BY SHANE NIX, MICHAEL BLOOM, AND ELIZABETH STIEFF

Tips and Traps in Structuring Equity Deals for Social Media Influencers

BUSINESSES HAVE LONG RECOGNIZED the benefits of using a celebrity or "influencer" to market their products or services. As opportunities for direct engagement between influencers and the public grow through social media, so do the influencers' abilities to impact the shopping habits of their followers. Realizing their growing impact on consumer behavior, many influencers are reconsidering traditional flat-fee compensation for their endorsement services in favor of equity (or equity equivalents) in the business they are promoting. From the company's perspective, granting an influencer equity can be an effective tool to maximize the influencer's incentive to promote the business with minimal cash outlay, but such arrangements must be carefully structured.

While there are many legal issues to consider in such an engagement (e.g., intellectual property rights, corporate governance issues, and Federal Trade Commission endorsement guidelines), ignoring tax considerations can greatly reduce an influencer's economic benefit. As a business looks to hire an influencer, structuring an equity grant tax efficiently can prevent lost deductions and potentially reduce the amount of equity necessary to provide the influencer with equivalent economics.

At the outset, the influencer and the business must make various decisions regarding the structure of a "sweat-equity" deal. One threshold issue is the type of equity (or equity equivalent) to be granted. There are many types to choose from, and the type chosen can greatly impact the tax consequences to the company and the bottom-line to the influencer.

The choice of equity often is driven by tax considerations. The legal form of the company hiring the influencer (C-corporation, S-corporation, partnership, or limited liability company) often dictates the type of equity that can be issued. For example, C-corporations and S-corporations cannot issue "profits interests," which can be disadvantageous to the influencer because profits interests are usually the most tax-advantaged form of equity to the influencer.[1] Thus, choice of equity may be limited unless the business is willing to restructure its existing operations. If the influencer has enough negotiating leverage, a tax-efficient structure may be achieved to obtain his or her desired choice of equity.

The parties also need to negotiate when the equity will be received, i.e., will it be received immediately, over time, or when the company hits certain business metrics? A vesting schedule can be imposed on any type of equity, which is often a four-year schedule with a one-year cliff, but a quicker schedule may be appropriate in some cases.[2]

In deciding choice of equity, the applicable tax rates must be considered to evaluate the net value to the influencer. On this point, significant changes went into effect pursuant to the 2017 Tax Cut and Jobs Act.[3] For 2018, the highest marginal federal income tax rate on ordinary income for an individual taxpayer is 37 percent. If the taxpayer is a resident in California, the state and local income tax (SALT) rate may be as high as 13.3 percent for a combined effective income tax rate of over 50 percent (the federal deduction for SALT is no longer available in excess of $10,000).[4] Thus, if the influencer is a tax resident of California, after taking into account both corporate-level taxes (now a federal 21 percent rate) and shareholder-level taxes, distributions from a C-corporation may be taxed at an effective rate of 65 percent.[5] These potentially high tax rates make tax planning for any influencer engagement essential—particularly if the influencer resides in a high tax jurisdiction like New York or California.

RICHARD EWING

If the business is a "qualified business," payments with respect to equity may be eligible for the new 20-percent deduction on pass-through income, producing an effective tax rate of approximately 43 percent (assuming the taxpayer is a resident of California).[6] The act did not impact tax rates on long-term capital gains, which remain at 20 percent for capital assets held

Shane Nix is counsel in the Los Angeles office of Venable LLP, where he advises clients on transactional tax matters relating to the acquisition, disposition, and restructuring of businesses, corporations, and partnerships, especially in the entertainment industry. Michael Bloom, counsel in the firm's New York office, provides tax advice on corporate transactions, including mergers and acquisitions, restructurings, and venture capital investments. Elizabeth Stieff is an associate in Venable's Baltimore office where she advises on corporate matters, including acquisitions, mergers, joint ventures, and tax controversies.

for more than one year.

Given the large impact that tax can have on an influencer's returns from an influencer engagement, the choice of equity is important to consider at the outset of the deal. Common types of equity include 1) straight equity, 2) restricted equity, 3) corporate stock options, 4) phantom equity, and 5) profits interests.

