

Strafford

Presenting a live 90-minute teleconference with interactive Q&A

Structuring Equity Compensation for Partnerships and LLCs

Navigating Capital and Profits Interests Plus Section 409A and Tax Consequences

WEDNESDAY, MARCH 23, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Edward E. Bintz, Partner, **Arnold & Porter**, Washington, D.C.

Brian J. O'Connor, Partner, **Venable**, Baltimore

Attendees seeking CPE credit must listen to the audio over the telephone.

Please refer to the instructions emailed to registrants for dial-in information. Attendees can still view the presentation slides online. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

Conference Materials

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the + sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Continuing Education Credits

FOR LIVE EVENT ONLY

For CLE credits, please let us know how many people are listening online by completing each of the following steps:

- Close the notification box
- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the blue icon beside the box to send

For CPE credits, attendees **must** listen to the audio over the telephone. Attendees can still view the presentation slides online.

Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

Tips for Optimal Quality

Sound Quality

For this program, you must listen via the telephone by dialing 1-866-873-1442 and entering your PIN when prompted. There will be no sound over the web connection.

If you dialed in and have any difficulties during the call, press *0 for assistance. You may also send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Structuring Equity Compensation for Partnerships and LLCs

March 23, 2011

- Edward E. Bintz (202) 942-5045
Edward.Bintz@aporter.com
- Brian O'Connor (410) 244-7863
bjconnor@venable.com

Overview – Discussion Topics

- Partnerships and LLCs – Core Principles
- Profits interests
- Capital interests
- Options
- Phantom arrangements
- Partner/employee status
- Section 409A considerations
- Corporate conversions

Partnerships and LLCs – Core Principles

- Classification Issues – LLCs generally taxed as partnerships unless elections are made to treat them as corporations
- Consequences of Pass-through Tax Treatment – No entity level tax and income, gain, loss and deduction flow-through to entity owners regardless of distributions by the entity

Partnerships and LLCs – Core Principles (cont.)

- Allocation and Distribution Provisions
 - Section 704(b) safe harbor
 - Capital account maintenance
 - Book-ups
 - Liquidating or not liquidating with capital accounts
 - Treatment of partnership distributions
 - Differences between distributions made with regard to income and distributions made without regard to income

Equity Compensation Alternatives – Profits Interests (cont.)

- What is a profits interest?
- Case law
 - Diamond v. Com'r, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974)
 - St. John v. U.S., 84-1, USTC ¶ 9158 (C.D. Ill 1983)
 - Kenroy Inc. v. Com'r, 47 T.C.M. 1749 (1984).
 - Campbell v. Com'r, 59 T.C.M. 236 (1990), aff'd in part and rev'd in part, 943 F.2d 815 (8th Cir. 1991).

Equity Compensation Alternatives – Profits Interests (cont.)

- Rev. Proc. 93-27

- Provides guidance on what constitutes a profits interests and tax consequences associated with profits interests
- Profits interest defined as an interest other than a capital interest. A capital interest is an interest that gives holder a share of proceeds if partnership's assets sold at FMV and proceeds distributed in liquidation
- If Rev Proc 93-27 applies, grant of profits interest not a taxable event for service provider or partnership
 - Applies if profits interest is granted to person for provision of services to (or for the benefit) of a partnership in partner capacity or in anticipation of being a partner.

Equity Compensation Alternatives – Profits Interests (cont.)

- Does not apply if:
 - Profits interests relates to substantially certain stream of income from partnership assets (such as high grade debt security or net lease)
 - Profits interests is disposed of within two years
 - Profits interests is an LP interest in a publicly traded partnership

Equity Compensation Alternatives – Profits Interests (cont.)

- Rev. Proc. 2001-43
 - Provides guidance on treatment on profits interests subject to vesting requirements
 - Provides that Rev. Proc. 93-27 applies at the time of grant of a profits interests even if not vested if:
 - Service provider treated as owner of the partnership interest from the date of grant and takes into account allocations of income, loss, etc. in determining tax liability
 - Neither partnership nor partners claim a deduction upon grant or vesting of the profits interests
- 83(b) elections
- Importance of book-ups; valuations
- Effect of forfeiture

Equity Compensation Alternatives – Profits Interests (cont.)

