NATIONAL VETERINARY LAW GROUP AT MANDELBAUM BARRETT PC

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Unlocking the Value: Equity Interests as an Option for Veterinary Practice Employees

Incentivizing veterinary employees with an equity interest in the practice is an important tool for attracting and retaining quality veterinarians and support staff. This handbook addresses different types of equity that can be offered to veterinary employees, including stock options and profits interests.

1: Employee Stock Option Plans

An Employee Stock Option Plan for professional corporations, or an Employee Unit Option Plan for a professional limited liability company, are the more traditional means of granting employees equity in a veterinary practice as a form of compensation. Stock and Unit Options are also popular ways to allow an associate veterinarian to buy into a veterinary practice.

While the specific terms of such Option Plans can vary greatly, the essential elements are the same:

- The employees are given the opportunity (i.e., the option) to purchase a certain number of shares or units in the practice entity at a specified price over a limited period of time.
- There is a vesting schedule under which the employee is granted the option to buy a certain number of shares or units each time the employee reaches a number of years of employment, and the employee has a limited "window" of time during which they can exercise these options.
- The Option Plan provides for a preferred price at which the employee can purchase the shares or units, or the price is set at some point below the actual value of the shares/units being purchased.

While these types of Option Plans are a popular choice for veterinary practice owners, they have quite a few potential downsides for both the practice and employee.

First, the employee must have the financial ability to pay for the shares or units. Although the employer/practice can "lend" the employee the amount of the purchase price, the employee will still have to repay this loan and may suffer an adverse tax consequence, as discussed below. Further, if the practice ultimately forgives the loan, then the practice will be disadvantaged in the sense that the owner of the practice has given up part of their ownership interest without receiving any payment in return.

Second, there are certain tax disadvantages for the employee. When an employee purchases an interest in their employer's entity and the purchase price is below the fair market value of that interest, the difference between the purchase price and the actual value will be considered taxable income to the employee when the employee exercises their option to purchase. Similarly, if the employer, in effect, loans the employee the funds to purchase the shares\units and then forgives the loan, this forgiven amount will still be considered taxable income to the employee, and the employer will be entitled to a corresponding deduction.

Finally, there are risks to these types of Option Plans, which many employees are either unwilling or financially unable to take. For example, the practice may not increase in value over time, and may even decrease. Therefore, the employee's investment may be worth less over time. In addition, the employee may have little control over the management of the practice because the employee oftentimes only has a minority stake in the practice. So, an owner of the majority of the practice can control how much money is disbursed as dividends and distributions. This means that a majority owner of the practice, unless compelled in a Shareholders' Agreement or Operating Agreement of the practice, could decide to withhold distributions to shareholders or unit holders. Thus, delaying when an employee receives an economic benefit as a result of his/her investment.

2: Profits Interests

If a veterinary practice entity is taxed as a partnership for Federal income tax purposes, granting employees a 'Profits Interest' in the practice entity is another form of equity compensation that may be available. Offering employees Profits Interests may be an enticing option, as it avoids many of the pitfalls associated with Option Plans and provides several additional benefits to both the practice and employee. It is worth noting that only limited liability companies or partnerships can offer employees Profits Interests; however, as discussed below, there are means through which a professional corporation practice may create an entity structure which will permit granting Profits Interests.

Like with Options Plans, offering employees Profits Interests grants real equity (i.e., ownership) in the practice entity, but, unlike with Option Plans, the employee's interest is limited to a portion of the practice's future profits. Additionally, Profits Interests involve an outright grant to the employee, as compared to an Option Plan where the employee must decide whether to exercise the option to purchase and pay for the equity, whether in cash or with a promissory note. With Profits Interests, the employee does not pay for the interests; instead, the interests for future profits are granted in consideration for the employee's services and other contributions to the practice.

Because Profits Interests only grant employees an interest in the practice's future profits, there are generally two situations when the employee can receive the benefits of a Profits Interest. First, it can be limited to when the practice entity (or some portion of it) is sold. In many if not most practices, however, the occurrence of a liquidity event is so far in the future that it is not a sufficient present incentive for employees to perform well to enhance the practice's value.

Because of this, our recommendation is the second option, which involves providing holders of Profits Interests with yearly distributions of a share of the practice's profits, in addition to receiving a share of the proceeds at the time of a liquidity event. This structure can also be combined with a vesting schedule, meaning that no shares of practice profits would be distributed until the employee has held the Profits Interests over a certain number of years, which can enhance employee loyalty and retention.

There is no taxable income to the employees at the time that the Profits Interests are granted to them. When the Profits Interests are granted to the employee, the practice must determine the "Profits Interest Hurdle" (which is essentially the value of the practice on the date of the grant) and this valuation amount must be listed in the agreement granting the employee the interests. The general equity owners of the practice must receive no less than the Profits Interest Hurdle amount in any liquidity event before any portion of the purchase price for the practice is distributed to the Profits Interest holders. This process assures that the value of the Profits Interests is zero at the time it is granted to the employee and, therefore, the employee has no tax liability at that time.

The tax advantage for the holders of Profits Interests comes at the time of a sale of the practice because, assuming the employee has held the Profits Interests for more than one year, the receipt of the proceeds from a sale can be taxed at the lower capital gains rate as opposed to the higher rate for ordinary income. By way of example, let's say that, at the time a Profits Interest is granted, the relevant practice is valued at $1,000,000.00, and the Profits Interests represent a 10% ownership in the practice. In this scenario, if the practice is subsequently sold for $1,500,000.00, then the general equity owners would receive the first $1,000,000 in proceeds, and the Profits Interest holders would receive 10% of the $500,000.00 in excess proceeds (or $50,000.00) from the purchase price, and it is this $50,000.00 that can be taxed at the capital gains rates.

If the practice decides to offer holders of Profits Interests yearly distributions of profits, the practice has great flexibility in structuring how the yearly distribution of its profits will be calculated and how it will be allocated among its owners. As previously noted, a Profits Interest is real equity in the practice, and so the employee holder of a Profits Interest has ownership rights similar to those of the owners of general equity units. Consequently, the yearly distribution of profits can be proportionate to the number of Profits Interest units as compared to all the authorized and outstanding units in the practice. For example, if there are 1,000 units authorized and outstanding and 100 are Profits Interest units, then the employee holders are entitled to 10% of the practice's profits for that year. The Profits Interest units granted to employees can also be structured such that the yearly distributions of profits are limited to those profits realized from one location where that employee works.

Another approach is for the practice to set a dollar amount of profits which are paid only to the owners of the general equity units (i.e., a floor). Only the profits above this fixed amount (i.e., above the floor) are then distributed to the owners of the general equity units and the employee owners of the Profits Interest units, proportionately. The advantage of this structure is that the owners holding general equity units, who have presumably invested capital in the practice, taken all the entrepreneurial risks, and managed the practice's success, can ensure a certain level of return on their investment before any profits are distributed to employees as a form of compensation for their services.

As previously noted, Profits Interests can only be granted in professional or non-professional limited liability companies and partnerships. For those veterinary practices which are structured as professional corporations, it may be possible for the corporation to be a member of a limited liability company or for the corporation to be a partner in a partnership, which would then permit the granting of Profits Interests. Whether such arrangements are legally permissible often depends on the professional corporation laws in a particular state. Given the advantages of granting employees Profits Interests as a form of equity compensation, practices which are professional corporations should investigate with their attorneys whether or not they can create or participate in another business entity which will permit the granting of Profits Interests.

Notes

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