

INCENTIVE UNIT PLAN FAQs

WHAT IS AN INCENTIVE UNIT PLAN?

An Incentive Unit Plan is a class of membership units (or membership interests) that are reserved for issuance to service providers as equity compensation. Incentive Unit Plans are only used for limited liability companies. The reserved units may be referenced as an employee pool, or simply as the number of Incentive Units available, in contrast to other classes of units available in the limited liability company.

WHAT IS AN INCENTIVE UNIT PLAN FOR?

Equity compensation aligns the interests of the service providers with that of the company by giving them a stake in the company. If the company's valuation goes up, both the company and the award recipient benefit. Investors frequently want to see an Incentive Unit Plan with a reserve pool in place because this locks in a cushion of incentive units that may be disbursed to the company's service providers.

HOW DOES A COMPANY SET UP AN INCENTIVE UNIT PLAN?

A company establishing an Incentive Unit Plan will need a couple of documents: (1) an Incentive Plan Document; (2) a form of Award Agreement; (3) an amendment to the Company Agreement, Operating Agreement, limited liability company agreement, or similar document of the company ("Operating Agreement"); and (4) a resolution or consent approving the plan and Operating Agreement amendment.

Typically, the Company needs its Managers' (if applicable) and members' authorization in order to adopt the Plan and any resulting Operating Agreement amendments. Authorization can be obtained through a meeting or a written consent, as permitted by the company's governing documents. Upon this authorization, the managers and members also approve the size of the Pool and a set of documents, including the Incentive Unit Plan and the forms of award agreements. The company's managers and members may later change the Pool size and make amendments to the documents. The term "Incentive Unit Plan" refers both to the Incentive Unit Plan document which sets out the rules and procedures of the Plan as well as the intangible structure of the company's Plan Pool and the authority for the company to issue awards from the Plan Pool.

WHAT RIGHTS DO INCENTIVE UNIT HOLDERS HAVE?

Incentive Units, unlike common shares or stock options under an Equity Incentive Plan in a corporation, are typically a separate class of membership units in a limited liability company with their own voting and financial rights. If the Company wants a separate class of membership units with distinct voting and/or financial rights, then the Company's Operating Agreement would need to specify the rights, privileges, and obligations of the Incentive Units.

If, however, the Company does not create a special class of membership units, then an Incentive Unit holder will have the same rights as other partners in the Company. Depending on the state in that the Company is in, these rights may also include the right to inspect records such as the Company's books and tax returns.

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WHAT ARE INCENTIVE UNITS?

Incentive Units are a special class or type of equity in a limited liability company. Incentive Units are typically structured so that they allow the holder of the Incentive Units to share in the appreciate of the company's value above a "threshold" or "hurdle price," which represents the value of the company at the time the Incentive Units are granted to the participant. An Incentive Unit Plan participant will not typically be allowed to participate in distributions or a sale event (change in control) until the other members have received distributions worth the full threshold or hurdle amount. This often, but not always, will not occur until a change of control (sale event), resulting in the Incentive Unit Plan participants not receiving distributions under the plan unless and until a sale of the company occurs.

HOW DOES A COMPANY ISSUE EQUITY AWARDS FROM THE INCENTIVE UNIT PLAN?

The Company's managers will typically issue award agreements to service providers under the Incentive Unit Plan. These awards may be authorized at a manager meeting, or through a manager consent. In rare cases, the Company's Operating Agreement may require member consent for certain Incentive Unit issuances.

WHAT KIND OF EQUITY AWARDS CAN BE ISSUED UNDER AN INCENTIVE UNIT PLAN?

The only type of equity award available under an Incentive Unit Plan is an Incentive Unit Award.

WHO CAN BE AWARDED INCENTIVE UNITS?

Incentive units may be awarded to service providers of the Company. However, companies must exercise caution when granting Incentive Units because, per IRS rules, an Incentive Unit Award recipient is considered to be a partner of the Company and will receive Form K-1s. Further, this means that the award recipient can no longer be an employee once granted the award and any compensation earned from the recipient's service to the Company is deemed to be self-employment income.

WHAT IS VESTING?

Vesting means conditions on the release of the award. For an incentive unit award, the recipient does not own the unvested units underlying the award free and clear until the units are vested. Absent unusual circumstances, equity awards should always be subject to vesting. There are two types of vesting: (1) time based and (2) milestone based. Time based vesting means that the vesting is conditioned on the service provider continuing to work for the company. Milestone vesting means the release of units is conditioned on performance goals set by the company. An Award agreement can also have a combination of time and milestone based vesting.

HOW ARE INCENTIVE UNITS TAXED?

Incentive Units, because of the threshold or hurdle amount (see below), are considered by the IRS to have a value of \$0.00 on the grant date. The threshold or hurdle amount is the amount that must be distributed to other equity holders before the Incentive Unit holder participates in distributions. Assuming a Section 83(b) election is filed and that the participant holds the Incentive Units for at least one (1) year, the participant will likely receive capital gains treatment upon sale of the Incentive Units. In the event that the participant does not file a Section 83(b) election, the participant will need to report ordinary income on the difference between the value of the Incentive Unit at the time it vests, and the threshold or hurdle amount.

