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EQUITY-BASED COMPENSATION FOR CORPORATIONS, PARTNERSHIPS AND LLCS

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Corporations, partnerships and limited liability companies ("LLCs") can choose from a variety of equity-based compensation awards to recruit and retain talented service providers and to motivate those individuals to increase the value of the organization. Equity-based compensation includes any compensation paid to an employee, director, contractor, consultant or other service provider that is based on the value of a specified stock of a corporation or unit of a partnership or LLC.[1] Before a company can award equity-based compensation, it must select the appropriate type of award.

The first step in selecting the appropriate type of equity-based compensation award depends on the type of organization, such as an LLC or a corporation, and how it is structured. Specifically, for equity-based compensation, you need to know how an organization is capitalized and how the organization (or organizations) is taxed to determine what types of awards may make sense.

As described in more detail below, the awards that are commonly used by a corporation operate differently than those typically used by a partnership or LLC.[2] While there is no "best" type of equity-based compensation, we recommend considering (i) what types of awards are common for the applicable type of organization, (ii) the key tax provisions that apply to the common awards; and (iii) the intended tax treatment for the organization and the service provider.[3]

1. COMMON AWARDS BY CORPORATIONS.

For corporations, the common award types are: (1) stock options, (2) restricted stock, (3) phantom stock (also referred to as a restricted stock unit or performance stock unit), and (4) stock appreciation rights ("SARs"). These common corporate award types are listed below with a description and

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Employee Benefits and Executive Compensation example to compare the basic terminology and economics of the awards. For simplification purposes, the examples listed below each involve a hypothetical corporation that makes an award to a service provider on January 1, 2020, when the fair market value of the corporation's common stock is $10 per share. Each example considers an award of, or based on, either 100 shares or the $1,000 represented by those shares' value. The examples each assume that the award "vests," meaning that it is no longer subject to substantial risk of forfeiture, on January 1, 2024, at which time the hypothetical corporation's common stock is worth $15 per share ($1,500 for 100 shares).

Corporate Award Description
Stock options: When a corporation grants a stock option, it offers the recipient a right to purchase a set number of shares of stock at a defined purchas
Restricted stock: When a corporation grants restricted stock, it awards the recipient a specified number of shares of the corporation's stock, subject to ve
Phantom stock, also referred to as a restricted stock unit ("RSU") or performance stock unit ("PSU"): When a corporation grants phantom stock, it gives the recipient the right to receive a payment (in cash or shares) equal to the value of a
Stock appreciation rights ("SARs"): When a corporation grants SARs, it gives the recipient the right to receive a cash payment equal to the value of a specified number of sh Like stock options, SARs only provide the value of any increase in the stock price. However, the recipients of SARs typically receive cash;

COMMON AWARDS FROM PARTNERSHIPS / LLCS.

For partnerships and LLCs, the common award types are: (1) profits interests, (2) phantom equity, and (3) unit appreciation rights. Partnerships and LLCs may also consider granting a capital interest (also referred to as a unit or restricted unit), or an option to purchase units; however, these two types of awards are typically less favorable as compared to the three other common awards for partnerships and LLCs. For simplification purposes, the examples listed below each involve a hypothetical LLC, taxed as a partnership, that makes an award to a service provider on January 1, 2020 when the fair market value of the LLC's assets are worth $100,000, and 1% of the LLC's assets are worth $1,000. The examples each assume that the award "vests," meaning that it is no longer subject to substantial risk of forfeiture, on January 1, 2024, at which time the hypothetical LLC's assets are worth $150,000, and 1% of the LLC's assets are worth $1,500.

LLC Award Description
Profits Interest:

When a partnership or LLC grants a profits interest, it awards the recipient a right to share in the future profits and appreciation in value As a potentially major downside to granting a profits interest, an employee who receives a profits interest is no longer considered an em
Phantom Equity: When a partnership or LLC grants phantom equity, it awards the recipient a right to receive a cash payment equal to the value of a specif
Unit Appreciation Rights: When a partnership or LLC grants unit appreciation rights, it awards the recipient a right to receive a cash payment equal to the apprecia
Restricted capital interests, also referred to as a restricted unit: When a partnership or LLC grants a restricted capital interest or restricted unit, it awards the recipient a right to the distribution of a por
Options to purchase capital interests: When a partnership or LLC grants a compensatory option, it offers the recipient a right to purchase capital interests at a specified exercis

In the above hypotheticals, we simplified the awards by treating the last day of a four-year vesting period as the “settlement” date when the award recipient receives a payment in cash or shares. In practice, the settlement date is determined based on a separate set of conditions and often does not align with the end of the vesting period, especially for awards settled in cash. An award “vests” when it is no longer subject to a substantial risk of forfeiture, like four years of service in the above hypotheticals, and the award recipient has a right to a payment in cash or shares. However, a typical settlement date would be a liquidity event, such as the sale of an organization, when the organization can use the sale proceeds to make cash payments to award recipients to settle the awards.

