EQUITY INCENTIVE COMPENSATION IN LIMITED LIABILITY COMPANIES

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CHAPTER 4

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Mr. Sparkman received his A. B. degree in 1968 from Princeton University and his J. D. degree with high honors from the University of Texas School of Law. In 2015, Mr. Sparkman received a Certificate in Theology and Ministry from Princeton Theological Seminary. Mr. Sparkman is listed in THE BEST LAWYERS IN AMERICA® for both Colorado and Texas and speaks regularly at continuing legal education seminars in Colorado, Texas, and nationally on entity selection, fiduciary duties and governance, mergers and conversion, veil piercing, ethics, series LLCs, and tax planning. Mr. Sparkman has presented more than 100 papers at continuing education programs for the American Bar Association, the Colorado Bar Association, Continuing Legal Education in Colorado, the State Bar of Texas, the University of Texas School of Law, the Professional Education Broadcast Network, the Practicing Law Institute, the National Business Institute, and other continuing education providers.

With Herrick Lidstone, Mr. Sparkman is author of Using Limited Liability Companies in Colorado (CLE in Colorado, Inc. 2015 second edition January, 2017) This book won the 2016 Award for Outstanding Achievement from the Association for Continuing Legal Education. He is the author of numerous articles on choice of business entity, series LLCs, and other legal topics. Mr. Sparkman's published articles include "Charging Orders—A Reconsideration," available at http://ssrn.com/abstract=2727973; "Will Your Veil Be Pierced? How Strong is Your Entity's Liability Shield?—Piercing the Veil, Alter Ego, and Other Bases for Holding an Owner Liable for Debts of an Entity," 12 *Hastings B. L. J.* 349 (2015-2016) available at http://ssrn.com/abstract=267620; with Herrick K. Lidstone, Jr., "Pick Your Partner Versus the United States Bankruptcy Code", 46 Texas Journal of Business Law, No. 2 at 23 (Fall 2015), available at http://ssrn.com/abstract=2866418; "Through the Looking Glass: Series LLCs in 2015,"3 Bus. & Bankr. L.J. 1 (2016), available at http://ssrn.com/abstract=2591548; "Series LLCs", 53 *The REPTL Reporter* No. 2 (Real Estate, Probate and Trust Law Section, State Bar of Texas, February, 2015); "The Rescission Doctrine: Everything Old is New Again," 4 AM. U. BUS. L. REV. 183 (2015), available at http://ssrn.com/abstract=251294; "Fifth Circuit Misses Opportunity to Bring Clarity to Series LLC Questions", *Business Law Today* (April 2014); "Series LLCs in Interstate Commerce" and "Tax Aspects of

Series LLCs," *Business Law Today* (February 2013); and "The Series LCC: A New Planning Tool" by Adrienne Randle Bond and Allen Sparkman, 45 *Texas Journal of Business Law* (Fall 2012). Mr. Sparkman is a contributing author to Practitioner's Guide to Colorado Business Organizations (Colorado Bar Association, Allen E. F. Rozansky and E. Lee Reichert, Managing Editors), and Guide for Colorado Nonprofit Organizations (Colorado Bar Association, Karen E. Leaffer, Managing Editor).

Mr. Sparkman has served several times as an expert witness in Colorado, Texas, and California in cases involving duties of directors, director deadlock, duties of managers, duties of partners, construction of operating agreements, construction of partnership agreements, construction of contracts, veil piercing, and attorney malpractice. Mr. Sparkman has been qualified as an expert witness in the district court for Denver, Colorado.

