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UNLOCKING GROWTH WITH EMPLOYEE EQUITY: A SMART GUIDE FOR BUSINESS OWNERS

INTRODUCTION

Equity compensation is a powerful tool for aligning employee interests with the long-term success of a company. By offering a stake in the business, companies can reward performance, boost retention, and foster a sense of ownership among employees—motivating them to think and act like true stakeholders in the company's growth. For many growing businesses, startups, and cash-conscious companies, equity is also a strategic way to attract and retain top talent without putting strain on immediate cash flow. When structured properly, an equity compensation plan can create a win-win scenario where employees share in the company's success while the business preserves capital to fuel expansion.

Equity compensation is a key strategy that successful, growing companies use to attract, retain, and motivate top talent while preserving cash for expansion. In this overview, we will focus on true equity awards —those that grant actual ownership in a company—rather than alternatives like phantom equity, stock appreciation rights (SARs), bonuses, or revenue shares, which do not confer real equity.

Additionally, we are limiting our discussion to LLCs, S corporations, and C corporations, as these are the most common entity structures for growing businesses. Each of these entities has distinct tax, legal, and structural considerations when it comes to issuing equity, and understanding these nuances is critical to designing an effective and compliant equity compensation plan. Whether you're a startup, an established business preparing for growth, or a company planning for investment, this guide will help you navigate the right equity strategies for your structure and goals.

SECURITIES LAWS

Offering equity to an employee is the same as offering a security, and as provided in Section 5 of the Securities Act of 1933, as amended, all securities must be registered with the SEC unless an exemption applies. A popular exemption for private companies granting equity to employees is Rule 701, which allows businesses to offer stock options, restricted stock, or other equity compensation without SEC registration, as long as certain conditions are met.

To qualify for the Rule 701 exemption, a company must have a written employee incentive plan in place and ensure that total equity issuances under the exemption do not exceed specific financial thresholds. Rule 701 satisfies federal securities requirements, but it does not preempt state securities laws. When offering equity, companies must also comply with the state securities laws ("Blue Sky Laws") of the employee's state of residence.

Fortunately, most states offer exemptions for equity issued under a bona fide equity incentive plan, meaning that if a company complies with Rule 701 and operates under a properly structured plan, it is likely to satisfy both federal and state securities laws. However, companies should still review individual state requirements to ensure full compliance and avoid any unintended regulatory issues.

LLC/PARTNERSHIP

Overview

Limited Liability Companies ("LLCs") are a flexible entity structure that offer significant advantages in ownership and taxation. LLCs can elect to be taxed in various ways, including as C corporations, S corporations, partnerships, or sole proprietorships (for single-member LLCs).

For our purposes, we will focus on LLCs that elect to be taxed as partnerships, as this is the most common structure for growing businesses that wish to offer equity while maintaining pass-through taxation. The same equity compensation analysis discussed here also applies to other pass-through partnership entities, such as general partnerships (GPs), limited partnerships (LPs), and limited liability partnerships (LLPs).

Because partnerships do not issue corporate stock, their equity compensation strategies differ from those of S corps and C corps. Instead of stock options or restricted stock, partnerships typically grant profit interests or capital interests, which have unique tax, governance, and securities law implications. Understanding these nuances is essential for structuring an effective and compliant equity compensation plan within an LLC or partnership.

ADVANTAGES

- Flexible business structure
- Less corporate governance
- Pass through taxation at the entity level
- Deduct business losses on per sonal tax returns
- Ability to award Profits Interests

DISADVANTAGES

- Employees Become Partners, Not Employees*
  - Unlike corporations, where employees can receive stock options or restricted stock and remain W-2 employees, equity holders in an LLC become partners. This creates several complications.
  - Loss of W-2 Status – Once an employee becomes an LLC partner, they can no longer be paid via payroll and instead receive K-1s for their share of the company's income.
  - No More Payroll Tax Withholding– The company can no longer withhold income taxes, Social Security, and Medicare from the employee's paycheck. The new partner must pay estimated quarterly taxes.
  - Self-Employment Taxes Apply – Unlike corporate shareholders, LLC partners must pay 15.3% self-employment tax on their allocated earnings.
- Phantom Income: Employees Owe Taxes on Profits They May Not Receive
  - Employees must pay taxes on allocated profits, even if the company does not distribute any cash.
  - Employees may face unexpected tax bills without corresponding cash flow to cover them.
- Loss of Employee Benefits
  - Employees cannot participate in company-sponsored 401(k) plans, cafeteria plans, or pre-tax benefits.
  - Health insurance premiums paid by the LLC must be reported as taxable income to the employee.