Straight equity is the grant of a current equity stake in the business. The company usually gets a deduction for the value of the equity grant, which is good for the company. Straight equity grants, however, are rarely used because the influencer will have current ordinary income equal to the value of the equity received. In addition, straight equity grants may not benefit the company if the company does not have sufficient taxable income to use the deduction. The influencer's gain on a sale of the equity generally qualifies as long-term capital gain if held for more than one year.[7]

To mitigate the income tax "hit" to the influencer, the grant of straight equity may be coupled with a loan or a cash bonus to pay the tax. If a cash bonus is paid, the amount of the cash bonus is taxable so it also needs to be "grossed up," which further increases the amount of the required bonus payment to the influencer, putting additional cash strains on the business. For this reason, the business may prefer to loan the influencer the funds to cover the influencer's tax burden, while the influencer clearly would prefer a bonus.

Restricted equity is straight equity subject to certain restrictions, such as vesting and forfeiture. For example, a corporation may grant shares of stock to an influencer but provide that the influencer is entitled to the shares only if the influencer continues to provide services to the business for the applicable vesting period. Adding vesting is a common technique to ensure the influencer's continued performance of his or her obligations under the engagement. It is common that equity grants to influencers be subject to a vesting schedule and a risk of forfeiture in the event the influencer terminates the agreement without good reason or is terminated by the company for cause. From a business perspective, there is risk to tying one's brand to the reputation of a particular individual. Consequently, businesses may seek to have the definition of "cause" include the failure of the influencer to adhere to certain standards of conduct that are adverse to the company's brand and corporate message (e.g., an athlete found to have been using performance-enhancing drugs).

From a tax perspective, neither the influencer nor the company has tax consequences at the time of the restricted equity grant.[8] Instead, the tax consequences are deferred until the vesting conditions lapse (unless a certain tax election is made, which is referred to as a "Section 83(b) election"), and are determined in the same manner as they would be upon the grant of straight equity (i.e., taxable ordinary income equal to the fair market value of the vested stock at the time of vesting and a corresponding deduction to the business).[9] The potential benefit of deferring recognition of income until the time of vesting is often outweighed by the fact that the business may appreciate dramatically over that time, resulting in a larger tax impact at the time of recognition—particularly in the case of emerging companies.

To mitigate such cost of deferral, the influencer may consider making a Section 83(b) election. If the influencer makes this election, the influencer can elect to disregard the vesting restrictions for purposes of determining his or her taxable income upon receipt of the restricted equity.[10] In this case, the influencer would be required to recognize ordinary income equal to the value of the restricted stock on the grant date, not the vesting date.[11] Any subsequent appreciation in value from the date of the grant may be eligible for the more favorable long-term capital gains treatment for federal income tax purposes.[12] A Section 83(b) election generally is advisable if 1) on the date of the grant, the restricted stock has a relatively low value, and/or 2) the influencer expects the stock value to appreciate significantly during the vesting period. An 83(b) election should be considered anytime the influencer receives any form of equity that is subject to vesting or other substantial risk of forfeiture, including, but not limited to, a forfeiture for less than fair market value. It is critical that the election be made within 30 days of the grant date (and in some cases, from the date of a binding term sheet) or else the election cannot be made.

An option is a right to purchase equity of the company in the future. Generally, there are no tax consequences for the influencer, or tax benefits for the business, when an influencer is granted an option, as long as the strike price is equal to current fair market value. (Otherwise, the option grant may trigger adverse tax consequences to the influencer-recipient.[13]) The applicable regulations do not specify how to determine fair market value, only that the valuation must be reasonable under the circumstances.[14] Upon exercise, the influencer has taxable (ordinary) income equal to the difference between the fair market value of the equity and the exercise price of the option. As in the case of a straight equity grant, the influencer generally will come out of pocket to pay the tax (creating a liquidity need).[15] To postpone this tax liability (and potential liquidity problem), option holders often do not exercise their options until there is a liquidity event (i.e., a sale of the business), which comes at a cost. Specifically, such postponement generally prevents the option holder from recognizing long-term capital gain because the holding period in the underlying stock will not exceed one year if exercised immediately before a sale.[16]