Mr. Sparkman is a member of the American, Colorado, and Houston Bar Associations, the State Bar of Texas, the Texas Center for Legal Ethics, and the Center for Professional Responsibility. For the American Bar Association, Mr. Sparkman is an active member of the Business Law Section and its Committees on Corporate Governance; LLCs, Partnerships and Unincorporated Associations (chair, task force on model Series LLC operating agreement; chair, governance subcommittee); Mergers and Acquisitions; Middle Market and Small Business (chair, governance subcommittee); Nonprofit Organizations; and Professional Responsibility (chair, subcommittee on state and local liaisons). The Governance Subcommittees of the LLCs, Partnerships and Unincorporated Committee and the Middle Market and Small Business Committee constitute a joint subcommittee of those Committees and have joined with the Governance of Private and Family-controlled Entities Subcommittee of the Corporate Governance Committee to form a new American Bar Association Business Law Section Task Force on Contractual Governance of Business Entities. The Task Force will be led by the named governance subcommittees of the Corporate Governance Committee, the LLCs, Partnerships, and Unincorporated Associations Committee, and the Middle Market and Small Business Committee. Mr. Sparkman is also a member of the American Bar Association Tax Law Section and Real Property, Probate and Trust Law Section.

Mr. Sparkman is a member of the Drafting Committee on Series of Unincorporated Business Entities of the National Conference of Commissioners on Uniform State Laws as an ABA Section Advisor, ABA Business Law Section.

Mr. Sparkman is a past chair of the Business Law Section of the Colorado Bar Association. Mr. Sparkman is an active member of the Ethics Committee of the Colorado Bar Association, the Colorado Secretary of State's Advisory Committee for Business and Commercial Laws, and the Legislative Drafting Committee of the Business Law Section of the Colorado Bar Association. Mr. Sparkman was the Colorado reporter for State Limited Partnership Laws and State Limited Liability Company Laws while those were published by Aspen Law & Business.

TABLE OF CONTENTS

EQUITY INCENTIVE COMPENSATION IN LIMITED LIABILITY COMPANIES

I. EQUITY COMPENSATION IN ALTERNATIVE ENTITIES DIFFERS FROM THE CORPORATE SETTING.

A. Tax Differences.

One key difference between equity compensation in alternative entities and in corporations derives from the fundamental difference between the tax consequences of issuing equity in exchange for services in each form of entity. Receipt of stock from a corporation in exchange for services is generally taxable, absent use of an incentive stock option plan, while receipt of interests in an LLC or partnership may be non-taxable if the interests issued are profits interests.

B. Securities Laws.

Some securities law differences exist. A share of corporate stock is always a "security."[1] Whether an interest in an LLC or partnership is a security depends on the facts and circumstances of the particular case, in particular, whether there are investors who can be said to be relying on the efforts of others.[2]

C. Document Drafting.

Document drafting in alternative entities often presents challenges not encountered in the corporate world. The flexibility afforded by alternative entity statutes prevents extensive use of forms. Attorneys should avoid using corporate terms without an understanding of how they might differ in an alternative entity. In particular, if an LLC agreement provides for compensatory interests where not all interests are outstanding, there are allocation implications. For example, can one "reserve" units for issuance later to employees—is there anything allocated or distributed prior to admission of the service provider? (income/profits must be allocated to a current member). A possible solution is for the company agreement to provide that a maximum % of interests may be granted as compensatory interests. The % interest of a particular grantee will be determined at time of grant, and any ungranted compensatory interests will either be ignored for allocation purposes or treated as owned proportionately by the other members. Stated differently, if the concept is for compensatory interests that are "granted" but do not share in allocations or receive distributions until they vest, are these interests at all (e.g., for state law or income tax purposes)? Does it matter if the service provider has made a section 83(b) election? If a compensatory interest is granted and the LLC does not intend that the interest share in allocations and distributions before vesting, that may prevent treatment of the interest as a "profits interest." See II A. 2. B. "Time of Determination." Also see the materials for a program at the 2015 annual meeting of the Business Law Section of the American Bar Association: "Corporate-Like Terms: The Dangers and Pitfalls of Using Corporate Concepts."[3]