COMMON EQUITY AWARDS

- Capital Interest: Grants the employee immediate ownership in the LLC's existing value, including current assets and accumulated profits. It is taxable at grant based on its fair market value (FMV) and gives the holder rights to a share of distributions and proceeds if the company is sold. This is typically used for founders and investors.
- Profit Interest: Provides the employee with a share of future profits and appreciation without granting ownership in the company's existing value. If structured properly, it is not taxable at grant and is only taxed when the recipient receives income or sells their interest. Profit interests are often used to incentivize employees and key contributors by aligning their rewards with the company's future growth.

*Possible to create a work around where the employees are partners in a management company and the management company is a partner of the company, however, this approach usually too expensive for early stage companies.

S CORPORATIONS

Overview

S corporations ("S corps") are a popular entity structure for small and mid-sized businesses due to their pass-through taxation and legal protections. Unlike C corporations, which face double taxation (corporate and individual levels), S corps allow profits and losses to flow directly to shareholders, avoiding corporate income tax. Unlike LLCs and partnerships, S Corp shareholders can be employees, receive salary, and pay payroll tax, and do not have to file K-1s that are subject to self-employment tax. Moreover, unlike with an LLC or partnership, where equity holders must pay self-employment tax on their entire share of company earnings, S Corp shareholders only pay payroll tax on their salary, and not on distributions of profit.

However, S corporations must navigate strict ownership restrictions, including (i) a limit of 100 shareholders, (ii) the ability to issue only one class of stock, and (iii) with limited exceptions, all shareholders must either be natural persons who are U.S. citizens or resident aliens. Therefore, the governing documents of S Corps must have strong transfer restrictions to prevent ineligible persons from becoming shareholders, which would result in the S Corporation losing its favorable tax status.

ADVANTAGES

- All Shareholders, including employees, can be W-2
- All Shareholders can receive benefits
- Pass through Taxation
- Payroll tax on salary only, and not on distributions

DISADVANTAGES

- Limit of 100 Shareholders
- One class of Stock (economic interest only)
- All Shareholders must be natural persons who are U.S. Citizens or Resident Aliens (narrow exceptions for certain trusts and tax-exempt entities).

COMMON EQUITY AWARDS

- Incentive Stock Options ("ISO"): Equity award available only to employees. Employees have the "option" to purchase stock in the corporation on the vesting date, at the strike price. Employees are not taxed at the date of grant of the option, and usually are not taxed when they exercise the option (unless Alternative Minimum Tax applies). If employees own the stock for at least two years from the date of grant, and one year from the date of exercise, they are taxed at the lower long term capital gains rate.*
- Non-Qualified Stock Options ("NSO"): Available to independent contractors, directors, advisors and employees. Recipients have the "option" to purchase stock in the corporation on the vesting date, at the strike price. Recipients are taxed at ordinary income rates, each time they exercise the option to purchase stock. Tax is the difference between the fair market value of the stock and the strike price. Stock is subject to capital gains tax rates when they are sold.
- Restricted Stock Awards ("RSA"): Unlike options that employees must pay for, RSAs are grants, which are free. RSAs are usually subject to "reverse vesting," where the recipient gets full economic and voting rights to all the stock up front, but the stock may be forfeit if certain milestones are not achieved. RSAs are not restricted to just employees, and may be awarded to directors, advisors, inde pendent contracts and consultants, as well as employees. When RSAs vest, the recipient is taxed at the ordinary income rate on the fair market value of the stock. Upon the sale of the stock, recipients are taxed at the capital gains rate.
- Restricted Stock Units ("RSU"): Grants that the employee does not have to pay for. Recipients may be employees, consultants, advisors, and independent contractors. Generally subject to vesting. When RSAs vest, the recipient is taxed at the ordinary income rate on the fair market value of the stock. Upon the sale of the stock, recipients are taxed at the capital gains rate.

*Special rules for shareholders who own > 10% of the company and for options worth > $100k

C CORPORATIONS

Overview

C corporations ("C corps") are the most common entity structure for high-growth businesses, particularly those seeking venture capital investment or planning for an IPO. Unlike S corps and LLCs, C corporations are separate taxable entities, meaning they pay corporate income tax on profits. However, C corps allow for unlimited shareholders, multiple classes of stock, and complex equity compensation plans, making them ideal for companies looking to scale.

Unlike partnerships and LLCs, C corp shareholders can be employees, receive a salary and benefits, and participate in equity compensation programs without restrictions. Additionally, C corps can issue preferred stock, which is crucial for raising capital from institutional investors. However, unlike S corps, C corp shareholders do not benefit from pass-through taxation, meaning that corporate profits are taxed at both the corporate level and again when distributed as dividends (known as double taxation).

Another significant advantage of forming a C corporation is the potential for shareholders to qualify for the Qualified Small Business Stock ("QSBS") exemption. This provision allows eligible shareholders to exclude up to 100% of capital gains on the sale of their stock, subject to the certain. QSBS can provide significant tax savings for early investors, founders, and employees who receive equity awards.

