Capitalizing an LLC and Incentivizing Employees/Service Providers in a Tax Efficient Manner

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Initial LLC Capitalization

When forming an LLC to invest in real estate or operate a business, the following familiar fact pattern occurs: certain members make cash capital contributions to purchase real estate/provide start-up capital for a business, while other members provide the "sweat equity" or services required to run/operate the business. To understand the tax consequences that result from this typical fact pattern, it is illustrative to use a specific example.

BUYER LLC will be purchasing an office building and requires an equity contribution of $1,000,000. Investor will fund the full $1,000,000 amount while Developer, who sourced the deal and will manage the building, will contribute no capital but will receive a 20% interest for its services. BUYER LLC's operating agreement provides that all distributions (including distributions upon a liquidation of the entity) are to go 80% to Investor and 20% to Developer. The result of this structure is that Developer must recognize taxable income of $200,000 on its tax return for the year of purchase, even though Developer has received no distribution or cash to pay this tax. The reason is that a "capital shift" has occurred upon the funding of BUYER LLC. Because Developer would be entitled to receive $200,000 if BUYER LLC were liquidated the day after its funding, the value of Developer's 20% interest is taxable. This result often causes Developer significant heartburn come tax time (and often would not reflect the thinking of the Investor). Using a 40% tax rate, Developer now must come out of pocket with $80,000 for taxes with no matching cash distributions to pay the tax.

In order to resolve this undesirable tax result for Developer, a tweak to the distribution section of BUYER LLC's operating agreement provides a fix. The IRS has ruled that if Developer's

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20% interest has a $0 liquidation value on the day the interest is issued, then the Developer's interest is valued at $0 for tax purposes and no tax is owed out of the box (Developer will only owe tax when they receive actual distributions). As a result, Developer is still able to share in its 20% of BUYER LLC's operating proceeds from dollar one, so long as upon a liquidation of BUYER LLC, Investor is entitled to the first $1,000,000 of liquidation proceeds before Developer receives anything. While there are other ways to skin this cat, the "liquidation preference" to Investor often provides a resolution that works for all parties.

Incentivizing Employees/Service Providers

The same capital shift issues applicable upon an initial capitalization of an LLC are also relevant when structuring equity incentives for LLC employees/service providers. When owners of an LLC wish to incentivize their employees/service providers with an equity grant, it is critical that all parties understand and properly report the tax consequences of such equity grant.

One method to prevent employee/service providers from recognizing tax on an equity grant with no corresponding cash is to value the LLC (a formal valuation is not necessary) on the date of the employee/service provider equity grant (the "Existing Value"). The employee/service provider would not receive any distributions from the LLC until an amount equal to the Existing Value is distributed to the existing LLC members. This is referred to as a "profits interest."[1] The employee/service providers: (i) are appropriately incentivized since they only receive equity distributions on the value that is created in the LLC from the date they become a member, and (ii) do not incur any adverse tax results.

Part three of this client alert series, coming November 16.

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[1] It must be noted that an individual cannot be both a W-2 employee and profits interest holder in an LLC. We can assist you with tax planning to address this issue.