Note that under Section 83(i) (added by the act), different rules may apply with respect to certain stock options issued by corporations. Specifically, if certain criteria are satisfied, the influencer can defer the tax otherwise due upon the exercise of the stock option for up to five years.[17] To satisfy the criteria, among other things, 1) the influencer cannot hold a 1 percent or greater interest in the company prior to exercise and cannot hold a position as a key officer of the company, and 2) the company must grant the option to the influencer in connection with his/her performance of services as an employee.[18]

Phantom equity is a contractual right to receive a certain percentage of company earnings or sale proceeds or both when non-phantom equity holders receive operating distributions and/or sale proceeds upon a liquidity event. For example, if the business hiring the influencer is a corporation, that corporation may grant the influencer "phantom stock" that gives the influencer a contractual right to a cash payment equal to the amount of cash that the holder of 1,000 shares of corporate stock in the company would be receiving upon a change in control event (i.e., a sale of the company). There are no tax consequences to either the influencer or the company at the time the phantom equity is granted.[19]

Although this arrangement may be administratively convenient for the company (not having to address voting, fiduciary, and other rights of the influencer as an owner), this costs the influencer the potential for long-term capital gain treatment upon an exit event, as the receipt of sale proceeds should be treated as ordinary income. Phantom equity may constitute nonqualified deferred compensation, and care should be taken to ensure that the phantom equity plan is compliant with Section 409A. Otherwise, the influencer may suffer catastrophic tax consequences, including acceleration of all deferred compensation subject to ordinary income tax rates, plus a 20-percent federal tax penalty,

plus a 5-percent tax penalty in California, if applicable.[20]

A profits interest in a business taxed as a partnership gives the owner a right to share in future business profits but has no current liquidation value on the grant date.[21] A profits interest has no current liquidation value if, in the event the business was sold on the grant date, the influencer would not be entitled to any share of the proceeds of such sale.[22] The influencer generally is not taxed at the time of grant provided that, in addition to the liquidation value requirement, 1) the partnership is not publicly traded, 2) there is not a certain stream of income, 3) the influencer is treated as a partner from the date of grant, and 4) the interest is not disposed of for two years.[23] A business generally can grant a profits interest only if, for federal income tax purposes, the business is taxed as a partnership immediately before, or would become a partnership immediately after, the profits interest grant.[24] The business is not entitled to a deduction for the issuance of the interest.[25] Although a Section 83(b) election may not be required for a profits interest if the foregoing requirements are satisfied, even if the profits interest is subject to vesting or other substantial risk of forfeiture, the influencer should consider making a "protective" election to protect against ordinary income recognition if the determined value of the company at the time of grant is incorrect or the interest is transferred within two years of the grant date.[26]

Similar to the phantom equity scenario, the influencer may share in operating distributions of the business with the other equity holders from the grant date. Unlike phantom equity, however, gain from a sale of a profits interest may be eligible for long-term capital gain upon a sale of the equity if the influencer's holding period exceeds one year, except to the extent of gain attributable to certain "hot assets" (e.g., inventory and unrealized receivables) that is subject to ordinary income tax rates.[27] For this reason, a profits interest tends to be a better choice for an influencer than phantom equity, provided that the partnership agreement is carefully drafted to protect the influencer's interest as a partner in the business. Although the business does not receive a deduction upon a profits interest grant, the business receives the economic equivalent of a deduction because, to the extent that the influencer is entitled to current or future distributions from the business, the business would allocate a corresponding amount of income to the influencer (and away from the other members or partners of the business).

One potential downside to a profits interest is that the influencer does not participate in the prior appreciation of the business given the requirement that the profits interest has a zero liquidation value on the date of grant. To mitigate this result, the influencer may be able to negotiate what is referred to as a "catch-up feature," i.e., a mechanism by which the liquidation waterfall will first give existing owners the first liquidation distributions equal to the value of the company immediately prior to the profits interest grant. The next tranche of liquidating distributions then goes entirely to the influencer until the influencer receives an amount to catch up as though he or she participated from dollar-one, and the remaining balance gets distributed to all members on a pro rata basis. The caveat is that the business must have appreciated enough to fully "catch-up" the influencer.