- Is it a profits interests or a bonus arrangement?
- Current proposed regulations and other proposed guidance
- Common structural approaches for profits interests
- Carried interest legislation and the President's 2012 budget

Equity Compensation Alternatives – Capital Interests

- What is a capital interest?
 - As of date of grant entitles holder to share of liquidation proceeds if partnership liquidated
 - Also entitles holder to share of future profits
- Tax treatment of capital interests
 - Similar to tax consequences associated with compensatory transfers of stock
 - Service provider recognizes income equal to FMV value of interest at time vested (less any amount paid). Basis equal to income recognized
 - 83(b) elections
 - Partnership (and therefore partners) get compensation deduction equal to FMV included in service provider's income (subject to Sections 162 and 212)

Equity Compensation Alternatives – Capital Interests (cont.)

- Capital shift issues
 - Valuation of capital interest – liquidation value or arm's length sale price for capital interest
 - Effect of forfeiture
- Is a “fill-up” a profits interest or a capital interest?

Equity Compensation Alternatives – Options on Partnership and LLC Interests

- Options to acquire capital interests
 - Similar to stock options
 - Upon exercise service provider and partnership have same tax treatment as grant of capital interest (taking into account payment of exercise price)
- Options to acquire profits interests
 - No income to service provider at time of exercise and no deduction for partnership
 - Generally not attractive to service providers from economic perspective

Equity Compensation Alternatives – Phantom Interests

- Similar to phantom stock
- Service provider recognizes ordinary income at time of payment
- Partnership gets deduction equal to amount paid
- Can be subject to Section 409A if not eligible for short-term deferral exception or other exceptions

Partner/Employee Status

- Can a partner be an employee?
 - Case law – Armstrong v. Phinney, 394 F.2d 611 (5th Cir. 1968)
 - IRS pronouncements – Rev. Rul. 69-184; GCM 34001 (Dec. 23, 1969); GCM 34173 (July 25, 1969)
 - Practical considerations
- Income tax consequences of non-employee treatment
 - Withholding issues
 - Employment taxes
 - Employee deductions
 - State tax considerations
 - Compliance burdens

Partner/Employee Status (cont.)

- Employee benefit consequences of Non-employee status
 - Not eligible to participate in cafeteria plans
 - Health benefits not excluded from income, but deduction for premiums paid by self employed
 - No group term life insurance exclusion
 - Qualified transportation and qualified moving expense reimbursements not available
 - Can still participate in qualified retirement plans

Applicability of Section 409A

- Final regulations do not address partnership equity compensation
- Preamble says that until guidance issued can rely on Notice 2005-1
- Under Notice 2005-1:
 - May treat issuance of a partnership interest or an option to acquire a partnership interest in connection with performance of services under same principles as govern issuance of stock
 - Service provider stock requirement for options
 - Option modification/extension rules
 - If profits interest is treated under applicable guidance as not resulting in inclusion of income by service provider then not 409A deferred compensation
 - May treat issuance of capital interest in same manner as issuance of stock
 - Guaranteed Payments

Equity Compensation Alternatives – What is the Best Choice?

- Profits interests generally preferred
- Liquidity/exit considerations
- Partner/employee issues
- Complexity

Corporate Conversions

- General rules applicable when partnerships convert to corporations
- Treatment of corporate conversions to holders of profits interests
 - Possibility of compensation treatment
 - Valuation considerations
- Treatment of corporate conversions to holders of capital interests
- Treatment of corporate conversions to holders of compensatory options
- Treatment of corporate conversions to beneficiaries of phantom arrangements

Contact Information

Edward Bintz
Arnold & Porter LLP
555 Twelfth Street
Washington, DC 20004
(202) 942-5045
edward.bintz@aporter.com

Brian O'Connor
Venable LLP
750 E. Pratt Street
Baltimore, MD 21202
(410) 244-7863
bjocconnor@venable.com

Disclaimer

Pursuant to IRS Circular 230, please be advised that, to the extent this communication contains any tax advice, it is not intended to be, was not written to be and cannot be, used by any taxpayer for the purpose of avoiding penalties under U.S. federal tax law.