AVOIDING PITFALLS WHEN ADDING SWEAT EQUITY MEMBERS IN AN LLC

Many owners and businesses desire to reward employees with ownership interests for services rendered. This can be a valuable incentive that recognizes past accomplishments and improves employee engagement and retention by allowing them to share in the success of the business without requiring a capital investment. While bonuses, raises, or phantom equity can often accomplish similar goals with fewer structural considerations, the allure of being a true owner is sometimes hard to match. More likely than not, the flexibility and reduced formality of an LLC were factors in making it the entity of choice. However, because LLC ownership is unique, there are several key issues to consider when adding this sweat equity member to make sure all parties understand the consequences.

First, how is the LLC managed? If it is a member-managed LLC (default in Wisconsin), the new employee-member could have full agency power and could enter into contracts or agreements on behalf of the LLC. While the employee might already have significant authority according to his or her job title or responsibilities, this member agency authority extends to issues outside of the ordinary course of business, such as taking out a loan or purchasing real estate. On the other hand, a member of a manager-managed LLC is viewed more akin to a passive, limited partner, with no actual agency power. Therefore, before adding the employee as a member, the current members should review the ownership structure and possibly amend the LLC's articles of organization to align their goals.

Second, does the LLC have an operating agreement? Outside of being an essential tool to structure and manage the business, an operating agreement can modify default provisions of the Wisconsin statutes that govern LLCs (Wisconsin Statutes Chapter 183). For example, unless modified in an operating agreement, Wisconsin law provides that voting in member-managed LLCs is based on members' capital contributions, and not on members' ownership interests. An employee receiving a member's interest for services will have voting rights based on the value of his or her services as recognized on the LLC's capital account, regardless of the actual member's interest received. To remedy this situation, the LLC should document all members' capital contributions (including the value for services) and draft (or amend) an operating agreement that clearly defines voting rights for all members. There are many ways to accomplish this goal (unitizing the members' interest, etc.), but it is important to make sure all parties understand their respective rights and roles in the LLC.

Lastly, what are the tax consequences? If the LLC is taxed as a partnership (default), the employee receives a regular capital interest in the LLC, that member's interest would be considered compensation in exchange for services that will likely be taxed as ordinary income. Depending on the value of those services, the employee could have a significant tax burden in the year he or she receives the capital interest without any guarantee of receiving cash distributions from the LLC to help cover that tax. Think winning a car on *The Price is Right*, only to discover a several thousand dollar tax bill waiting off-stage. The LLC can address this by offering the employee an interest consisting of the future profits/losses of the business. A profits interest still allows the employee to have similar rights as a member in the LLC, but because there is no initial value assigned to the profits interest (and thus no liquidation value), the employee has no immediate tax obligation. The employee-member would then owe tax only on his or her allocation of future company profits. While taxes are inevitable, proper planning can avoid surprises and headaches for the employee and company, alike.

In conclusion, while LLCs provide flexibility for adding sweat equity members, careful design and implementation is required to avoid any potential surprises.