II. EQUITY COMPENSATION IN LLC TAXED AS PARTNERSHIPS.

A. Issuance of Interest for Services.

1. <u>Background.</u>

Generally, no gain or loss is recognized to a partnership or its partners upon the contribution of property to the partnership in exchange for a partnership interest. However, Treas. Reg. §1.721-1(b)(1) states: "[t]o the extent any of the partners gives up part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services … [IRC §] 721 does not apply." The regulation seems to indicate by negative implication that the receipt of an interest solely in future partnership profits is not a taxable event even though the recipient has received economic value. Courts differed. Compare *Diamond v. Commissioner*, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974) with *Campbell v. Commissioner*, 943 F. 2d 815 (8th Cir. 1991). Much of the early debate over the taxation of receipts of profits interests centered on the difficulty of valuing such an interest. For example, in *St. John v. United States*, 84-1 USTC ¶ 9158 (C.D. Ill. 1983), the court held the taxpayer was not required to report income from the receipt of a partnership interest that did not entitle the taxpayer to assets upon liquidation of the partnership until all other partners were repaid their initial capital contributions and the value of the partnership assets in the year of receipt of the interest did not exceed the value of the initial contributions by the other partners.

2. <u>IRS Provides Some Certainty for Planning Purposes.</u>

   a. <u>Profits Interest Generally Not Taxable</u>. Rev. Proc. 93-27, 1993-2 C. B. 343, as clarified by Rev. Proc. 2001-43, 2001-34 I. R. B. 1, provides some certainty for planning purposes. Rev. Proc. 93-27 declares that the receipt of a profits interest in exchange for services in a partner capacity, or in anticipation of becoming a partner, will not be treated as taxable event to either the recipient partner or the partnership. Rev. Proc. 93-27

[1] Securities Act of 1933 §2(a)(3)

[2] *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

[3] Available to members of the Business Law Section of the ABA on the ABA website.

provides that a "profits interest" is anything other than a capital interest, and a "capital interest" is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." However, Rev. Proc. 93-27 does not apply if (a) the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (b) if within two years of receipt the partner disposes of the profits interest; or (c) if the profits interest is a limited partnership interest in a publicly traded partnership.

b. Time of Determination. Rev. Proc. 93-27 provides that the determination whether an interest is capital in nature is made at the time of receipt of the interest. Rev. Proc. 2001-43 provides that the determination is made at the time of the grant of the interest, regardless whether the interest is substantially vested (under IRC §83) if: (a) the partnership and service provider treat the service provider as the owner of the interest from the date of grant, and the service provider takes into account the distributive share of partnership income, gain, loss, etc. associated with that interest for purposes of computing the service provider's income tax liability; and (b) upon the grant of the interest or at the time it becomes substantially vested, neither the partnership nor any other partner deduct any amount for the fair market value of the interest.

c. Contributions of Services and Cash. What if a partnership transfers an interest intended to be a profits interest to a service provider who also makes a cash capital contribution for an interest? Under the partnership tax regulations, a taxpayer has a single capital account so arguably the profits interest would not qualify as such because upon a deemed liquidation of the partnership the service provider would receive his cash contribution. Notwithstanding that the service provider has a single capital account, the better view appears to be that if in the deemed liquidation of the partnership the only property the service provider receives is his cash capital contribution, he has received nothing in respect of his service interest and the service interest, accordingly, should qualify as a profits interest.

d. Transfer of Capital Interest. If a partnership transfers a capital interest as compensation for services, the service provider will be taxable under IRC §83. If the capital interest is not subject to a substantial risk of forfeiture at the time of grant, the service provider will immediately recognize income in the amount of the fair market value of the capital interest, reduced by the amount, if any, the service provider pays for the interest. All of this income will be ordinary compensation income, subject to wage withholding and payroll taxes if the service provider is an employee.[4]

