

**Understanding Equity Incentives: From Legal
Frameworks to Tax Implications**
Wednesday, September 24, 2025

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Our next Private Equity Special Interest Group event:

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Speakers



Steve Bartz
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Understanding Equity Incentives:
*From Legal Frameworks to
Tax Implications*

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Steve Bartz focuses his practice on sophisticated private equity transactions, including mergers, acquisitions, and divestitures. Leveraging his deep and multifaceted private equity experience and business-minded approach, Steve routinely advises private equity sponsors, portfolio companies, and strategic buyers and sellers in matters crucial to the execution of their most important strategic initiatives.

A leader in his field, Steve has been recognized by numerous publications, including *Best Lawyers in America*[®], *The Legal 500*, *Texas Rising Stars*[®], and *D Magazine*’s “Best Lawyers in Dallas.”



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Kurtis Dixon, CPA, has more than eighteen years of experience in public accounting. He focuses on providing tax compliance, planning and consulting services to corporations, S Corporations, partnerships and individuals. He is particularly focused on serving the needs of health care professionals, other service professionals, inventory-based businesses, manufacturing, and multi-state issues. Kurtis also has experience with preparation and review of income tax provisions

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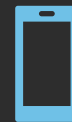
Trade & Tariffs



Antitrust



Tax Policy



Digital Assets



Carried Interest



Rare Earth Elements



Deregulation



Defense



Energy Policy



Space

Why Equity?

Aligning interests of management with owners

- Equity creates long-term incentives and encourages creation of long-term value
- Retention, golden handcuffs
- Creates “ownership” mentality

Equity can be cheaper to the Company in the short-term

- If Company fails to grow, appreciation-based equity awards are worthless
- Potential for favorable accounting treatment
- Private companies may have limited cash flow

Tax treatment, tax deferral

- Many senior executives have limited immediate needs for cash, or wish to defer taxation to a later date (e.g., retirement)

Common Types of “Incentive” Equity Awards

Stock Options

- Right to purchase shares in the future at the fair market value per share on the grant date
- No out-of-pocket cash until the option is exercised
- Tax-deferred until exercise (ordinary income) or later if 'incentive stock option'
- Generally only used for entities taxed as a C corporation

Profits Interests

- Interest in a partnership (or LLC taxed as a partnership); partnership corollary to options or SARs
- Special tax rules allow for capital gains potential upon exit
- These are the most common types of awards for private equity sponsored companies

Common Types of “Incentive” Equity Awards

Restricted Stock Grants

- Actual share issued, subject to vesting
- No out-of-pocket cash, but taxed at grant (if elected) or at vesting (despite lack of liquidity)

Phantom Equity / Transaction Bonuses

- Right to receive a cash payment that is equal to the value of an equity interest, at a future date
- Income tax payable on receipt (vesting and receipt can be structured to be at different times)
- Often used for mid to lower-level employees and international employees

Comparison of Incentive Equity Arrangements

	Stock Options	Profits Interests	Restricted Stock	Phantom Equity
<i>Type of Entity</i>	Corporation, LLC or partnership	LLC or partnership	Corporation, LLC or partnership	Corporation, LLC or partnership
<i>Risk shared by management</i>	Upside only	Upside only	Upside and downside	Upside and downside or upside only
<i>'Out-of-pocket' cash requirements</i>	On exercise, for exercise price and withholding taxes (but may be net-settled)	None	None; vesting may require cash payment (but may be net-settled)	None
<i>Amount subject to taxation</i>	In-the-money value at time of exercise (unless an ISO)	Liquidation value of profits interest (\$0.00 at grant)	Value of shares at vesting	Value of cash paid
<i>Timing of tax event</i>	Exercise	Sale of interests (or any allocation of profits)	Vesting	Payment
<i>Tax consequences to Company</i>	Deductible	No deduction available	Deductible	Deductible
<i>Tax consequences to management</i>	Ordinary income	Potential for capital gains	Ordinary income	Ordinary income

