Motivate LLC Employees with Smart ESOP Alternatives

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One ever-present challenge with LLC's is that forcibly grafting corporate concepts and structures into the LLC format is counterproductive at best. Simply, pass-through membership interests are very different from corporate stock. As a result, several options and best practices have arisen to expressly leverage the best aspects of LLC's to achieve similar goals to the traditional stock option plan. However, these approaches operate in very different fashions from the venerable stock option as further detailed below.

I. Capital Interest vs. Profits Interests

The first and most important concept to grasp is that most incentive awards in the LLC context are driven by actual equity ownership in the company, or actual ownership of LLC membership interests. Contrast that with a stock option which is merely a contractual right to purchase stock and hold equity at some later date, meaning a stock option holder does not hold actual equity. That said, LLC membership interests can be broadly split into two categories: a "Capital Interest" or a "Profits Interest."

The basic capital interest is more or less tantamount to so called "common stock" in the corporate context. Capital interest holders enjoy the right to a proportionate share of the capital, profits, and residual value of the LLC. On the other hand, the basic profits interest is exactly like its capital interest cousin. The fundamental difference, however, is that a profits interest holder, on the date of the grant, gets no interest in the present day value of the company or its capital account balances. Hence, since that is the only difference, like capital interests, profits interests share in the profits and residual value of the LLC. Put another way, a profits interest begins with a zero dollar value and eventually increases in value as the LLC valuation increases. Bear in mind that a profits interest recipient actually becomes a "member" of the LLC, complete with a Schedule K-1 for accounting purposes.

II. Profits Interests Plans

A profits interest works very much like a stock option, in that it gives employees a portion of the upside from the date of grant but since there is no strike price, it more accurately operates like a restricted stock grant. A common source of confusion is the term ***"profits interest"*** itself is slightly misleading. The word "profits" in this context conflates both actual profits earned from the continued operations of the LLC and the "value increase" in the equity itself that is realized on a liquidity event like the sale of the LLC. Hence, operational profits are also allocated to profit interest members as they are earned. In addition, when an LLC grows in value and an allocation event occurs, the LLC allocates the value accretion as if it were profits. (Note: unrealized gain due to increases in company valuation, unlike actual profits, do not automatically result in taxable income for the recipient.)

Profits interests have many advantages over the traditional stock option as a means to provide equity compensation to LLC employees. Assuming certain tax rules are met, the grant of a profits interest to an employee is tax free on the date of grant despite the potential to participate in the upside growth of the business.

How Plans Are Often Implemented: First, consider a "unit" in an LLC to be equivalent with a share of stock. If the LLC were to begin with say an initial 100 units issued to existing owners, after several years the existing unit holders may want to incentivize their workforce or consultants/advisors, through the issuance of a new separate class of units. A new Class B Profits Interest Class can be created with the profits interest attributes listed above. This would be done pursuant to a Profits Interest Plan, which is an authorizing and administrative policy document that lays out the metes and bounds of the Class B Units, as well as the LLC management's rights to issue more, redeem, and award such units.

Tax Benefits of Profits Interests: Stock options often require the immediate outlay of cash by the employee and may have severe and adverse tax consequences if exercised at a strike price below market value. In addition, granting common equity of any kind (e.g., common stock, restricted stock, and/or capital interests) often forces the employee to pay ordinary income taxes on the market value at the time of grant. Again in contrast, if the grant of a profits interest is properly made pursuant to a properly drafted an implemented plan, the employee may have no tax consequence at all at the time of grant. Moreover, so long as the holder of a profits interest grant is a holder for over two years from the date of grant, further applicable taxes are considered capital gains. This is the result of a tax revenue ruling that greatly clarified and augmented the tax benefits of profits interest at the time of grant.

However, a potential downside of a profits interest is that the employee may have to report all income on a K-1 as opposed to the W-2, meaning: (1) the employee has to file quarterly estimated tax payments instead of having taxes withheld from every paycheck; (2) the company does not match FICA payments but instead the employee has to pay the full tax; and (3) in the worst case, certain benefits to the employee, such as medical insurance, may be taxable. Hence to avoid these consequences, any LLC should closely consult with its tax advisors.

III. Unit Appreciation Rights

An alternative to profits interests is a so called unit appreciation right ("UAR"). UAR's have similar economic consequences to profits interests, but do not actually make the employee a member nor provides the employee "real" equity at the time of grant. Rather, a UAR is a contractual right to participate in a portion of the proceeds generated by the LLC through a liquidity event, such as a sale. Hence, this is can be a boon and a drawback depending on the parties' relative goals and perspectives (some employees may prefer actual equity, for example).

Often UAR's are called "phantom units" and are awarded pursuant to a phantom unit plan. A phantom unit plan, unlike the profits interest plan, provides the employee an award that is solely based on the value of the LLC not operational profits. These plans can be called into play when the company cannot or will not make the employee a shareholder per se. And this is a viable strategy to offset some of the drawbacks of providing actual equity for privately held businesses. Reasons for not issuing actual equity include: 1) making the employee an actual shareholder might give him/her voting rights, or unforeseen minority rights under state law; 2) there are additional agreements that come into play, which increase complexity and legal fees; 3) there are issues when it comes to the fate of profits interest issued to an employee that separates for whatever reason from the company; and 4) if there is a buyout provision that applies to a departing employee, in order to keep the profits interests in the possession of the company, that can be a costly proposition to carry out.

The phantom plan “units” themselves are credited to the employee with each unit initially corresponding to the value of an outstanding unit of company membership interest. The typical upside of the unit given to the employee is the “appreciation” in value, between the award of the unit and the time the actual benefit is paid out, of the corresponding capital interest unit. It should be noted that profits interests give rise to income that is taxed at either ordinary income rates or capital gains rates depending on the source of the underlying company income (typically the sale of the business will create mostly capital gain), while phantom units will always give rise to income taxed at ordinary income rates.

Actual payment of the benefits is usually delayed until the employment relationship is terminated due to retirement, death /disability, or a predetermined date. In many cases, as per the operative agreements, the benefit is paid in installments to protect the company’s cash flow. Another useful aspect of the phantom unit plan is that employee tax liability is deferred until the monetary benefit is actually paid, as opposed to when the employee receives the phantom unit award.

IV. Conclusions

While stock options have their advantages, the tax advantages offered by profits interests and phantom units makes an LLC a true contender in terms of employee equity incentive plans. Hence, LLC owners have a toolset that they can call upon to fit their particular goals and needs. Also, while it may be advisable to simply use a profits interest plan or a phantom unit plan, LLC’s can and do often have a mix of profits interest and phantom units.