Upon receipt of the capital interest, the service provider generally should become a partner in the partnership for both state and tax law purposes.[5] The service provider should be treated as a partner because, among other reasons, the amount that the service provider receives in respect of the service provider's partnership interest is subject to entrepreneurial risk of the partnership. *Crescent Holdings, LLC v. Commissioner*[6] sheds some light on the tax consequences of issuing a capital interest. In that case, the taxpayer was granted "a 2% restricted membership interest" in Crescent Holdings LLC ("Crescent Holdings").[7] The interest was not vested when granted, and the taxpayer did not make a section 83(b) election.[8] Crescent Holdings allocated substantial amounts to the taxpayer in respect of the restricted membership interest but did not make any partnership distributions to the taxpayer.[9] In the final partnership administrative adjustments issued to Crescent Holdings, the Commissioner took the position that the taxpayer was a partner in Crescent Holdings for purposes of allocating partnership items.[10] However, at trial, the Commissioner took the position that the taxpayer was not the owner for tax purposes of the restricted membership interest.[11] After reviewing the distribution provisions of the Crescent Holdings operating agreement, the court determined that the restricted membership interest taxpayer received was a capital interest, not a profits interest.[12] The court then

[4] *See* Treas. Reg. § 1.721-1(b)(1); *See also* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships*, Warren, Gorham & Lamont, 3d edition at ¶ 5.01 (1997).
[5] *See* Gary C. Karch, *Equity Compensation by Partnership Operating Businesses*, Taxes, December 1996 at 725.
[6] 141 T. C. 478 (2013).
[7] 141 T. C. at 480.
[8] 141 T. C. at 481.
[9] Crescent Holdings did, after several pleas by the taxpayer, distribute money to him for taxes, but did not treat that payment as a partnership distribution. 141 T. C at 482.
[10] 141 T. C. at 484.
[11] 141 T. C. at 486.
[12] 141 T. C. at 490-494.

stated that section 83 applied to capital interests.[13] The court then held that, pursuant to Treas. Reg. § 1.83-1(a)(1), the transferor of an unvested capital interest must include in income the undistributed allocations of income with respect to the interest.[14] If, along with the other partners, the service provider/partner is subsequently allocated a distributive share of partnership income, the character of such income will be capital or ordinary, depending on the character at the partnership level.

If a capital interest is conveyed, the partnership should be entitled to a deduction equal to the amount of income recognized by the service provider at the time of issuance (provided that such an expense is not required to be capitalized by the partnership because it is a direct expense of acquiring or constructing a capital asset). If capitalization is required, the partnership should be entitled to recover that capitalized cost through depreciation or amortization deductions, and the partnership may want to consider allocating those deductions to partners other than the service provider.

It is uncertain whether the transfer of a capital interest will cause the partnership to recognize gain from the issuance, especially if the partnership has appreciated assets. Under general principles of taxation, the satisfaction of an obligation with appreciated property is a taxable event.[15] Therefore, the issuance of the capital interest could be viewed to involve a deemed transfer of an undivided interest in the partnership's assets to the service provider followed immediately by the recontribution of such assets to the partnership. This treatment should mark-to-market the tax basis of the assets deemed transferred to the service provider and the service provider should enjoy the benefit of the basis adjustment.[16] Generally, it is appropriate to "book-up" the capital accounts[17] immediately prior to the transfer of the capital interest, and to allocate the compensation or other deductions with respect to the capital interest transfer to the historical partners in accordance with the partnership agreement.

Alternatively, the partnership could be viewed as having paid to the service provider cash equivalent to the income recognized by the service provider. The service provider would then be viewed as having contributed to the partnership the cash deemed transferred to the service provider. Under this so-called "cash-out cash-in" approach no gain is recognized by the partnership upon grant of a capital interest to the service provider. The deduction attributable to the partnership's deemed compensatory payment of cash to the service provider should be allocated entirely to the historical partners in accordance with the partnership agreement. It is clearly appropriate, and generally recommended, to book-up the capital accounts under the cash-out cash-in approach.

If the capital interest is subject to a substantial risk of forfeiture, then the service provider will not be taxed upon the issuance of the interest.[18] The timing of the payment of the tax will be at the point when the restrictions lapse. The character of the income, in part, will depend on whether the service provider made an election under Section 83(b). The service provider may elect, under IRC §83(b), to be taxed currently on the fair market value of the issued capital interest.