2. KEY TAX CONSIDERATIONS

When selecting an appropriate equity-based compensation award, an organization should consider the impact of Sections 409A and 83 of the Internal Revenue Code of 1986, as amended (the “Code”). Code Section 409A applies to equity-based compensation that is deemed or otherwise results in deferred compensation that is earned in one year, but paid in another year. Specifically, when a corporation awards stock options, SARs, or phantom stock, or when a partnership or LLC awards phantom equity, unit appreciation rights, or options, the award should be designed to be exempt from or to comply with Code Section 409A. By contrast, equity-based compensation awards of property are subject to Code Section 83 and are generally not considered deferred compensation subject to Code Section 409A. Specifically, when a corporation grants restricted stock, or when a partnership or LLC grants a profits interest or a capital interest, the award is considered property subject to Code Section 83.

[5]

	Primarily Consider Code Section 409A	Primarily Consider Code Section 83
Common Awards from Corporations	Stock options Stock appreciation rights Phantom stock (RSU / PSU)	Restricted Stock
Common Awards from Partnerships / LLCs	Phantom equity Unit appreciation rights Options	Profits Interest Capital Interest (Units)

When an organization grants an award subject to Code Section 83, it should consider whether the employee (or other service provider) should be permitted to make a Code Section 83(b) election ("83(b) election").[6] An 83(b) election must be made within 30 days of the date of grant to make the applicable award subject to taxation on the date of grant. Note, if an 83(b) election is made and the award is subsequently forfeited, the employee will not be able to recover the taxable income recognized as a result of the 83(b) election.

When considering Code Section 409A, the type of award will dictate whether the award should be designed to: (1) fit within an exemption, or (2) be designed to comply with the requirements. When granting options or appreciation rights, the organization can generally design the award to be exempt from Code Section 409A by establishing an exercise or strike price of at least fair market value of the organization's common stock or common equity units on the date of grant. When granting phantom stock or phantom equity, the organization should design the award to comply with the requirements of Code Section 409A, including permissible payment events, restrictions on funding, requirements for deferral elections, and other applicable requirements. If an award subject to Code Section 409A does not qualify for an exemption and fails to comply with Code Section 409A requirements, then the employee (or other service provider) will be subject to acceleration of income and an additional 20% income tax. However, the careful drafting of awards can typically avoid these draconian adverse tax consequences without interfering with the organization's compensation objectives.

3. TAX COMPARISON CHART FOR RECOMMENDED COMMON AWARDS

The "right" type of equity-based compensation award should depend, in part, on the intended tax treatment for the employee (or other service provider) and the granting organization. The following chart is intended as a reference tool to identify when the taxes will be payable by the employee and potentially deductible by the organization: (1) taxable when the award is granted; (2) when the award vests and is no longer subject to a substantial risk of forfeiture; (3) when the award is exercised or settled in exchange for value (e.g., cash or equity); (4) when any future value is received upon the subsequent sale of shares or other distributions; and (5) if the organization should expect to receive a tax deduction with respect to the award.

Type of Organization: Common Award Type	(1) Taxable on Grant	(2) Taxable on Vesting	(3) Taxable on Exercise or Settlement	(4) Taxable on Sale of Share or Other Distributions	(5) Tax Deduction for Organization
Corporation: Non-qualified stock options ("NQSO")	Generally not taxable to employee on grant.	No, not taxable to employee on vesting.	Ordinary income on the "spread" (i.e., the excess of the fair market value	Long- or short-term capital gain (depending on how long the shares are held) on	Deduction equal to amount of ordinary income recognized by employee upon exercise.