The recent tax reform legislation includes a provision that allows partners in partnerships a deduction of up to 20 percent of the entity's "qualified business income" (subject to certain limitations based on the amount of W-2 wages that the company pays and the tax basis of certain tangible depreciable property), which is limited for specified service businesses, including performing arts, consulting, and athletics.[28] Although a discussion of the requirements and limitations of the deduction is outside the scope of this article, if the business is a qualified business, the effective tax rate on pass-through income is substantially reduced; therefore, influencers generally should prefer a profits interest over phantom equity. The business, on the other hand, may prefer a phantom equity plan in order to increase the business's W-2 wage base to maximize the deduction. There are structuring techniques, however, to accommodate both the influencer and the business under these circumstances.[29]

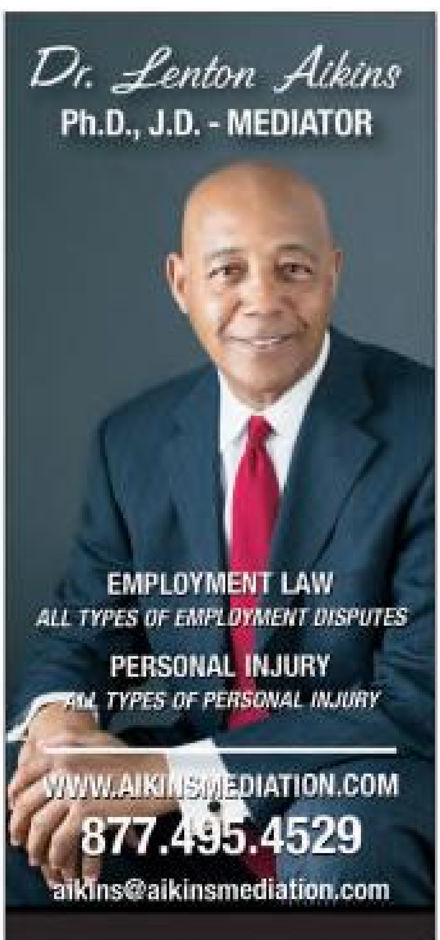
To the extent that the business is a C-corporation or an S-corporation, the grant of equity to an influencer is tax inefficient because 1) the grant of straight equity in this type of business is subject to ordinary income tax upon receipt by the influencer and 2) a conversion of the business to a limited liability company in order to grant the influencer a profits interest is a taxable liquidation of the business that may adversely impact the existing owners. If the influencer has sufficient negotiating power, structuring techniques are available to migrate the business to a limited liability company taxed as a partnership without liquidating the C-corporation or S-corporation.[30] Once the business is migrated to a limited liability company, the business may grant a profits interest in the limited liability company and achieve the benefits described above.

In any event when the business is a pass-through entity (i.e., a partnership or S-corporation), it is important that the influencer negotiate mandatory "tax distributions" because a pass-through entity allocates currently taxable business income to its owners, which is subject to tax without regard to whether the business makes cash distributions to the owners (referred to as "phantom income"). To mitigate this result, it is important to negotiate mandatory tax distributions (preferably quarterly to pay estimated taxes), which are distributions intended to be sufficient for the influencer to pay any current tax liability.

In addition, most partnership agreements provide for "drag" and/or "tag" rights, which, respectively, provide 1) a selling majority member (or members) a right to drag minority members along with them in a sale of the business or 2) minority members a right to tag-along in a sale by such selling majority member(s). It is important to draft carefully the drag and tag provisions to comply with the profits interest rules in order to maintain the influencer's interest as a valid profits interest.

When structuring an equity deal between a business and an influencer, a common technique to force a sale to the company is the use of a put or a call option, which are important contractual tools to protect the influencer's reputation, as well as the business's brand. Because put and call rights may not be included in off-the-shelf agreements, the parties should ensure that these issues are adequately addressed in the written documents addressing the equity issuance and ownership.

