

Structuring Equity Compensation for Partnerships and LLCs

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

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Structuring Equity Compensation for Partnerships and LLCs

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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 2013 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 661 (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

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