, however, comes at a cost, as ISOs are only available to employees and are also subject to stringent requirements. These stringent requirements include two separate holding period requirements: namely, the stock received from the exercise of the option must be held (1) at least two years from the date of grant of the ISO, and (2) at least one year from the date of exercise of the ISO. And, the exercise price of the ISO also must be equal to at least the fair market value of the underlying stock at the date of grant (which is often not insignificant).[3] Consequently, many employees wait to exercise their options until shortly before a liquidity/exit event when it is more certain that the stock received on exercise will be worth more than the exercise price (or the recipients are simply cashed out on an as-converted basis on exit). And, therefore, in many instances those who receive what is initially a grant of ISOs do not meet the second holding period requirement and, in fact, ultimately end up with ordinary income.

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Alternatively, NSOs are taxed as compensation income at ordinary income rates at the time of exercise, but capital gain when the underlying shares are sold. However, like with ISOs, recipients generally wait to exercise until an exit event (or the recipients are simply cashed out on exit on an as-converted basis), which will yield ordinary income. In such case, the recipients will never hold the underlying stock for a sufficient period of time to allow for appreciation in the stock to be taxed as capital gains. Accordingly, whether ISOs or NSOs are used, as a practical matter it can be difficult to achieve meaningful capital gains treatment for the recipients.

On the other hand, if a business is taxed as a partnership for federal tax purposes (this includes many LLCs),[4] the most common, tax-favorable way to grant incentive equity to service providers is through awards of "profits interests." If the requirements of an IRS safe harbor are met, neither the grant nor vesting of a profits interest will be taxable to the recipient. One key to qualifying under the profits interest safe harbor is setting a "hurdle value" equal to the fair market value of the business on the date of grant. In other words, as an example, if the business is valued at $1 million at the time of grant (the "hurdle value"), the service provider receives a 1 percent profits interest in the business, and the business later appreciates and sells for $10 million (net cash proceeds), the recipient receives 1 percent of $9 million ($10 million less the $1 million hurdle value) not 1 percent of $10 million.[5] From the IRS's perspective, this mechanism ensures that the service provider only receives appreciation in the business after the date of grant, something that is not certain to happen at the time of grant. Given this, the tax rules reason that the grant can fairly be valued at zero, and thus the grant can be tax-free. Further, the relevant IRS guidance provides that if the safe harbor requirements are otherwise met, even if a profits interest is subject to vesting, there will be no tax consequence to the recipient on vesting.[6] Although currently a Section 83(b) election is not required to ensure there is no tax consequence on vesting, a "protective" Section 83(b) election is often made nonetheless (and if made, must be made within 30 days of the date of grant).

For grants that achieve valid "profits interest" status, there is not only no tax event on issuance but the appreciation on exit may qualify for capital gains treatment. Further, there is no "exercise," and therefore no holding period following exercise, which in the case of ISOs is hard to meet and, therefore, as noted above, often results in ordinary income instead of capital gains.

Accordingly, when compared to the common types of incentive equity granted by corporations, profits interests arguably end up providing the best tax result and lowest cost to the recipient, giving businesses another factor to balance when making the choice of entity decision.

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ENDNOTES:

1. Multi-member LLCs are classified as partnerships for federal tax purposes by default but may make an election to be treated as a corporation. This article refers to "corporations" in a generic way, but corporations can be further classified as "C corporations" or "S corporations."
2. However, at the time of exercise, the "spread" (i.e., the difference between the fair market value of the stock and the exercise price) is considered a "preference item" for purposes of the alternative minimum tax.
3. And, in the case of an employee who holds more than 10 percent of the outstanding shares, equal to 110 percent of the fair market value on the date of grant.
4. Again, multi-member LLCs are partnerships for federal tax purposes by default, but an election to be treated as a corporation may be made.
5. This example assumes there is no "catch-up" provision.
6. It is of note that, in the Partnership Agreement/LLC Agreement, the business can choose to designate the profits interests as non-voting equity and can also set aside any distributions to the recipient until vested.