A put right may be utilized to protect the influencer if the business engages in an activity that could potentially damage the influencer's reputation. For example, an athlete who enters into an influencer deal with a vitamin supplement business that subsequently is investigated by the FDA may want to have a built-in eject mechanism to eliminate his or her involvement with the company immediately rather than wait until the FDA issue is resolved. Correspondingly, the business may want a similar feature to protect its brand if the influencer is involved in a publicized scandal, which may include a call right to purchase the equity from the influencer upon a specified date or event. In either case, the terms of any arrangement should specify the procedures for the purchase and sale of the equity, including the determination of the purchase price.



Confidence At The Courthouse.

Business litigation is increasingly complex. That is why we believe valuation issues must be addressed with the same meticulous care as legal issues. Analysis must be clear. Opinions must be defensible. Expert testimony must be thorough and articulate. HML has extensive trial experience and can provide legal counsel with a powerful resource for expert testimony and litigation support.

HIGGINS MARCUS & LOVETT
BUSINESS VALUATION

For More Information Call 213-617-7775
Or visit us on the web at www.hmlinc.com

BUSINESS VALUATION • LOSS OF GOODWILL • ECONOMIC DAMAGES • LOST PROFITS

The terms of every deal are different, and the parties should carefully consider their tax benefits and liabilities and ability to exit the deal upon potentially harmful events or to accelerate liquidity. ■

---

[1] A profits interest is an ownership interest issued by an entity treated as a partnership for income tax purposes. *See generally* I.R.S. Rev. Proc. 93-27, 1993-27 C.B. 343; I.R.S. Rev. Proc. 2001-43, 2001-2 C.B. 191.
[2] A one-year cliff is a vesting stipulation, whereby it is agreed that if a partner quits or is terminated within the first year, the departing partner forfeits all of his/her equity.
[3] Tax Cuts and Jobs Act, H.R. 1, 115th Cong. (2017), Pub. L. No. 115-97.
[4] Based on 2018 tax rates of 37 percent maximum federal and 13.3 percent California State. I.R.C. §1; Rev. & Tax. Code §17041.
[5] I.R.C. §164.
[6] *See* I.R.C. §199A (generally, any trade or business other than certain specified service businesses).
[7] Note that gain from the sale of a partnership interest may be subject to ordinary income tax to the extent the partnership owns "hot assets" e.g., inventory and unrealized receivables.
[8] *See generally* I.R.C. §83.
[9] *Id.*
[10] *Id.*
[11] *See* I.R.C. §83(b).
[12] *Id.*
[13] Section 409A is a provision of the Internal Revenue Code of 1986, as amended, that applies to compensation earned in one year but paid in a future year. If an option is not exempt from Section 409A, an influencer may currently recognize as ordinary income the difference between the fair market value of the stock and the exercise price at the time of issuance. The influencer may be subject to a 20-percent penalty and 5-percent penalty for federal income tax and California income tax purposes, respectively.]
[14] Treas. Reg. §1.421-1(e)(2).
[15] If the option agreement provides, the exercise price can be paid in cash or by "net exercise" whereby the influencer uses a portion of the underlying stock to pay the exercise price (reducing the total amount of cash received by the amount of the aggregate exercise price).
[16] *See generally* I.R.C. §1223.
[17] I.R.C. §83(i)(1)(B).
[18] I.R.C. §§83(i)(3)(B)(i), 83(i)(2)(A)(ii)(1).
[19] Generally, a phantom equity is a right to receive W-2 wages payable concurrently when proceeds are paid to equity holders.
[20] *See* I.R.C. §409A(a)(1)(B)(i)(II); Rev. & Tax. Code §17508.2.
[21] *See* I.R.S. Rev. Proc. 93-27, 1993-27 C.B. 343; I.R.S. Rev. Proc. 2001-43, 2001-2 C.B. 191.
[22] *Id.*
[23] *Id.*
[24] *See id.*
[25] *See id.*
[26] I.R.C. §83(b); I.R.S. Rev. Proc. 2001-43, 2001-2 C.B. 191.
[27] I.R.C. §751.
[28] Note that sole proprietorships and shareholders of an S-corporation (but not a C-corporation) may also be eligible for the 20-percent deduction.
[29] For example, a management holding company may be admitted as the direct owner of the business such that the business may pay the indirect owner W-2 wages.
[30] For example, the S-corporation or C-corporation contributes the business to a limited liability company and admits new equity holders directly to the limited liability company.