Management Equity Overview: Stock Options

Generally

- A right to acquire a shares at a specified “exercise price” upon “exercise” of the option
- Usually granted over the stock of an operating company or a holding corporation, but can also be granted over LLC/LP interests but not common unless taxed as a corporation

Advantages

- Allows an employee to participate in the appreciation of the Company’s stock value without being an actual shareholder; options are granted at no cost to employee
- Optionee chooses when taxable event occurs (unless cashed out in connection with transaction or exit)
- Very common; readily understood and easy to administer

Potential disadvantages

- Withholding taxes due at time of exercise; generally, optionee is required to pay in cash (although share withholding is possible)
- In-the-money value of option is subject to ordinary income tax rates
- Option must be granted at exercise price equal to then-current FMV otherwise creates potential 409A issues

Variation

- Cash-settled appreciation right

Management Equity Overview: Profits Interests

Generally

- Entitles the holder to a share of future profits and appreciation of the limited liability company (an “LLC”) or partnership
 - Share of profits is subordinate to return of capital and to capital interest holders (e.g., the sponsor and other co-investors) and a performance hurdle (*i.e.*, profits interest has zero “liquidation value” on the date of grant)
 - Profits interests may be issued with special distribution “catch-up” rights after the applicable distribution hurdle is satisfied
- Upon IPO, interests maybe converted into common stock of an operating company

Advantages

- No tax at grant or vesting, if properly structured and treated as a partnership interest
- Generally eligible for capital gains treatment under current U.S. tax law upon exit of investment; potential for meaningful tax savings for senior management
- Bespoke nature of LLC documentation grants significant flexibility for sponsor
 - Examples: participation thresholds, preferred returns

Management Equity Overview: Profits Interests

Disadvantages

- Administration for Company is complex:
 - Executive is treated as a partner or member, and will receive partnership income tax statements (*i.e.*, a Form K-1); Allocation of income to the Executive (including in respect of unvested profits interests) may come as a surprise and Company may need to make tax distributions to the Executive to avoid phantom income
 - Executive generally cannot be treated as a W-2 employee of the Company;
 - Employee holding company is a common structure to enable the Executive to be treated as a partner of the Company and a W-2 employee of the operating company
 - Executive generally will make a tax filing at time of grant (Section 83(b) election)
 - Executive may be required to file tax returns in every state where the Company does business
- Legal documentation is lengthy and complicated
- No deduction available to Company

Management Equity Overview: Profits Interests

Additional Considerations (Slide 1 of 5)

- A profits interest may be either:
 - initially granted as a fully vested; or
 - may vest based on continued service or the achievement of business benchmarks related to the partnership's operations.
- A profits interest may be structured similarly to a stock option but may be more attractive to the recipient because a profits interest grant, ***in some cases, can provide that all appreciation in value be taxed as long-term capital gains rather than ordinary income.***
- ***Unlike an option, a profits interest holder need not pay an exercise price*** to obtain the equity interest represented by the profits interest because the recipient is already viewed as a partner under the law.
- A profits interest holder also ***may fully participate*** in the partnership in a manner similar to other partners (or in a lesser role if that is what is decided) while the original members retain their full value of the partnership created prior to the grant of the profits interest.

Management Equity Overview: Profits Interests

Additional Considerations (Slide 2 of 5)

- As noted above, the ***receipt of a profits interest should not be taxable to the recipient*** – to achieve that end, the tax law provides safe harbors where purported profits interests will be respected as such if certain conditions are met.
- **Vested profits interest**. The receipt of a ***not be treated as a taxable event*** profits interest in exchange for past or future services will for the recipient or the partnership ***if the following conditions are met***:
 - the recipient must receive the profits interest in his or her capacity as a partner, or in anticipation of becoming a partner, in exchange ***for the provision of services*** to or for the benefit of the partnership granting the interest;
 - the interest ***must not relate to a substantially certain and predictable stream of income*** from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
 - the recipient ***must not dispose of the profits interest within 2 years of receipt***; and s
 - the profits interest ***must not be*** a limited partnership interest in a ***"publicly traded partnership."***