			when exercised over the exercise price).	the appreciation since the exercise.	
Corporation: Incentive stock option (“ISO”)	Generally not taxable to employee on grant.	No, not taxable to employee on vesting.	No, unless Alternative Minimum Tax (AMT) applies.	Taxable to employee upon sale of share. Capital gain or ordinary income, depending on how long the shares are held.	No deduction unless employee has ordinary income recognized upon sale of shares.
Corporation: Restricted stock	Not taxable on grant unless employee timely files an 83(b)	Ordinary income on fair market value less any amount	Not applicable.	Long- or short-term capital gain (depending on how	Deduction equal to ordinary income recognized by employee (at either grant or vesting, depending on 83(b) election).

	election within 30 days of grant. Ordinary income on fair market value less any amount paid if employee timely files an 83(b) election.	paid, except if employee timely filed an 83(b) election at grant. Not taxable on vesting if employee timely filed an 83(b) election.		long the shares are held) on the appreciation since grant or vesting, depending on 83(b) election.	
Corporation: Phantom stock (also referred to as RSU or PSU)	No, not taxable to employee on grant.	No federal income tax on vesting, but subject to FICA tax.	Ordinary income recognized at settlement equal to amount of cash or fair market value of stock	If stock-settled, then long- or short-term capital gain (depending on how long the shares are	Deduction equal to amount of ordinary income recognized by employee.

			received in settlement.	held) on the appreciation since settlement.	
Corporation: Stock appreciation rights ("SARs")	No, not taxable to employee on grant.	No, not taxable to employee on vesting.	Ordinary income recognized equal to amount of cash received upon settlement.	Generally not applicable.	Deduction equal to amount of ordinary income recognized by employee.
Partnership / LLC: Profits interest	Profits interest should be designed to have no value on grant; consider a protective 83(b)	Not taxable on vesting if profits interest holder timely filed an 83(b) election.	Not applicable.	Long- or short-term capital gain (depending on how long the profits interest are held) on	Generally no deduction for organization on valid profits interest.

	election. [7]			the distributions with respect to profits interest.	
Partnership / LLC: Phantom equity	No, not taxable to employee on grant.	No, not taxable to employee on vesting.	Ordinary income recognized equal to amount of cash received.	Not applicable.	Deduction equal to amount of ordinary income recognized by employee.
Partnership / LLC: Unit appreciation rights	No, not taxable to employee on grant.	No, not taxable to employee on vesting.	Ordinary income recognized equal to amount of cash received upon settlement.	Not applicable.	Deduction equal to amount of ordinary income recognized by employee.

[1] The IRS provides useful background information on equity-based

compensation in its audit techniques guide, available online here: https://www.irs.gov/businesses/corporations/equity-stock-based-compensation-audit-techniques-guide.

[2] Note, an LLC will generally be taxed as a partnership by default; however, an LLC can elect to be taxed as a corporation by filing Form 8832 with the IRS. For purposes of this article, we assume that the LLC is taxed as a partnership, rather than a corporation.

[3] We also note that there are other applicable governance, accounting, and securities considerations; however, those considerations are outside the scope of this article.

[4] The holder of a restricted capital interest (who does not file an 83(b) election) should not be considered a partner or LLC member until the capital interest vests, consistent with the general principle that the service provider does not own the interest until it vests.

[5] Property awards subject to Code Section 83 are generally not considered deferred compensation subject to Code Section 409A; however, if these awards contain a deferral feature they could become subject to Code Section 409A. If the right to payment may be deferred to a subsequent taxable year, these awards should also be designed to be exempt from or to comply with Code Section 409A.

[6] For the IRS sample 83(b) election, see Rev. Proc. 2012-29. An organization will typically give the service provider a form 83(b) election that the service provider may file with the IRS. If the service provider decides to do so, the 83(b) election must be filed with IRS within 30 days of grant. The organization should require the service provider to return to the organization a copy of any 83(b) election the service provider files with the IRS.

[7] Rev. Proc. 2001-43 (the vesting of a profits interest does not constitute a taxable event if an 83(b) election has been made provided: (1) the profits interest meets the three safe harbors under Rev. Proc. 93-27 are met; (2) the holder is treated as a partner or LLC member from the grant date; (3) the holder takes into account the distributed share of the organization's income, gain, loss, and deduction associated with the profits interest from the grant date; (4) the organization (nor its partners or LLC members) do not take a compensation deduction for the value of the profits interest.