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WHAT IS AN 83(B) ELECTION?

An 83(b) election is an election that the recipient makes with the IRS that allows for the recipient to pay taxes based upon the fair market value of the stock (or units) as of the date of issuance.

The reason the 83(b) election can be a powerful tool for equity awards is because it shifts the timing of the ordinary income tax treatment to the date of issuance of the award as opposed to the vesting of the award. This effectively shifts the value of the Incentive Units from potentially a large dollar value to a value of near \$0.00.

An example is helpful: A new pre-revenue startup wants to attract an Advisor by issuing 100 incentive units with a per unit hurdle price of \$50. Because the startup is pre-revenue and hasn't raised any money from investors yet, the value of a unit is still low at \$0.01. For this example, we will assume the Advisor's income is taxable at an ordinary income tax rate of 37% and a capital gains tax rate of 20%. If the Advisor makes a timely 83(b) election, then the ordinary income for the advisor would be $10,000 \times \$0.01 = \100 . The Advisor pays $\$100 \times 37\% = \37 in ordinary income taxes. The startup is a major success. Six months later, a unit is worth \$50. Because the 83(b) was filed, the recipient doesn't owe ordinary income tax when the hurdle price of \$50 per unit is reached. The Advisor later decides to sell the units. If the units are still worth \$50 per unit when the Advisor sells, the Advisor would need to pay capital gains tax on $\$500,000 - \$100 = \$499,900$. The Advisor's capital gains tax owed would be $\$499,900 \times 20\% = \$99,980$. The total tax paid in this scenario is \$100,017.

Roll back the clock and imagine the Advisor did not make the 83(b) election. When the hurdle price of \$50 is reached, the Advisor must pay the higher ordinary income tax on $10,000 \times \$50 = \$500,000$. The Advisor owes ordinary income tax of $\$500,000 \times 37\% = \$185,000$. Only when the Advisor later sells the units would the capital gains tax rate of 20% come in to play. If the Advisor later sells the units for \$500,000, then the capital gains tax owed would be $\$500,000 - \$500,000 = \$0$. As you can see, the 83(b) election can be a powerful tool to shift the timing of the ordinary income tax and capital gains tax treatment.

The two examples are also demonstrated in the chart below.

	Date of Issuance (Year Y)	Hurdle Price Reached (Year Y + 6 Months)	Date of Sale of Units (Year Z)	Total Taxes
Taxes Owed If 83(b) Election Made	$\$100 \times 37\% = \37	None	$\$499,900 \times 20\% =$ $\$99,980$	\$100,017
Taxes Owed If 83(b) Election Not Made	None	$\$500,000 \times 37\% =$ $\$185,000$	$\$500,000 - \$500,000 =$ $\$0$	\$185,000

The catch with 83(b) elections is that the recipient pays taxes up front even though the units are subject to a substantial risk of forfeiture. So what happens if the units never reach the hurdle price? Tough luck, because the recipient will have already paid the taxes associated with the incentive units. While some practitioners argue that an 83(b) is not necessary for incentive units, it will still most likely make sense for recipients to make the 83(b) election where the company's valuation is at par value or relatively low compared to the expected valuation in the future.

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HOW DO RECIPIENTS MAKE AN 83(B) ELECTION?

A complete Incentive Unit Award form will include an 83(b) election form that makes it easy for recipients to make the election. The election must be made within 30 days of the issuance of the stock. Be careful with the timing as it is exceedingly rare for the IRS Commissioner to grant an exception to this 30-day deadline.

WHAT HAPPENS TO UNITS OF AN AWARD THAT DON'T VEST?

The unvested units automatically go back to the Incentive Unit Plan's reserve of Incentive Units. There is no action needed on the part of the company because this mechanism is written into a well-drafted Incentive Unit Plan. However, it is best practice to confirm that the Incentive Units have been forfeited in the Termination Letter for the employee or contractor.

CAN AN INCENTIVE UNIT PLAN ALLOW DISTRIBUTIONS TO INCENTIVE UNIT MEMBERS?

Certain Incentive Unit Plans allow Incentive Unit holders to receive funds at the same time as members in the company receive distributions. However, this is not the typical structure for an Incentive Unit Plan, and could result in additional taxes being due to an Incentive Unit Plan participant. Certain types of plans like this may also be structured as "bonus" plans rather than Incentive Unit Plans. You should visit with your tax advisor and your attorney to determine the best structure for you here.

CAN I HAVE MORE THAN ONE PLAN?

Certainly. It is fairly common for a limited liability company to have more than one type of employee equity, equity like, or incentive or benefit plan. Options include bonus plans, Incentive Unit Plans, phantom stock (synthetic equity or parallel unit) plans, and contractual options, to name a few. You should visit with your tax advisor and your attorney to determine the best structure(s) for your company's goals.