

# Welcome!

## Taxing LLC Options (It's Complicated)

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*Presented by Walter R. Rogers, Jr.*



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# Reminder...

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# Stock Options $\neq$ LLC Options



Noncompensatory options are not options issued in connection with the performance of services.

NCOs include call options, warrants, conversion feature of convertible debt and conversion feature of convertible equity.



Describing the NCO

Partnership Agreement or LLC

Operating Agreement

Underlying Partnership Interest

Regulatory Provisions

Grant Document

Underlying Partnership Interest

Option Price

Exercise Price



# Tax Consequences of **Issuance** of NCO Partnership or LLC Option Holder



Tax Consequences of **Exercise** of NCO  
Partnership or LLC – Not Taxable  
Option Holder  
Generally Not Taxable  
Exceptions





# Tax Consequences of **Lapse** of NCO Partnership or LLC – Income Option Holder - Loss



When is an option holder treated as a partner?

1. Rights that are substantially similar to the rights afforded a partner and
2. Strong likelihood that failure to treat option holder as a partner would result in a substantial reduction in the present value of partners' and option holder's aggregate Federal tax liabilities



Rights Substantially Similar to Partner Rights if either

1. Option reasonably certain to be exercised, or
2. Option holder has partner attributes



# Option Reasonably Certain to Be Exercised

Facts and circumstances test  
Safe harbor



## Partner Attributes

Facts and circumstances test

“Conclusively” present when

1. Option holder has rights to share in distributions, or
2. Option holder agrees to bear losses



# Strong Likelihood of Substantial Reduction in Tax – A Facts and Circumstances Test



# Accounting for NCOs

## Exercises

Revaluations while NCOs are outstanding

Allocations while NCOs are outstanding



## Accounting for Exercises

Credits to capital account of  
option holder (exercising  
partner)

Revaluations upon exercise

Share of partnership capital of  
acquired partnership interest

Corrective allocations





# Revaluations While NCOs Outstanding

- Options in the money
- Options not in the money



## Allocations While NCOs Outstanding – Requirements to Be Deemed in Accordance with Partners' Interests in the Partnership

1. Holder of NCO not a partner
2. Mandatory provisions for partnership agreement
3. Allocations and capital account adjustments would be respected if no NCOs were outstanding



## What to Remember about Taxing NCOs

Partnership or LLC NCOs are taxed differently than stock options.

Holder of NCO may be treated as a partner for tax purposes.

Terms of the NCO and the underlying partnership or LLC interest must be clear from the partnership or LLC documents, and all documents concerning the NCOs must be coordinated.

Tax regulations mandate certain provisions for NCOs in partnership or LLC agreement.

Once NCOs are issued the partnership or LLC will have substantially more accounting work.



# Thank you!

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