If a Section 83(b) election is *not* made, at the time the capital interest vests in the future, the service provider will recognize income in the amount of the fair market value of the capital interest on the date of vesting (less any amount the service provider paid for the interest). The gain will be ordinary compensation income. Note that the amount of gain could be substantial due to the possible appreciation of the capital interest between the time of issuance and the time of vesting.

Under Section 1.83-1(a)(1) of the Treasury Regulations, the service provider is not treated as the owner of the capital interest until the service provider's capital interest vests.[19] This likely means that: (1) items of partnership income and loss should not be allocated to the service provider before vesting; and (2) any distributions made by the partnership to the service provider will constitute ordinary compensation income. If income *is* allocated to the capital interest but not distributed, the other partners will be taxed on their allocable shares of the undistributed income. *Crescent Holdings, LLC v. Commissioner*, 141 T. C. 478 (2013).

After the capital interest vests, the service provider will likely be recognized as a partner for tax purposes;

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[13] 141 T. C. at 495, *citing Larson v. Commissioner*, 1988 T. C. Memo. 387.
[14] 141 T. C. at 502.
[15] *See generally, McKee*, *supra* note 4 at ¶ 5.08[2][b].
[16] The amount of gain or loss recognized on the transfer would equal the sum of the amount, if any, paid by the service provider, the amount of the partnership's compensation deduction, and the service provider's share of partnership liabilities, minus the partnership's basis in the assets deemed transferred to the service provider.
[17] *See* Treas. Reg. § 1.704-1(b)(2)(iv)*(f)*.
[18] Note that the rules of Section 83 will apply to any interest received by a service provider, even if the service provider has paid fair market value for the interest when obtained. *Alves v. Commissioner*, 79 T. C. 864 (1982), *aff'd* 734 F.2d 478 (9th Cir. 1984). As a result, it will generally be prudent for partners who purchase interests from the partnership (i.e., receive them in exchange for a capital contribution) but who may have to resell them to the entity for a discounted price to make a Section 83(b) election.
[19] *See* Treas. Reg. § 1.83-1(a)(1) ("[u]ntil [unvested] property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the service performer . . . constitutes additional compensation").

the service provider's distributive share of partnership profits and losses, however, will be either capital or ordinary, depending on the character at the partnership level.

If a Section 83(b) election is made, the service provider will recognize gain immediately upon the issuance of the capital interest (fair market value over amount paid by the service provider). The future vesting of the capital interest will be a non-event from a tax standpoint. It appears that the filing of a Section 83(b) election causes the service provider to become a partner for tax purposes at the time of issuance, even though the capital interest will still be "substantially nonvested."[20]

If the service provider is regarded as the "owner" of the capital interest once a Section 83(b) election is made and the service provider satisfies the traditional requirements to become a partner for tax purposes, then future allocations of partnership gain or loss made to the service provider should be either capital or ordinary, depending on the character at the partnership level.

At the time the service provider recognizes income (either at the time of vesting or at the time of issuance if a Section 83(b) election is filed), the partnership generally will be entitled to a corresponding compensation deduction. It is unclear whether the partnership will recognize gain upon a deemed capital shift of partnership assets to the service provider.[21] If a Section 83(b) election is not filed, any distributions with respect to the partnership interest before the restrictions lapse should be treated as compensation paid by the partnership.[22]

> **Note:** The foregoing sets forth the applicable law as of the date of finalization of this paper. Proposed Regulations relating to the issuance of partnership interests for services were published in the Federal Register for May 24, 2005, and Notice 2005—43 was published in 2005-24 I. R. B on June 13, 2005. These proposed regulations and this Notice would impose new technical requirements and requirements for an election under IRC §83 to continue the liquidation-value basis for the determination of the existence of a profits interest. The required election could not be made effective before its execution.

