

Welcome!

Taxing LLC Options (It's Complicated)

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Stock Options \neq LLC Options



Noncompensatory options are not options issued in connection with the performance of services.

NCOs include call options, warrants, conversion feature of convertible debt and conversion feature of convertible equity.

Describing the NCO

Partnership Agreement or LLC

Operating Agreement

Underlying Partnership Interest

Regulatory Provisions

Grant Document

Underlying Partnership Interest

Option Price

Exercise Price

Tax Consequences of **Issuance** of NCO
Partnership or LLC
Option Holder

Tax Consequences of **Exercise** of NCO
Partnership or LLC – Not Taxable
Option Holder
Generally Not Taxable
Exceptions

Tax Consequences of **Lapse** of NCO
Partnership or LLC – Income
Option Holder - Loss

When is an option holder treated as a partner?

1. Rights that are substantially similar to the rights afforded a partner and
2. Strong likelihood that failure to treat option holder as a partner would result in a substantial reduction in the present value of partners' and option holder's aggregate Federal tax liabilities

Rights Substantially Similar to Partner Rights if either

1. Option reasonably certain to be exercised, or
2. Option holder has partner attributes

Option Reasonably Certain to Be Exercised

Facts and circumstances test
Safe harbor



Partner Attributes

Facts and circumstances test

“Conclusively” present when

1. Option holder has rights to share in distributions, or
2. Option holder agrees to bear losses

Strong Likelihood of Substantial Reduction in Tax – A Facts and Circumstances Test

Accounting for NCOs

Exercises

Revaluations while NCOs are outstanding

Allocations while NCOs are outstanding

Accounting for Exercises

Credits to capital account of option holder (exercising partner)

Revaluations upon exercise

Share of partnership capital of acquired partnership interest

Corrective allocations

Revaluations While NCOs Outstanding

- Options in the money
- Options not in the money



Allocations While NCOs Outstanding – Requirements to Be Deemed in Accordance with Partners’ Interests in the Partnership

1. Holder of NCO not a partner
2. Mandatory provisions for partnership agreement
3. Allocations and capital account adjustments would be respected if no NCOs were outstanding

What to Remember about Taxing NCOs

Partnership or LLC NCOs are taxed differently than stock options.

Holder of NCO may be treated as a partner for tax purposes.

Terms of the NCO and the underlying partnership or LLC interest must be clear from the partnership or LLC documents, and all documents concerning the NCOs must be coordinated.

Tax regulations mandate certain provisions for NCOs in partnership or LLC agreement.

Once NCOs are issued the partnership or LLC will have substantially more accounting work.

Thank you!

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