

LLC EQUITY INCENTIVES FOR SERVICE PROVIDERS

LEGEND: CI: capital interest; FMV: fair market value; PI: profits interest; PSP: partnership/LLC; RCI: restricted capital interest; RPI: restricted profits interest; PTR: partner; SP: service provider

Type of Interest	Description	Consequences to Service Provider (SP)		Consequences to Partnership (PSP)	
Capital Interest (CI)	<p>Entitles the holder to a share of proceeds upon an immediate liquidation of the PSP's property at FMV.</p> <p>A CI constitutes "property" for purposes of IRC section 83.</p>	<p>Taxable upon receipt to SP in an amount equal to FMV of CI over amount paid for the CI, if any.</p> <p>SP becomes a PTR upon receipt.</p>		<p>Likely treated as a deemed taxable transfer of a proportionate share of PSP property to SP, followed by a contribution of the distributed property.</p> <p>Related gain/loss and deduction on deemed transfer of property (if any) allocated to existing PTRs. Note: Proposed Treasury Regulations provide that there is a deemed transfer of cash (instead of property) to SP. This approach eliminates the gain and loss on the deemed transfer of property.</p> <p>The PSP's compensation deduction depends upon whether the payment for the services is a deductible expenditure.</p>	
Restricted Capital Interest (RCI)	<p>An RCI is a CI issued subject to risk of forfeiture or is not transferable.</p> <p>An RCI constitutes "property" for purposes of IRC section 83.</p>	<p><i>No Section 83(b) Election Made</i> * * *</p> <p>Taxable event as restrictions lapse in an amount equal to then FMV of the then-vested portion of the RCI over amount paid for the interest, if any.</p> <p>The PSP owns the RCI until the restrictions lapse.</p> <p>SP becomes a PTR upon vesting; allocations in line with vested interest.</p>	<p><i>Section 83(b) Election Made</i> * * *</p> <p>Taxable upon receipt by SP in an amount equal to FMV of RCI over amount paid for the RCI, if any.</p> <p>SP becomes a PTR upon receipt; receives full share of allocations.</p> <p>Restricted property is still restricted (i.e., subject to forfeiture or nontransferable) even if an IRC section 83(b) election is</p>	<p><i>No Section 83(b) Election Made</i> * * *</p> <p>Taxable event as restrictions lapse.</p> <p>Under present law, treated as a deemed taxable transfer of a proportionate share of PSP property to SP upon lapse; followed by a contribution by SP of the distributed property back to PSP. Note: Proposed Treasury Regulations provide that there is a deemed transfer of cash (instead of property) to SP. This approach eliminates the gain and loss on the deemed transfer of property.</p> <p>Related gain/loss and deduction (if any) allocated to existing PTRs upon</p>	<p><i>Section 83(b) Election Made</i> * * *</p> <p>Taxable upon grant.</p> <p>Under present law, treated as a deemed taxable transfer of a proportionate share of PSP property to SP; followed by a contribution of the distributed property.</p> <p>Related gain/loss and deduction (if any) allocated to existing PTRs upon grant. Note: Proposed Treasury Regulations provide that there is a deemed transfer of cash (instead of property) to SP. This approach eliminates the gain and loss on the</p>

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			made for tax purposes.	lapse. Under IRC section 83, the PSP owns the RCI until the restrictions lapse.	deemed transfer of property. Restricted property is still restricted (i.e., subject to forfeiture or nontransferable) even if an IRC section 83(b) election is made for tax purposes.
Profits Interest (PI)	An interest that does not entitle the holder to a distributive share of proceeds upon an immediate liquidation of the PSP's property at FMV. Value of a PI is zero upon grant. PI is not property for IRC section 83 purposes.	The receipt of a PI to a SP for the provision of services to a PSP is not a taxable event to the SP. Exceptions: PIs transferred by the SP within two years of receipt; PIs in PSPs holding property producing a certain and predictable income stream; and PIs in publicly traded PSPs. See: Revenue Procedure 93-27. Exceptions analyzed under case law. SP becomes a PTR upon receipt of the PI and is allocated income, gain or loss.		No gain/loss or deduction to the PSP or the existing partners.	
Restricted Profits Interest (RPI)	An RPI is a PI issued subject to risk of forfeiture or not transferable. The determination of whether a restricted interest is a RPI or a RCI is made on the date it is issued, not on the vesting date.	The receipt of a PI to a SP for the provision of services to a PSP is not a taxable event to the SP, <i>irrespective of whether an IRC section 83(b) election is made.</i> Neither the grant nor the vesting of an RPI will be taxable to the SP so long as 1) SP is treated as owning the interest from the date of grant (including for the purposes of making allocations of income, gain or loss) and 2) the PSP takes no deduction for the issuance.		No gain/loss or deduction to the PSP or the existing partners upon grant. If Revenue Procedure 2001-43 applies, there is no gain/loss or deduction upon vesting restricted PI. Upon forfeiture remaining PTRs receive allocations related to forfeiture.	

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	<p>IRS guidance suggests (without stating) that IRC section 83 is not applicable and that no IRC section 83(b) election is required with respect to RPIs.</p> <p>Note: many practitioners make "protective elections" under IRC section 83(b).</p>	<p>Exceptions: PIs transferred by the SP within two years of receipt; PIs in PSPs holding property producing a certain and predictable income stream; and PIs in publicly traded PSPs. Exceptions analyzed under case law</p> <p>Upon forfeiture, SP should be entitled to a loss equal to his basis (as adjusted for income and gain allocated).</p>	
Options	<p>Contractual right to purchase a CI at a fixed price in the future.</p> <p>Deep Discounted Options are likely to be viewed as an issuance of the underlying equity, except if option complies with IRC section 409A.</p>	<p>No tax upon grant of compensatory options at FMV and no additional feature of deferral or of a below-FMV option that complies with IRC section 409A.</p> <p>FMV determined in accordance with IRC section 409A.</p> <p>Upon exercise, SP should recognize ordinary income equal to the FMV of the interest over the exercise price.</p> <p>SP becomes a PTR upon exercise.</p>	<p>No deduction, generally at the time of grant if the option is not subject to or is compliant with IRC section 409A.</p> <p>Upon exercise, if related to deductible services, PSP should be entitled to a deduction in an amount equal to the ordinary income realized by the SP.</p> <p>It is not clear whether the exercise would be treated as a deemed taxable transfer of a proportionate share of PSP property to SP; followed by a contribution of the distributed property.</p>
Equity Appreciation Right or Bonus Based on Value of Equity	<p>Contractual right to be paid a sum of money based on the performance of the PSP equity; not a grant of equity.</p>	<p>So long as right complies with or is not subject to or is compliant with IRC section 409A, no tax upon grant.</p> <p>SP will have ordinary income upon payment.</p> <p>SP not a PTR.</p>	<p>No deduction, generally at the time of grant if the right is not subject to or is compliant with IRC section 409A.</p> <p>Upon payment, if related to deductible services, PSP should be entitled to a deduction in an amount equal to the ordinary income realized by the SP.</p>