3. Examples.

   a. Assume Joe and Bill form a new LLC to purchase a building and operate a restaurant. Joe and Bill each contribute $500,000 in cash to enable the LLC to purchase the building and necessary equipment. They agree with Chuck Cook to grant Cook a 1/3 interest in the LLC in exchange for Cook's agreement to be the executive chef. Under the analysis above, so long as the LLC's operating agreement provides for liquidation in accordance with capital accounts, no more is needed for Cook's interest to be considered a profits interest. If the LLC liquidated immediately after Cook's admission as a member, Joe and Bill would each be entitled to receive back the $500,000 each had contributed, and Cook would receive nothing because he has a zero capital account at that time.

   b. Assume the restaurant operates for a number of years and is very successful. Unfortunately, Chuck Cook one day eats some bad mushrooms and dies. Cook's heirs receive the buy-out provided by the operating agreement, and Joe and Bill begin looking for another executive chef. They make a deal with Jane Goodcook to become a 1/3 member in exchange for her agreement to serve as executive chef. Assume that the restaurant building has appreciated in value to $10,000,000, and an appraisal of the LLC performed in connection with the buy-out of Chuck Cook's interest found that it had a total value of $15,000,000, including the building, goodwill, and intellectual property that has been developed for the LLC. Unlike the first example, unless the operating agreement provides that the members' capital accounts will be booked up immediately before the admission of Goodcook, if the LLC were to liquidate immediately after Goodcook's admission, Joe, Bill, and Goodcook each would be entitled to receive $5,000,000. Not only would this result in Goodcook realizing $5,000,000 of ordinary income, this allocation of pre-existing value to Goodcook almost certainly is not what Joe and Bill desire or

[20] *See* Treas. Reg. § 1.83-2(a) ("[i]f this election is made, the substantial vesting rules of Section 83(a) and the regulations thereunder do not apply with respect to such property . . . property with respect to which this election is made shall be includible in gross income as of the time of transfer even though such property is substantially nonvested"). The regulations do not, however, specifically address the tax ownership of property with respect to which a Section 83(b) election has been made, and this situation was not before the court in *Crescent Holdings* as the restricted membership interest in that case never vested.

[21] *See* text accompanying notes 15-17, *supra*.

[22] Treas. Reg. § 1.83-1(a)(1).

intend.

4. Alternative to Booking Up.

Clients sometimes prefer to avoid the technical booking up procedure in the regulations. An alternative that achieves the same economic result is as follows:

> The Class B Membership Interests are intended to constitute "profits interests" as that term (or any term of similar import) is used in Internal Revenue Service Revenue Procedure 93-27, 1993-2 C. B. 343 and Revenue Procedure 2001-43, 2001-2 C. B. 191, and any successor provisions of the Code, Treasury Regulations, IRS Revenue Procedures or Revenue Rulings, or other administrative notices or announcements, with the intended results that: (A) no compensation or other income shall be recognized by an owner of the Class B Membership Interests by reason of the issuance of such Class B Membership Interests; and (B) no compensation expense shall be deducted by the Company by reason of the issuance of such Class B Membership Interests. The Managers shall designate a threshold value, not less than zero (such value, the "**Threshold Value**") applicable to each Class B Membership Interest to the extent necessary to cause such Class B Membership Interest to constitute a "profits interest" as provided in this Section. The Class B Membership Interests to be issued on the date of this Agreement (if any) have a Threshold Value of $[___]. The Threshold Value for each additional Class B Membership Interest issued after the date of this Agreement shall equal the amount that would, in the reasonable determination of the Managers, be distributed with respect to existing Members with respect to their Economic Interests if, immediately prior to the issuance of such additional series Class B Membership Interests the assets of the Company were sold for their fair market values and the proceeds (net of any liabilities of the Company) were distributed pursuant to Section _____.