Management Equity Overview: Profits Interests

Additional Considerations (Slide 3 of 5)

- **Unvested profits interest.**
 - Additional IRS safe harbor guidance provides that *neither* the **granting of a profits interest** nor the **vesting of a profits interest** will be treated as a **taxable event**.
 - In order for the recipient to be **treated as receiving the interest on the date of its grant**, the following conditions must be satisfied:
 - Both the partnership and the profits interest recipient **must treat the recipient as a "real" partner for tax purposes** with respect to the entire profits interest granted beginning on the date of grant (*meaning, among other things, that the partnership must provide the recipient with a Form K-1, and the recipient must pay his or her share of the taxes on the partnership's taxable income, to the extent there is any*);
 - **Neither the partnership nor the recipient may take any compensation deduction** in connection with the profits interest; and
 - **all of the requirements for vested interests must be satisfied** (see prior slide)

Management Equity Overview: Profits Interests

Additional Considerations (Slide 4 of 5)

- Under the safe harbors referenced above, ***no "Section 83(b) election" need be made*** upon the grant of a profits interest.
- In effect, the partnership and the recipient are treated ***as if a Section 83(b) election was made by the recipient*** and ***assessed the fair market value of the profits interest at zero***.
- Despite this protection, it is still ***advisable to file a "protective" Section 83(b) election*** upon receipt of a profits interest in the event any of the safe harbor requirements are not satisfied
 - *For example, there is a disposition of the interest within two years.*
- Any downside to filing an 83(b) election is generally considered minimal.

Management Equity Overview: Profits Interests

Additional Considerations (Slide 5 of 5)

- It is important to note that if an employee receives a profits interest, he or she ***can no longer be an "employee" of the partnership for tax purposes*** – the IRS position is that one cannot be both a partner and an employee of the same partnership.
 - This means that any payment for services is subject to ***self-employment tax*** and ***certain benefits*** offered to partnership employees ***may no longer be available*** (e.g., participation in cafeteria plans).
 - Additionally, because the recipient of a profits interest is considered a partner of the partnership under the tax law, the profits interest holder will be ***required to report and pay tax on any income passed through from the partnership*** (*whether or not* the holder receives cash distributions from the partnership).

Other Items to Consider

One Big Beautiful Bill Act (OBBBA) Impact?

- Alternative Minimum Tax (AMT), Section 162(m) limits, QSBS enhancements

Tokenized Options

- What are they? How do they work? Who is using them?

Variable Prepaid Forward Contracts

Executive Mobility Considerations

- State sourcing, International exposure, Double tax risk, Compliance

Equity Incentive Plan

What is it?

- A document, approved by the board of directors enabling the Company to grant equity-based awards
- Typical incentive equity pool size = 5% to 30% of fully diluted

What does it do?

- Provides default provisions for vesting, settlement, and adjustment of awards
- Provides default provisions for treatment of awards upon a change in control or other corporate transactions
- Specifies general terms applicable to equity awards
 - Eligible participants – employees, directors and/ or independent contractors.
 - Size of equity pool reserved for management, expressed as a number of shares or interests available for awards
 - Types of equity-based awards that may be granted

Equity Incentive Plan

Good to know:

- One company may have several equity incentive plans, containing different terms (*i.e.*, definition of "Change in Control")
- Public companies must file this with the SEC

Grant or Subscription Agreements

What is it?

- An agreement between the Company and the executive describing terms and conditions of the equity award

What does it do?

- Specifies the type of award (option, appreciation right, etc.) and the number of shares or interests subject to award
- Specifies the vesting schedule for an award (*i.e.*, when an award is no longer subject to forfeiture):
- May contain special terms or individually negotiated terms with key executives
- Treatment upon a change in control
- Acceleration of vesting on ‘good leaver’ terminations
- Appraisal rights, put rights or call rights (private company only)
- For options or SARs, the time period after a termination of employment during which the vested portion of the award may be exercised

Good to know:

- Public companies must file forms of agreements with NEOs, but may have other forms of agreement containing other terms which are not publicly filed

Thank you!