C corporations must also comply with more stringent regulatory and reporting requirements than LLCs and partnerships. However, they offer the broadest range of equity incentive plans, including stock options (ISOs & NSOs), restricted stock units (RSUs), and restricted stock awards (RSAs), which makes them highly attractive to employees and investors alike.

ADVANTAGES

- No restriction on the number of shareholders
- Ability to issue multiple classes of stock
- Shareholders can be employees and receive benefits
- Shareholders are eligible for QSBS tax exemption.

DISADVANTAGES

- Subject to double taxation (corporate tax and tax on dividends)
- More formal valuation requirements of company issued equity

COMMON EQUITY AWARDS

- Incentive Stock Options ("ISO"): Equity award available only to employees. Employees have the "option" to purchase stock in the corporation on the vesting date, at the strike price. Employees are not taxed at the date of grant of the option, and usually are not taxed when they exercise the option (unless Alternative Minimum Tax applies). If employees own the stock for at least two years from the date of grant, and one year from the date of exercise, they are taxed at the lower long term capital gains rate.*
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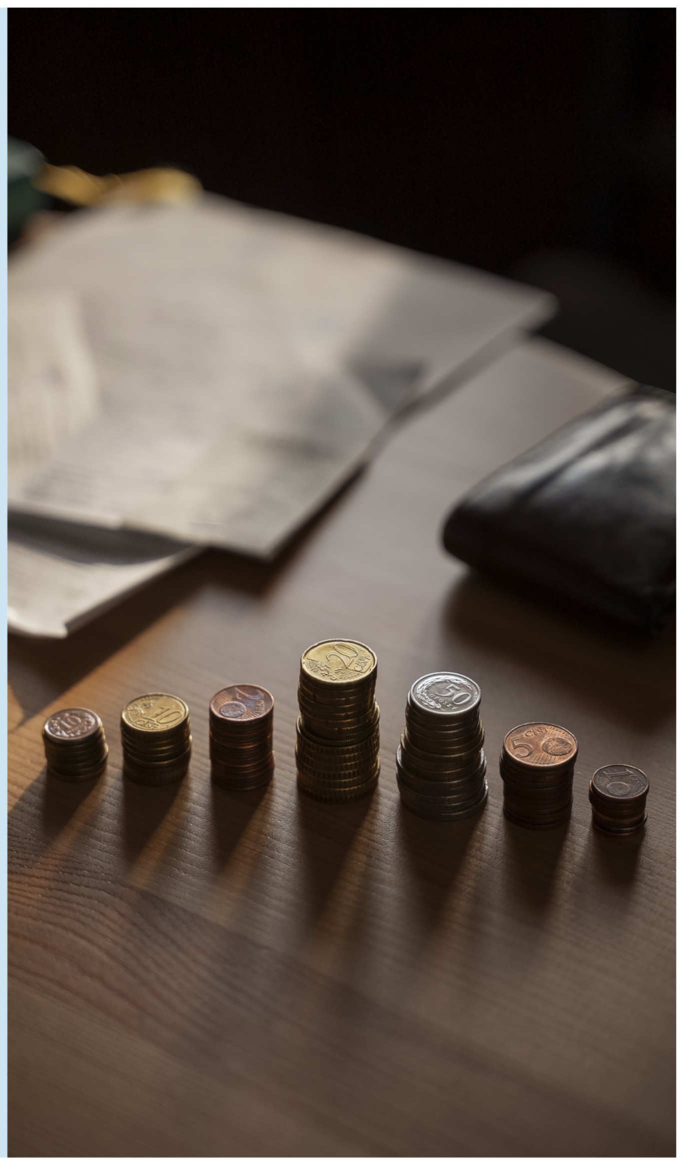

*Special rules for shareholders who own > 10% of the company and for options worth > $100k

COMPARISON CHART

Eligible Entity	Equity Award Type	Payment Required	Tax at Grant	Tax at Exercise / Vesting	Capital Gains Eligible	k-1 Issued	Eligible for all Benefits	Employees Only
LLC Partnership LP LLP	Capital Interest	No (usually paid into)	Yes	N/A	Yes	Yes	No	No
LLC Partnership LP LLP	Profit Interest	No	No	N/A	Yes	Yes	No	No
S Corp C Corp	ISO	Yes	No	No (unsless AMT	Yes	No	Yes	Yes
S Corp C Corp	NSO	Yes	No	Yes	Yes	No	Yes	No
S Corp C Corp	RSA	No	No	Yes	Yes	No	Yes	No
S Corp C Corp	RSU	No	No	Yes	Yes	No	Yes	No

TAKE THE NEXT STEP IN YOUR EQUITY STRATEGY!

Navigating employee equity can be complex, but you don't have to do it alone. Whether you're structuring profit interests for an LLC, stock options for a C Corp, or restricted stock for an S Corp, making the right choices now can help you attract top talent, retain key employees, and optimize tax efficiency.

- Schedule a Free Consultation – Get insights tailored to your business needs.

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