B. *Issuance of Options and Other Interests by LLCs*. Although a less frequent occurrence than the issuance of profits interest, LLCs might also issue options to acquire membership interests in exchange for services. The proposed regulations referenced above would apply IRC §83 to the issuance of compensatory options by LLCs. Section 83 does not apply to the grant of an option unless the option has a readily ascertainable fair market value.[23] Upon exercise of a compensatory option, the service provider recognizes income if the property received is substantially vested or if the service provider makes a section 83(b) election. LLCs may also have plans that provide compensation on a basis similar to that provided by corporations under Phantom Stock Plans and Stock Appreciation Rights.

III. IRC 409A.

A. *IRC §409A and Restricted Stock, Stock Options and SARs*. IRC §409A provides for the inclusion in income and the imposition of an extra 20% tax on compensation deferred under a nonqualified deferred compensation plan. Section 409A does not apply to incentive stock options.[24] Section 409A also does not apply to other stock options granted to service providers if the exercise price of the option may never be less than the fair market value of the underlying stock on the date of grant, the number of shares is fixed on the original date of grant of the option, the transfer or exercise of the option is taxable under IRC §83 and the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of (i) the exercise or disposition of the option under Treas. Reg. §1.83-7 or (ii) the date the stock acquired pursuant to exercise of the option first becomes substantially vested as defined in Treas. Reg. 1.83-3(b). If an employer issues restricted stock pursuant to a plan, there is no deferral of compensation for purposes of IRC §409A merely because the restricted stock is substantially nonvested as defined in Treas. Reg. §1.83-3(b) or is includible in income solely because of a valid election under section 83(b).[25] Finally, IRC §409A does not apply to a stock appreciation right if the compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock on the date the stock appreciation right is exercised over an amount specified on the date the stock appreciation right is granted with respect to a number of shares fixed on or before the date the right is granted, the

[23] Treas. Reg. § 1.83-3(a)(2).

[24] Treas. Reg. §1.409A-1(b)(5)(ii).

[25] Treas. Reg. §1.409A-1(b)(6).

exercise price of the right may never be less than the fair market value of the underlying stock on the date the right is granted and the stock appreciation right does not include any feature for the deferral of income other than the deferral of recognition until the exercise of the stock appreciation right.[26]

B. *IRC §409A and Partnership Interests*. Section III G of the preamble to the final regulations under section 409A, TD 9321 states:

> Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and section II. E. of the preamble to the proposed regulations. Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.

IV. ETHICAL CONSIDERATIONS.

A. *Who's Your Client?* An attorney preparing an equity incentive plan for an LLC should take care to be clear on who is the attorney's client. In most cases, the attorney will have been asked by the LLC or one of its governing persons to draft the plan. In the course of drafting the equity incentive plan, the attorney may be asked by the attorney's client (the LLC) to explain the plan and its workings to the persons who have been selected to participate in the plan. In that case, the attorney must be mindful of the rules discussed in B, below.

B. *Representation of an Entity.* Rule 1.12(a) and its comments tell us that a lawyer retained to represent an organization represents the organization as distinct from its directors, officers, employees, members, shareholders, or other constituents. However, an organization can speak and decide only through its agents or constituents. Accordingly, the lawyer must maintain the lawyer-client relationship through a constituent who acts as an intermediary between the organization and the lawyer. The lawyer must be confident that the intermediary legitimately represents the organization and must also be careful that the intermediary does not come to think of the lawyer as representing the intermediary. Too many lawyers think that Rule 1.12 somehow protects them from being viewed as the lawyer for an intermediary or another constituent of the entity; it does not. Accordingly, if the attorney accedes to the attorney's client's wishes and provides an explanation of the incentive plan to participants and, perhaps, answers questions from them, the attorney should take steps to ensure that the participants understand that the attorney is the attorney for the LLC and is not undertaking to represent any of the participants. This should include disclaimers in any written material that the attorney provides to the participants as well as frequent reminders in any oral presentations.

[26] Treas. Reg. §1.409A(1)(b)(5)(B).